July 30, 2014

2014 TRIENNIAL SURVEILLANCE REVIEW—EXTERNAL STUDY—INTEGRATING BILATERAL AND MULTILATERAL SURVEILLANCE ON A CONTINUING BASIS

Prepared By Kenneth Rogoff[1,2]

EXECUTIVE SUMMARY

Overall the Fund has done a good job anticipating possible problems in each of the cases being examined here, which for shorthand we will label Fed tapering, Abenomics, China growth risks, and German fiscal policy. Moreover, the messaging has been broadly consistent across the Fund's diverse range of products including multilateral surveillance products (e.g., the *World Economic Outlook* and the *Global Financial Stability Report*), bilateral products (including especially Article IV country reports), and the Fund's various new exercises aimed at proactively identifying risks, especially those of global systemic significance. The messaging is consistent in the sense that differences across products can mostly be explained by differences in timing, approach and emphasis, understanding that the problems involved are profoundly difficult with no one clear answer, much less a one-size-fits-all answer. Various modalities are listed and briefly summarized in the appendix to this report. The extent to which the Fund's analysis has weaknesses is largely related to political and market sensitivities, particularly in dealing with large influential members. For example, we will raise concerns about whether the Fund was forceful enough in pointing out possible risks posed by the U.S. Federal Reserve's third round of quantitative easing (QE III), initiated in September 2012, and whether it was forceful enough in advocating structural reforms (e.g., tax reform) that might have helped support long-term U.S. growth and helped soften spillover effects to other countries. In the case of Japan, the Fund was understandably quite supportive of Abenomics. But should it have worried about the financial stability risks if rising inflation expectations led to proportional (or greater) rises in long-term nominal interest rates in Japan? Given that the initial impulse of Abenomics was a large depreciation in the yen, should the Fund have placed even greater emphasis on "third arrow" structural reforms as an assurance that Abenomics would have a lasting long-term positive global impact, and not just short-term competitive effects? In the case of China, the Article IV reports were in fact quite alert to potential problems, and the 2013 report even incorporated results from a working paper on the global effects of a hard landing in China over the

[1] Harvard University. This paper represents the views of the author and does not necessarily represent IMF views or IMF policy. The views expressed herein should be attributed to the author and not to the IMF, its Executive Board, or its management.

[2] The author would like to thank the IMF TSR staff team for helpful background research.

medium term. But were these concerns sufficiently transmitted in the Fund's surveillance activities in the many economies that have become quite dependent on continuing rapid Chinese growth? One must hasten to add that all these issue are in fact covered in the Fund's reports that we are sampling, but sometimes key issues are somewhat buried deep in reports, in more technical sections, or in less prominent publications, thereby having the effect of downplaying them. Lastly, did the Fund give a balanced assessment of how a more expansionary German fiscal policy might have had positive spillovers for the troubled periphery of Europe, versus possible potential costs?

CONTENTS

INTRODUCTION

1. This short paper examines how the Fund has fulfilled its bilateral and multilateral surveillance with respect to four key issues that have faced the global economy over the past couple years: (1) The U.S. Federal Reserve's "taper" and the buildup in large-scale asset purchases that came before it, (2) Japan's ambitious economic strategy launched in April 2013 by newly elected Prime Minister Abe, (3) Rising recognition that even though the central scenario of Chinese growth continues to be a gradual slowdown to a more inclusive and sustainable growth paths, there is at least some risk of a hard landing that could have major implications not only for China but for the entire global economy, and (4) Germany's fiscal policy and the Euro-area crisis.[3]

2. Formally, the note here is an input to the IMF's 2014 Triennial Surveillance Review. The idea is that by looking at a few key issues the Fund has faced recently, one will gain insights into how effectively the IMF is integrating its multilateral and bilateral surveillance. More broadly, the aim is to deepen understanding of (1) to what extent are multilateral and bilateral surveillance mutually informative and reinforcing? (2) How well are new potential global spillovers being identified, how quickly are the issues being integrated into surveillance, and is the Fund's messaging consistent across modalities? and (3) how well are risks to financial stability being integrated into Fund surveillance? Needless to say, one cannot begin to catalog the Fund's surveillance activities in a brief note, much less discuss them in detail.

THE FUND'S SURVEILLANCE PRODUCT CYCLE

3. Figures 1 and 2 give an overview of the Fund's multilateral surveillance products, which have expanded considerably over the past fifteen years. The Fund's bilateral surveillance is conducted primarily through so-called Article IV consultations.[4] Since 2011, the outward spillovers from five systemically important regions (the U.S., the UK, the Euro Area, Japan and China) are examined in their Article IV reports on an annual basis. The *World Economic Outlook* (WEO) is, of course, the Fund's longest-standing multilateral surveillance product. It was supplemented beginning in 2002 by the *Global Financial Stability Report*, and more recently by the *Fiscal Monitor*. In addition to these reports, the Fund now produces regional surveillance reports, and twice a year there are off-peak updates to the WEO. Figure 1, however, lists several other modalities. These are described in Box 1 below.

[3] The study was completed in April 2014 (except for a few very minor subsequent edits), and takes into account information available up to that date.

[4] Following the Integrated Surveillance Decision adopted in July 2012, Article IV consultations became a vehicle for bilateral and multilateral surveillance.

Figure 1. Multilateral Surveillance Product Timeline

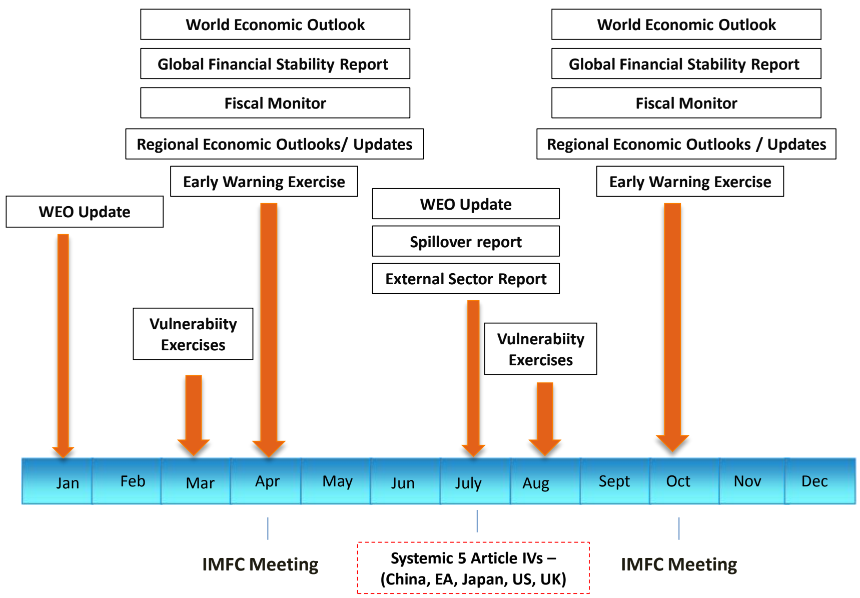
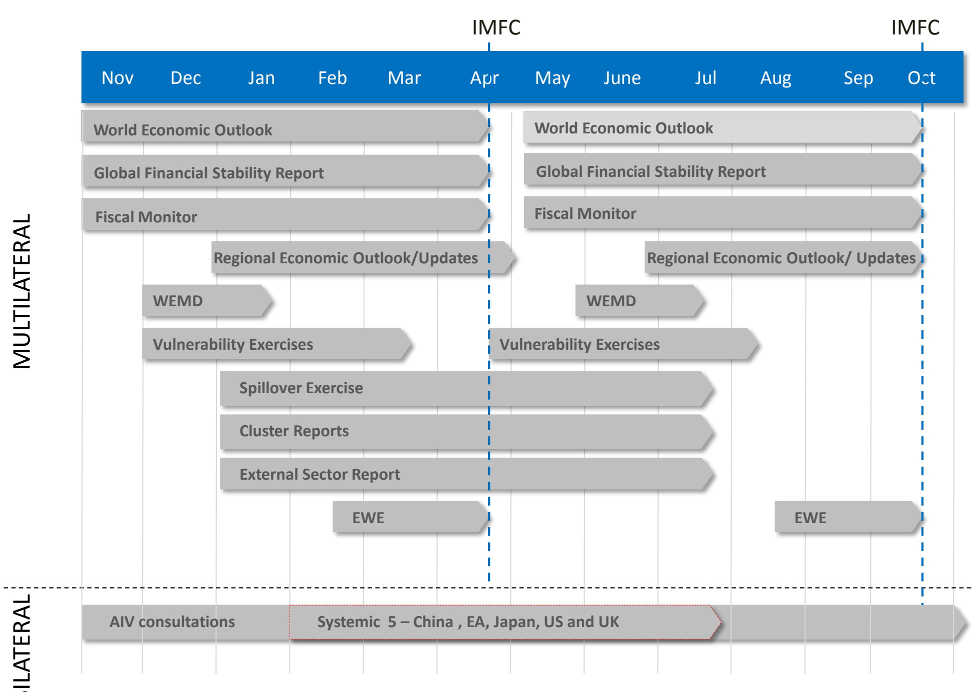


Figure 2. Timeline—IMF Surveillance Process



Box 1. Newer Modalities of Multilateral Surveillance at the Fund

Integrated Surveillance Decision (ISD). The Fund adopted an Integrated Surveillance Decision in 2012. According to that decision, in addition to assessing the contribution of members' policies to their domestic and balance of payments stability, Article IV consultations should cover potential or actual outward spillovers from members' policies that may significantly influence the effective operation of the international monetary system. Although technically a revision to the Fund's legal framework rather than a surveillance modality, the ISD is important because it clarifies the IMF's ability to use Article IV consultations to discuss policy spillovers from member countries onto global stability.

Spillover Reports (IMF publication). These reports assess how policies in the large systemic-five economies (China, Euro Area, Japan, UK and U.S.), impact the rest of the world, given the large volume of trade and financial linkages in the global economy. They were launched in 2011.

Pilot External Sector Reports (IMF publication). These new and ambitious reports, launched in 2012, aim to provide more effective surveillance of external imbalances by broadening the Fund's earlier assessment of exchange rate exercises to look more systematically at current accounts, balance sheet positions, reserves adequacy, capital flows, and capital flow measures. (The earlier exercise looked mainly at exchange rate misalignments, and did not give nearly as much emphasis to financial sector issues.) In principle, these reports provide a snapshot of multilaterally consistent analysis for the external positions of the 28 largest economies (and the Euro Area) simultaneously, and point to potential policy responses.

Early Warning Exercise (confidential presentation to the International Monetary and Financial Committee). This exercise assesses low-probability but high-impact risks to the global economy and identifies policies to mitigate them. It integrates macroeconomic and financial perspectives on systemic risks, drawing on a range of quantitative tools and broad-based consultations. It is a joint IMF and Financial Stability Board (FSB) exercise, launched in 2008.

Vulnerability Exercises (internal exercise). These exercises aim to provide a basis for regular, focused discussions on key risks and their implications for IMF policy, and policy prescriptions. Vulnerability exercises were first piloted in 2001 for emerging markets. They were extended to advanced economies in 2009 and to low-income countries in 2011. Given the country-specific nature of the results, the results inform the EWE but are not circulated to the IMF's Board or FSB members.

WEMD. These are presentations to the IMF directors on world economic and market developments (WEMD). They are presented to the Board by the Economic and Financial Counselors.

4. The rationale for having far more frequent and comprehensive reports is clear: it allows members to have much more frequent and timely information. The expanding number of products has also been intended, of course, to fill in perceived gaps in the surveillance toolkit. Of course, the proliferation of reports does risk stretching staff thin, both with producing the reports and the many related meetings. The burden on staff resources and the tradeoffs involved in producing so many products, particularly some of the new post-2010 exercises, is a question worth revisiting as the global financial crisis abates, but it is not our purpose to take it up here. However, we reiterate the point that messaging involves emphasis and communication, and not just an extensive cataloguing of risks. We will return to the issue of proliferation and communication in a final section.

5. Summary: As is apparent from Figure 1, the IMF's surveillance process is multidimensional, multifaceted and constantly in motion. Different modalities bring different perspectives to complex problems. Given the inherent difficulties in forecasting and assessing economic risks, difficulties experienced by even the best central banks and the best outside forecasters, the IMF faces the difficult challenge of balancing "Type I" and "Type II" error in its risk assessments. That is, it wants to correctly warn of high-risk, high-cost problems without too often warning of low-probability, relatively mild problems. Constantly changing risk assessments and different approaches naturally yield different results with the IMF's main challenge being to effectively communicate and interpret its analysis.

THE TAPER

6. Since the onset of the global financial crisis, few policies have caused such controversy as the U.S. Federal Reserve's policy of quantitative easing with its concomitant effects on emerging markets and exchange rates. The issues raised are at the heart of Fund surveillance activities, at both the national and multilateral levels.

A. Overview of Quantitative Easing

7. Though of profound importance, the issues raised by quantitative easing are also profoundly complex. The economic theory underlying the effects of quantitative easing is far less developed than the theory of conventional monetary policy, and the empirical evidence is thin. It is complex because, technically, quantitative easing expands the money supply, but when interest rates are zero, it can equivalently be viewed as expanding the supply of short-term debt. Indeed, if one recognizes that the government ultimately owns the central bank and its balance sheet, it is not immediately obvious why quantitative easing policy is any different from normal maturity transformation operations. From the perspective of its own integrated balance sheet and the assets held by the private sector, the U.S. government could achieve a similar effect to quantitative easing by having the Treasury issue more very-short-term debt and less long-term debt. A straightforward shortening of maturity structure would likely have been far less controversial. Of course, precisely because of different private sector perceptions, and the critical role of expectations in the transmission of monetary policy, the effects might have been very different also.

8. The claims by emerging markets that QE policies have had big effects on exchange rates and capital flows are even more difficult to disentangle. The fact that most emerging markets recovered far more quickly than advanced countries from the global financial crisis would have induced capital inflows and placed upward pressure on their exchange rates even absent ultra-loose advanced country monetary policy. Even if advanced countries had simply maintained zero interest rates and never gone the extra step of quantitative easing, emerging market economies would have experienced strong pressures from global investors. This is not to dismiss the concerns of emerging market policymakers; anecdotal evidence indeed suggests that quantitative easing policies did have effects on the timing, rhythm and intensity of capital market pressures.

9. The response of advanced economy monetary authorities, and of the U.S. Federal Reserve in particular, to emerging market concerns was to point out the weak post-financial crisis recovery that

the advanced economies were experiencing, and to suggest that efforts to energize their recoveries were very much in the interest of emerging markets. How did the Fund assess these tensions and issues?

B. The Fund's Surveillance of Quantitative Easing

10. Table 1a lists some of the Fund's key publications on quantitative easing, tracing back to its policy paper, already in mid-2010, on exit strategies from crisis interventions, written of course long before the Fed launched QE III in September 2012 or began to discuss tapering in May 2013.[5] Most of the Fund's more formal analysis of unconventional monetary policies begins in 2012, in parallel with when academics also began to first process the experience. Notable is the April 11, 2012, report produced for the G-20 ministers, which discusses the possibility that unconventional monetary policies might lead to excessive capital inflows into emerging markets and to mispricing of assets. The report concludes that in fact a variety of push and pull factors were inducing flows into emerging markets (e.g., higher growth in emerging markets, lingering risks in advanced economies).

11. In a March 2013 report prepared by the research department for the Fund's internal surveillance committee, Fund economists emphasize that the Fed's large balance sheet may lead to greater asset volatility during an exit. Also important is the April 2013 *Global Financial Stability Report* (GFSR), and related research papers, which highlighted another risk to the Fed's QE policy. The GFSR argued that prolonged ultra-easy monetary policy raised medium-term risks by making it easier for banks to defer repair of their balance sheets, and it warned especially of significant risks of policy strains in emerging markets during the exit phase. Needless to say, these reports and memoranda proved highly prescient when the United States Federal Reserve first began to publicly entertain the idea of tapering in May 2013.

12. The Fed taper of course caused huge strains on emerging markets, perhaps even more than had been anticipated in the IMF reports. It is difficult to sort out the causes and effects, which economists continue to work on, especially as around the same time, there began to be heightened concern about a slowdown of growth in China. The IMF Spillover Report (internally circulated July 2, 2013, externally circulated August 1, 2013) tried to put some perspective on the issues. It contained a broad discussion of the global benefits of QE, as well as the risks posed by a continuing exit. The document offers a high-end estimate of the positive effects of QE, arguing it may have lowered global long-term interest rates by over 100 basis points, and may have added as much as 1 percent cumulatively to global growth. These estimates, of course, could be used to provide support for the advanced economy contention that overall the effects of QE have been beneficial to emerging markets, despite concerns about exchange rate misalignments and capital flows. A number of further documents, highlighted in the table, expand on the view that QE policies supported growth during the early implementation phase, but have created risks of volatility on exit.

[5] Table 1 does not include important research such as Blanchard's (2010) analysis suggesting that a 2 percent inflation target may expose countries to high risk of hitting the zero bound on interest rates, and analyzing alternative, higher, target inflation rates.

Table 1a. Unconventional Monetary Policies

Publication Date	Publication / Forum	Analytical Piece	Dept.	Nature	Aspect	Details
2/4/10	IMF Policy Paper	Exiting from Crisis Intervention Policies	MCM/ FAD/RES	External	UMP exit	Formulated key elements of countries' strategies for exiting from crisis-related intervention policies, including UMP.
4/11/12	GFSR: Spring 2012	Chapter 3. Safe Assets: Financial System Cornerstone?	MCM	External	Benefits and Risks	Analyzed QE policies in the context of the markets for safe assets; warned of the risk of loss of asset safety and currency risks.
10/13/12	MD's Global Policy Agenda		SPR	External	IMF Policy Direction	Put priority on continuing to analyze the effectiveness of unconventional monetary policy, potential risks, possible spillovers, and potential exit strategies once the crisis abates.
11/4/12	Meetings of G-20 Ministers and Central Bank Governors, Mexico City	Box 2. Unconventional Monetary Policies—How Might They Work?	RES	External	Global spillovers	Signalled that UMP could lead to an upsurge of capital flows into EMs and upward pressures on some EM exchange rates, with a possible risk of global credit mispricing. However, it indicated little evidence of stronger purchases of EM securities by U.S. investors, and emphasized that empirical studies suggest commensurate role for pull and push factors.
4/11/13	GFSR: Spring 2013	Chapter 3. Do Central Bank Policies since the Crisis Carry Risks to Financial Stability	MCM	External	Benefits and Risks/Impact of UMP Exit	Showed a positive impact of UMP on domestic financial stability. However, pointed to: (i) higher risks of prolonged UMP, including delay in banks' balance sheet repair in banks and higher credit risks in the medium term; and (ii) potentially high market volatility due to policy missteps during a central bank's exit from certain markets. Indicated that UMP increased capital flows to EMs, and warned that excessive flows could elevate the risk of sudden reversals and put policy strains on EMs.
4/17/13	GFSR: Spring 2013	Chapter 1. Acute Risks Reduced: Actions Needed to Entrench Financial Stability	MCM	External	Benefits and Risks	Warned that a prolonged period of extraordinary monetary accommodation could push portfolio-rebalancing and risk-appetite to the point of creating significant adverse side effects. Indicated that the net benefits of UMP remained still highly favorable.
4/18/13	IMF Policy Paper	Unconventional Monetary Policies: Recent Experience and Prospects	MCM/RES/SPR	External	Benefits and Risks/Impact of UMP Exit	Closely related to Chapter 3 of the Spring 2013 GFSR. Findings and messages in both publications are fully congruent.
8/1/13	Spillover Report		Interdepartmental task force	External	Global spillovers	Suggested that QE in the U.S. appears to have reduced long-term U.S. bond yields by over 100 basis points prior to the market correction in May 2013, boosting world output by more than 1 percent.

Table 1a. Unconventional Monetary Policies (concluded)

8/23/13	Speech by the Managing Director	The Global Calculus of Unconventional Monetary Policies	COM/MCM/ RES/SPR	External	Benefits and Risks / Impact of UMP Exit	Analyzed the past and future impact of UMP and outlined policies to support sustainable growth going forward. Suggested that UMP has helped support economic activity and financial stability, domestically and globally. Indicated that there should be no rush to exit: the path to exit should be informed by the pace of recovery. Emphasized the need to understand better the balance of risks and spillovers. Pointed to the need for deeper structural reforms and central bank management of exit risks.
10/7/13	IMF Policy Paper	Global Impact and Challenges of Unconventional Monetary Policy	MCM/RES/SPR	External	Benefits and Risks/Impact of UMP Exit	Indicated that UMP have been successful in restoring market functioning / intermediation and supporting economic activity. Suggested that a potential UMP exit hides risks, including volatility spikes in certain markets and negative global spillovers. Warned that non-UMP countries should take measures to safeguard against instability related to an UMP exit and take policy steps to ensure sustained medium-term growth, and use buffers and appropriate policies in case of potential instability.
10/9/13	GFSR: Fall 2013	Chapter 1 Making the Transition to Stability	MCM	External	Impact of UMP Exit	Indicated that an UMP exit is more difficult, given that foreign investors have crowded into local EMs while market liquidity has deteriorated. An UMP exit could exacerbate EM vulnerabilities. Showed a sharp spike in the 10-year bond yields in some EMs under an extreme stress scenario. Underscored the need for EM to address macroeconomic imbalances, enhance policy credibility, and rebuild policy space to reduce vulnerabilities as financial conditions normalize.

13. The above discussions were all part of multilateral surveillance products. What of the Article IV reports on the United States, for example in July 2012 and July 2013? The bilateral reports included analysis of the risks of QE withdrawal albeit the focus was perhaps less central than in some other multilateral reports. The Article IV reports generally accepted the view of the United States' authorities that they possessed an adequate range of tools to handle the problems on the domestic economy, though noting the inevitable uncertainties due to QE's experimental nature. The Fund generally accepts the Fed's insistence that its mandate forced it to concentrate on U.S. inflation and employment outcomes, but this issue certainly merits further discussion in a dollar-centric world where Fed policy has such a profound and dominant effect on global financial markets. Both the Article IV report and the multilateral surveillance products (for example the *World Economic Outlook*) highlighted the risks of overly rapid fiscal tightening, or worse yet, U.S. government shut-downs and threats of debt default. It is notable, however, that neither modality gives as much attention to the need for structural reform in the United States (for example tax reform) as the IMF has tended to emphasize for other regions (for example, Europe, China, Japan).

14. Perhaps the most sensitive issue for national authorities is how the Fund translated its multilateral analysis into real-time bilateral commentary and advice, particularly for emerging markets that experienced strain as QE was withdrawn. The Fund certainly began to address the issue across many of its members after the initial strains of summer 2013. Risks posed by an eventual end to unconventional monetary policies in advanced countries start to be mentioned in several Article IV reports for emerging markets, with the tone sharpening further by February 2014. See Table 1b for a sampling of Article IV reports for emerging markets that note the high risk posed by the U.S. monetary policy tightening cycle.

15. The debate surrounding the sensitive issue of Fed tapering deals not only with the Fund's official staff publications and exercises but its broader communications strategies. Some countries have complained that the Fund was too quick to shift to assess the summer 2013 strains as a "crisis" when in fact the nature of the problem was quite diverse across countries. For example, Indian authorities might have argued that, with significant capital controls, a flexible exchange rate, and almost three hundred billion dollars in reserves, their country cannot be said to be vulnerable to a classic 1990s fixed exchange rate run. Equity flows and flexible exchange rates are shock-absorbing buffers, not necessarily trigger points. The semantics here are important and difficult to nuance precisely. It would probably have been more accurate to say India was suffering from twin problems of low growth and high inflation (stagflation), and the sharp exchange rate movements after the Fed taper were potentially destabilizing to fiscal policy, especially given fuel subsidies. The Fund's general analysis that some emerging markets were facing broader problems than simply the Fed taper was correct, as ultimately underscored by a second bout of uncertainty starting in January 2014. However, more might have been done to communicate the nature of the problems and to differentiate across countries, and the Fund arguably did a much better job of this during the second round in January 2014.

Table 1b. Unconventional Monetary Policies

Publication Date	Country Report	Section	Details
10/1/2013	**South Africa 2013 Article IV CR 13/303**	Developments (p. 6-11)	Notes that South Africa benefited from abundant global liquidity, but its financial market performance has been among the weakest in EMs, including during the recent turmoil.
		Outlook and Risks (p. 11-13)	Highlights a prolonged stop in capital inflows, which could force a disorderly adjustment of South Africa's twin deficits and cause a recession, as the main risk. Puts this risk in the context of continued and substantial global repricing of risk or term premia being the most likely external trigger linked to the unwinding of advanced economies' unconventional monetary policies. Notes that even a scenario with a stronger U.S. recovery that leads to a sharp rise in long-term U.S. yields would have negative spillovers on South Africa as it trades heavily with Europe, while its financial conditions are linked to those in the United States: events in global financial markets since May 2013 illustrate the potential for a sharp increase in financing costs.
		Policies (p. 14-16)	Refers to the tapering of unconventional monetary policy in the United States in the context of monetary and exchange rate policies and measures to deal with capital flows.
		Risk Assessment Matrix (p. 27-28)	Includes distortions from unconventional monetary policy as one of the major external risks.
10/21/2013	**Russia 2013 Article IV CR 13/310**	Recent Developments (p. 8-9)	Notes that the effect of announced possible tapering of unconventional monetary policy in the U.S. and other external developments have put some pressure on the exchange rate, the local bond market, and equities, and may have contributed to some acceleration of capital outflows.
		Box 4. Spillovers (p. 10)	The box discusses outward and inward spillovers. It highlights that Russia experienced accelerated outflows following announcements in May 2013 about expected changes in U.S. monetary policy.
		Outlook and Risks (p. 15)	Refers to an acceleration of capital outflows as a key external risk.
		Risk Assessment Matrix (p. 58)	Includes acceleration of capital outflows as a key external risk.
10/23/2013	**Brazil 2013 Article IV CR 13/312**	Outlook and Risks (p. 23-24)	Notes that key risks for Brazil are associated with the global financial implications of a sudden or sharp monetary tightening in the U.S. or contagion from an intensification of the crisis in Europe, either of which could prompt an increase in global risk aversion, lower flows to emerging markets, and tighter external financing conditions.
		Risk Assessment Matrix (p. 25)	Includes distortions from unconventional monetary policy as one of the major external risks.

Table 1b. Unconventional Monetary Policies (concluded)			
12/15/2013	**Indonesia 2013 Article IV CR 12/362**	Background (p. 5)	Notes that prospects of a tapering in unconventional monetary policies in the United States prompted a marked shift in funding conditions and sharp reversal in capital inflows for a number of EMEs in May 2013, especially in those countries with large external and/or fiscal imbalances. Among major EMEs, Indonesia has been one of the most seriously affected by recent market volatility. Since May 22, net bond and equity outflows have totaled US$2.7 billion (to end-October), notwithstanding sizable bond inflows recently in response to policy tightening and a delay in UMP tapering.
		Risks and Prospects (p. 8)	Observes that, at present, inward spillovers come mainly through the trade channel (via export demand and commodity prices) and net inflows in the financial account. In the near term, key external risks are protracted economic and financial volatility, especially in EMEs, and a fiscal policy shock in the United States, while in the medium term, they entail a sharper-than-envisaged slowdown of growth in China, as well as in other large EMEs.
		Policy Issues (p. 12-13)	Notes that while the current policy stance is broadly appropriate, the authorities should take full advantage of the current delay in UMP tapering to rebuild policy and financial buffers and improve market perceptions in light of recent volatility. To this end, continued vigilance over macroeconomic imbalances, clear communication of the policy framework, and firm follow-through on stabilization measures are needed. Contingent financing and swap arrangements, which have been put in place, could also provide important fiscal and reserve buffers in the event of further adverse shocks.
		Risk Assessment Matrix (p. 43)	Includes protracted economic and financial volatility, especially in emerging market economies (triggered by prospective exit from UMP) among key risks.
		Appendix 2. External Vulnerabilities in Perspective (p. 44-46)	The appendix looks at developments in Indonesia's external position and benchmarks its vulnerability indicators over time and across countries. It analyzes the impact of the 2013 U.S. tapering episode.
12/20/2013	**Turkey 2013 Article IV CR 13/363**	Recent Developments (p. 5)	Notes that lower global appetite for emerging market assets following expectations of tapering by the U.S. Federal Reserve exposed Turkey's Achilles heel: its large external financing needs and short-term funding composition.
		Outlook and Risks (p. 6-10)	Warns that the combination of expected monetary policy normalization in the United States and a growth slowdown in emerging economies could result in a sharp and sustained reversal of inflows. Given the size of Turkey's current account deficit, a sudden stop in inflows (one sharper and more sustained than the one seen in previous months) would require a large compression in absorption to close the external deficit, leading to negative GDP growth.
		Risk Assessment Matrix (p. 8)	Includes emerging markets capital flow reversal as one of the major external risks.

16. Messaging and communication are extremely subtle issues, and the main thing one can ask is that the Fund maintain the discipline of always going back to the core findings of its research and surveillance exercises, which in the end it has largely done. There are of course still huge uncertainties hanging over advanced country exit from stimulus, and these remain ongoing concerns.

17. If there is a more trenchant lasting question from this episode, it is whether the Fund is too deferential to the analysis and position of the U.S. Federal Reserve. On the one hand, the Fed's analysis is generally of a very high standard, but on the other hand it represents a much narrower set of interests than the Fund's economists are charged with serving. Also, even if the U.S. Federal Reserve has substantial independence, the Fund should always be evaluating the Fed's policies as part of the United States' overall policy stance. On this score, the Fund should be given credit especially for underscoring the risks posed by the paralysis the United States has experienced in executing fiscal policy (advice that if taken, might have tempered the uncertainties caused by QE). On the other hand, the Fund has not been as consistent in pushing for badly needed structural reforms, for example to the U.S. tax system. (Although the Fund has certainly noted the issue from time to time; the October 2013 Fiscal Monitor recommends simplifying the tax code and broadening the base.) As we shall see, the Fund has been very firm with China and Japan on the need for structural reform as part of an overall assessment of their policies, and it does no favors to the United States by not treating it fully in parallel. The risks posed by the tapering and by QE in general would have been lower if they had been part of a broader, better policy package from the United States.

18. One might argue, of course, that the U.S. is less in need of structural adjustment than many other countries, whereas exceptionally divisive political differences over U.S. fiscal policy have been transparently destructive. Nevertheless, an overemphasis on aggregate demand perhaps excessively downplays some of the longer-term secular problems the U.S. is facing due to rising competition from Asia, an aging workforce, and growing inequality.

ABENOMICS

19. A second key issue facing the IMF recently has been Japan's bold experiment with reflation. After his election in April 2013, Japan's new prime minister pledged to bring inflation to a more normal level of 2 percent within two years, and to adopt fiscal policies and structural reforms to support the Bank of Japan's efforts. Japan's efforts are of utmost importance to the global economy, and therefore to the IMF membership for several reasons (aside from the obvious impact on Japan).

20. First, several major advanced economies, including the Euro Area, the United States and the United Kingdom, also find themselves in post-financial crisis liquidity traps. If Japan's reflation proves a success, it will undoubtedly influence policymakers around the world. Second, one of the key initial impacts of Japan's reflation has been a sharp drop in the value of the yen—from the formation of the Abe Cabinet on December 26, 2012 to March 7, 2014 the yen depreciated by 27 percent against the euro, 22 percent against the Korean won and 21 percent against the dollar. In the normal course of events, a radical change in policy that appeared to work mainly through

currency depreciation would surely attract the Fund's attention. Of course, as Japan is arguably following advice the Fund has been insisting on for over a decade, it is difficult for the IMF to be too critical. A third reason why Japan's success is important is because a growing Japanese economy can help diversify Asian economies should China experience a slowdown.

21. The Fund's advice to Japan has generally been quite consistent on the multilateral and bilateral levels. Some of the highlights are detailed in Table 2. For example, the 2013 Article IV emphasizes the importance of implementing all three arrows, particularly structural reforms and not just monetary expansion. In particular, the Article IV states that in order for Japan "to generate growth synergies, measures should include deregulation in agriculture and domestic services, lifting constraints to the provision of risk capital, reducing Japan's excessive labor market duality, reforming the tax system to stimulate investment, and further relaxing immigration requirements to areas with labor shortages." The *World Economic Outlook* has similarly regularly called attention to the importance of structural reform as a path to escaping from deflation.

22. The Fund has also expressed consistent concern over Japan's long-term fiscal stability, and has taken the position of supporting plans to raise the consumption tax in 2014, albeit arguing that other temporary measures should be taken to ameliorate the growth impact. Per Table 2, the April 2011 *Global Financial Stability Report* underscored risks to Japan's long-term budget stability, pointing to both risks to Japan and to broader global financial stability. In the April 2013 internal meeting on surveillance issues, Fund staff asked the question of what would happen to long-term interest rates under Abenomics. Japan faces a risk of a rise in nominal interest rates if inflation expectations rise, a risk of a rise in real interest rates if fiscal discipline is weakened, and a risk that interest rates would incorporate a larger risk premium if investors became uncertain of how policy would respond to these challenges. Of course, such volatility would likely have large global spillovers.

23. On the more immediate issue of yen exchange rate depreciation, the April 2013 spillovers report found relatively modest spillovers of Abenomics to other countries, though it is perhaps early to fully assess the effects of the yen's sharp depreciation, for example on German and Korean manufacturers who compete with Japanese manufacturers. See Table 2 for further details on IMF reports on Japan. Note that the issue was also taken up in the 2013 Pilot External Sector Report (Box 2, "Impact of the Depreciation of the Yen on Other Currencies"). One might well ask why this issue did not receive even more attention, however, given that yen depreciation was one of the couple most dramatic developments in global asset markets in 2013.

Table 2. Reflation in Japan/Abenomics

Publication Date	Publication / Forum	Analytical Piece	Department	Nature	Aspect	Details
4/13/2011	GFSR: Spring 2011	Chapter 1. Key Risks and Challenges for Sustaining Financial Stability	MCM	External	Need for fiscal consolidation	Stressed the need for medium-term fiscal consolidation and pointed to the high sensitivity of Japan's debt to a potential rise in funding costs.
7/18/2011	Japan—Selected Issues	Chapter III. Bank of Japan's Monetary Easing: Is It Now More Effective?	APD	External	Policy Effectiveness	Assessed the impact of Japan's monetary easing, and found that while it supported economic activity, it had limited impact on inflation. The results—together with Lam (2011)—were seen as suggesting that further easing, including through purchases of private assets, could be more effective compared to the past in stimulating economic activity.
9/21/2011	GFSR: Fall 2011	Chapter 1. Overcoming Political Risks and Crisis Legacies	MCM	External	Need for fiscal consolidation	Stressed the need for Japan to mitigate sovereign risk via medium-term fiscal consolidation.
4/25/2013	REO Asia and Pacific: Spring 2013	Box 1.3. Effects and Spillover Channels of Successful Reflation in Japan	APD	External	Impact of Abenomics / Spillovers	Analysis of the key financial and trade spillover channels of the QQME policy within a month after its announcement. The analysis suggested that QQME should give rise to capital outflows, and emphasized that a successful reflation and persistent yen depreciation could lead to a considerable rebalancing of domestic investors' portfolios towards foreign (particularly Asian) assets. It also emphasized that stronger growth in Japan would benefit other countries, while the spillover effects of yen depreciation would depend on each trading counterpart's position in the supply chain.
8/1/2013	Spillover Report: 2013		SPR	External	Impact of Abenomics / Spillovers	It quantified QQME spillovers to other countries' growth. It found small negative short-lived (<1 year) spillovers in reaction to the QQME announcement, likely related to the sharp yen depreciation and the drop in equity prices outside Japan (the G35-S model), as well as statistically insignificant spillover effects (GIMF model).
8/5/2013	Article IV Report	Box 1. The Potential Effects of Japan's New Policies on Growth, Inflation, and Debt	APD	External	Impact of Abenomics	Analyzed the impact of Abenomics (complete and incomplete scenarios) on growth, inflation and debt.
10/8/2013	WEO: Fall 2013	Chapter 1. Global Prospects and Policies	RES	External	Policy Commitment / Need for Fiscal Consolidation	Emphasized the need to further support growth, including via scaled-up asset purchases (to boost inflation expectations), and full implementation of the structural reforms in the third arrow of Abenomics. However, it warned that Japan needs to commit to medium-term fiscal consolidation to curb fiscal vulnerabilities.
10/9/2013	GFSR: Fall 2013	Chapter 1. Making the Transition to Stability	MCM	External	Policy Commitment	Warned that Abenomics need to be completed, with the authorities following through on fiscal and structural policy commitments, to avoid downside risks. These policies are needed to contain a potential sharp rise in government bond risk premia if sovereign debt dynamics do not improve. To help mitigate stability risks, market structures also need to be made more resilient (such as through the modification of circuit breakers in derivatives markets) and the risk profile of regional banks addressed.

24. Overall, Fund surveillance has raised more or less all the main issues on Japan, but two areas might be highlighted for discussion. First, although the Fund has rightly praised Japan's efforts, it has perhaps downplayed the extent to which the initial success of Japan's policies stemmed from a dramatic depreciation of the yen. In its multilateral surveillance role, the Fund might have been more forceful in insisting that Japan follow through on structural reforms to underpin long-run growth, and thereby help ensure that the net spillovers to the rest of the world are positive over the medium term. This issue is especially important given that Japan's experience may prove a precedent for some other advanced countries, so the Fund needs to set a clear and consistent precedent. The 2013 Japan Article IV does address these concerns to some extent, largely arguing that the dramatic yen depreciation did not seem to have the large immediate impact some feared it might. The Article IV notes that sharp depreciation in the yen did not seem to carry a large trade balance impact, because it was counterbalanced by a rise in commodity prices, particularly energy imports. However, given the well-known lags in the transmission of exchange rate shocks to trade balances, it is far too soon to judge the effects, and of course Japan has had to pay much more for energy imports as it adjusts its energy policy after the Fukushima accident.

25. Second, despite the important warnings from the GFSR and the internal surveillance committee exercises, the Fund has arguably understated the global spillover risks from Japan's unsustainable fiscal situation. This is a very difficult call for many reasons, but given the Fund's clear concern over the risks posed by Japan's fiscal situation; this might figure more prominently in the array of long-term global risk factors the Fund catalogues periodically in various modalities. The staff report for the 2013 China Article IV does obliquely note that a reappraisal of sovereign risk in Japan (and the U.S.) would have negative consequences for China. Given, however, how Japan has been at the leading edge of advanced country financial crisis, debt, and aging challenges, it is perhaps surprising that the corresponding spillover risks do not seem to be mentioned in other Article IV country reports as of February 2014.

RISKS OF A HARD LANDING IN CHINA

26. China's spectacular ascent in the world economy has been one of the dominant themes of the past three decades. China's growth has not only lifted hundreds of millions of Chinese citizens out of poverty, but also propelled growth around the emerging world. China is now the world's second largest economy, on track to eventually become the largest. At times in recent years, China has accounted for more than half of global GDP growth (using PPP measures). Its huge investment needs have helped propel a secular commodity price boom; its demand for capital equipment has also helped fuel growth in advanced economies such as Germany and Switzerland. Without question, China has had a huge impact across a broad range of markets and in manifold ways.

27. For some time, of course, many observers including the IMF have noted that China's fast-growing economy suffers from myriad imbalances, and the question naturally arises whether there is a risk of a pause in fast growth. The IMF definitely has not viewed a Chinese hard landing as a central scenario, but given the enormous importance of China in the global economy, the Fund has increasingly begun to address the issue in recent years, both in external and internal exercises. The vulnerability of the global economy to an unexpected Chinese slowdown has been underscored by

the January collapse in emerging market currencies and equities, a collapse driven in part by a recalibration of markets to the mere possibility that China might have a slowdown some day. Of the four topics discussed here, the Fund's positions on China were until recently perhaps the least public and the least developed, though of course now risk of a Chinese hard landing has become a rising concern in global capital markets. Given the Fund's central role in supporting global economic and financial stability, and given China's preeminent role in the global economy, it is particularly interesting to understand how the Fund has approached the problem to date and, in keeping with the focus of this note, the consistency of its bilateral and multilateral surveillance. A listing of key highlights is given in Table 3a.

28. A review of the Fund's recent Article IV reports on China suggests that, by and large, the Fund has raised important macroeconomic issues in a clear and candid fashion, presumably in close cooperation with Chinese authorities. The 2013 Article IV report, for example, gives a sober assessment of the broad-based risks to the economy. It highlights, for example, how credit booms such as China's recent one have very often had a large impact on public finances. The China Article IV points to potential problems in local government finances and in the shadow-banking sectors. It includes an explicit exercise of how a medium-term hard landing would affect the economy both under a reform and a no-reform scenario; the underlying exercise was issued as a working paper. In general, though cautious and sober and not aiming to create unnecessary noise, the IMFs 2013 Article IV report on China conveys reasonably significant and immediate concern over China's economic growth path, especially should policy fail to adjust as needed. The question is whether this concern has been emphasized enough in bilateral advice to other countries that are particularly vulnerable to a slowdown in Chinese growth, or whether it has played enough of a role in multilateral surveillance.

29. The issue of a Chinese hard landing and its global effects are indeed taken up in the spillover reports and in a 2012 working paper. Substantively, many of the main issues are covered. Box 4.2 in the October 2012 *World Economic Outlook* considers in some detail the effects of a sharp slowdown in China, estimating that a 1 percent fall in China's investment growth would lead to a 0.4 percent fall in growth in a country such as Chile that is heavily dependent on commodity exports, and smaller changes in diversified economies. This is an excellent and useful exercise, but it arguably understates the effects of a China slowdown by not fully incorporating other transmission channels such as instability in financial markets. The risk of a slowdown in China has also surfaced in many Article IV reports, particularly for commodity exports, and particularly since summer of 2013. Indeed, the risk of a China slowdown headlines the staff report for Australia's 2013 Article IV consultations. Table 3b gives a sampling of Article IV reports that have incorporated risks of a Chinese hard landing to individual emerging markets.

30. In general, the Fund has been actively engaged in studying the risks of a hard landing in China. However, the results have been arguably relegated to more technical papers and appendices, and have not received quite the prominence that, say, risks of a euro meltdown have received. So whereas the bilateral and multilateral surveillance have both covered key risks on China, they have perhaps understated the issue in communicating with national authorities outside of China. This communication problem will surely be rectified in coming months, now that growth risks to China have so clearly been a factor in recent emerging market economy turmoil.

Table 3a. Potential for Hard Landing in China						
Publication Date	**Publication / Forum**	**Analytical Piece**	**Department**	**Nature**	**Aspect**	**Details**
8/1/2013	Spillover Report: 2013		SPR	External	Spillovers	Indicated that failure to rebalance the sources of growth from exports and investment to domestic consumption is likely to lead to a sharp and prolonged growth slowdown. In the baseline scenario, the impact of such a scenario was expected to occur in more than five years, given considerable policy space and resources. However, the report specified that timing was hard to predict and could, in fact, happen earlier. The spillovers from such a scenario were estimated to be at around 1.5 percent of global GDP.
10/9/2013	GFSR: Fall 2013	Chapter 1. Making the Transition to Stability	MCM	External	Policy Commitment	Emphasized that broad credit growth needs to be reined in to contain financial stability risks and promote the rebalancing of China's economy away from credit-fueled capital and property investment. It is important that prudential oversight of shadow banking activity be tightened, that incentives for regulatory arbitrage be removed through continued financial liberalization, and that the widespread belief in implicit guarantees and bailouts of risky corporate loans and saving products be counteracted. Warned that unless credit losses are taken by lenders and savers, the state faces large and unpredictable fiscal costs.

Table 3b. Potential for Hard Landing in China (Selected Article IV Reports)

Publication Date	Country report	Section	Details
08/23/2012	**South Africa 2012 Article IV CR 12/247**	Rising Risks, Still Moderate Vulnerabilities (p. 6.)	Points out that renewed concerns about the euro area and signs of a slowdown in China have recently tilted risks to the downside. External sources of risk include slower demand for South African exports and a further decline in commodity prices. Although the euro area remains the main regional trading partner, South Africa has been able to diversify its export markets through a significant increase in exports to China, and sub-Saharan Africa. Nevertheless, since the euro area and China are global players, disruption in one economy will likely have significant spillovers on the other and the rest of the world. Although the direct share of China is smaller than that of the euro area, it will likely have a strong indirect effect through its impact on commodity prices and other sub-Saharan African economies.
		Risk Assessment Matrix (p 39.)	Includes a sharp slowdown in China among the major risks.
09/25/2012	**Indonesia 2012 Article IV CR 12/277**	Recent Developments and Near-Term Outlook (pp.6-8)	Notes that specific sources of risk include a hard landing in China. The former would manifest through the capital account, where vulnerability lies in high foreign ownership of local currency debt and low interest rates. Direct trade linkages with Europe are limited, but a hard landing in China could have a significant impact on the current account.
		Box 2. China's Growth Pattern: Implications for Indonesia	Analyzes the channels through which China could impact Indonesia, and finds that going forward, a change in China's growth rate and pattern could have significant implications for Indonesia. Provides numerical estimates of the impact on Indonesia's GDP of slower Chinese growth.
7/8/2013	**Chile 2013 Article IV CR 13/198**	Outlook and Risks (pp. 16-18.)	Warns that a large and lasting copper price fall, e.g., triggered by a fall in investment in China (which consumes 40 percent of world copper) would have major effects on the current account and foreign direct investment, public finances, and medium-term growth prospects.
		Risk Assessment Matrix (p. 16)	Includes a large and lasting decline in copper prices (e.g., prompted by a sharp investment slowdown in China) among the major risks.
1/9/2014	**Zambia 2013 Article IV CR 14/5**	Risks (p.6)	Refers to trade and commodity price implications of a slowdown in emerging markets such as China among risks.
		Risk Assessment Matrix (p 40.)	Includes lower than anticipated growth potential in emerging markets among key external risks, and notes that lower demand from emerging markets, especially China, could result in a substantial drop in commodity prices.
2/12/2014	**Australia 2013 Article IV CR 14/51**	Outlook and Risks (p 6.)	Notes that Australia's growth prospects remain exposed to external developments, including a sharp slowdown in growth in China over the medium term and a related sustained decline in commodity prices. Over half of Australia's exports go to emerging Asia and nearly two thirds are non-rural commodity exports. With the volume of these exports increasing sharply in future years, Australia's economic outlook will be closely tied to developments in this region.
		Risk Assessment Matrix (p 38.)	Includes a sharp slowdown in China over the medium term among potential external shocks.

GERMAN FISCAL POLICY

31. The Eurozone has faced challenges of historic dimensions over the past several years, and it is not possible here to unpack all the myriad issues surrounding the Fund's engagement with the euro crisis. Corresponding to the IMF's significant commitment to Europe, the Fund has produced an impressive body of analysis covering Eurozone macroeconomic, regulatory, and financial issues, including spillovers, in its multilateral and Article IV surveillance activities. It is far beyond the scope of this short report to summarize the consistency of the IMF's multilateral and bilateral surveillance of the Eurozone during the crisis. However, we will briefly take up the IMF's analysis of German fiscal policy and its spillovers, as it has constituted a visible engagement between the IMF and another of its largest members. In particular, the IMF is sometimes viewed as having taken a strong stand on the need for Germany to engage in stronger countercyclical fiscal policy in order to serve as a locomotive to Europe's economy and especially to the troubled Eurozone periphery. Is such a strong stand for greater German fiscal stimulus reflected in the IMF reports? Taking into account the 2012 and 2013 Article IV surveillance reports for the Eurozone and Germany, the surrounding material, and related multilateral surveillance reports, it does appear that the IMF did at the margin favor greater German fiscal stimulus. But the analyses are in general quite nuanced, and the views quite muted. Perhaps this outcome is consistent with the fact that the IMF's own research pointed to relatively modest spillover effects from German fiscal policy to the rest of the Eurozone, and very limited effects to the periphery in particular. (See for example "Do Fiscal Spillovers Matter?" IMF working paper 11/211, September 2011, and Box 1 on p. 13 of the 2012 Article IV for Germany.) Importantly, the reports (particularly the 2013 Article IV report) do give a flavor of the great uncertainty and intense controversy over European fiscal policy in general and German fiscal policy in particular. One can presume that IMF's policy stance was the outgrowth of especially intense internal debate, so it would be deeply misleading to suggest there is a single IMF view on the topic.

32. The 2013 Article IV report, written perhaps at the peak of debate over German fiscal stimulus, nevertheless does take a clear position: "The small projected loosening of the fiscal stance is appropriate and fiscal overperformance should firmly be avoided in the current growth environment." As IMF Article IV reports go, this statement would appear to reflect a clear pro-fiscal bias. However, the 2013 Article IV report includes research suggesting that any spillover effects from German fiscal expansion were likely to be quite modest for the Eurozone as a whole and for the periphery countries in particular.[6] And the report also places considerable emphasis on the need for structural reform to raise long-term growth, and places by far the greatest emphasis on the need for financial sector reform and banking integration, in order to "alleviate uncertainty and reduce downside risks." Indeed, these and other reports prominently cite research suggesting (quite plausibly in this case) that policy uncertainty in Europe was likely a significant impediment to growth, including not only short-term policy uncertainty but long-term policy uncertainty on the pace of integration (or devolution) of the Eurozone.

[6] The 2013 IMF Article IV for Germany contains an innovative device for expressing the complexity of some of the issues, by including a Q and A format in one section to cover responses to alternative viewpoints. This also helps to communicate the lack of certainty over some issues, thereby helping authorities and the public better appreciate how to weigh the IMF's favored views.

Table 4. German Fiscal Policy

Publication Date	Publication/Forum	Analytical Piece	Department	Nature	Details
7/11/11	Consolidated Spillover Report: 2011	Implications from the Analysis of the Systemic-5	SPR	External	The external demand spillovers from fiscal consolidation in advanced economies would be small in comparison to those that would follow from compromised fiscal credibility.
9/1/11	Working paper	Do Fiscal Spillovers Matter?	EUR	External	The paper assesses the impact of fiscal spillovers on growth in the context of a coordinated exit from crisis management policies. The coordinated exit will have limited direct effect on European peripheral countries, with the exception of Ireland.
7/3/12	IMF survey online	German Economy Fares Well But Reform Agenda Still Unfinished	Fund	External	Germany's relatively strong performance sets conditions for domestic demand-led growth; Downside risks cloud near-term outlook; Accelerating structural, financial reforms would raise growth potential, also benefitting the euro area (EA).
7/3/12	Article IV Report	2012 Article IV consultation for Germany	EUR	External	The underlying strength of the labor market is expected to underpin domestic demand-led growth. In this regard, a pick-up in wages and asset prices should be seen as part of the natural process of private sector-led rebalancing.
7/3/12	2012 Euro area policies	2012 Article IV consultation	EUR	External	Fiscal consolidation should proceed decisively and credibly where market pressure is high, but more gradually elsewhere to help support demand in the region. The pace of adjustment should be guided by structural targets.
7/9/12	Spillover Report: 2012	Main document	SPR	External	Spillovers from a failure of policies to get ahead of the crisis would be widespread. Policy reactions by the whole euro area and its partners can mitigate these effects.
7/10/12	Spillover Report: 2012	Background papers	SPR	External	The intensification of financial stress in euro area countries would generate severe output losses in the EA, concentrated in the high yield and, to a lesser extent, in the mid-yield countries, with mild to moderate output losses in the rest of the world.
7/19/12	Article IV Report	2012 Article IV consultation for UK	EUR	External	More expansionary demand policies would close the output gap faster and reduce the risk of hysteresis. Further steps are needed to fortify financial sector stability.
7/1/13	Multi-country Report	German-Central European Supply Chain Cluster Report	EUR	External	Balance sheet fundamentals in Germany are a key determinant of the magnitude of shock spillovers to CE4 countries (Czech Republic, Hungary, Poland and the Slovak Republic) and beyond.
7/2/13	Spillover Report: 2013	IMF Multilateral Policy Issues Report	SPR	External	Main policy priorities: structural reforms to boost growth potential in Europe; continued monetary stimulus, accompanied by policies to reduce financial fragmentation.
7/3/13	Spillover Report: 2013	Analytical Underpinnings and Other Background	SPR	External	Elevated policy uncertainty in the U.S. and the euro area may have contributed to the serial disappointments and downward revisions in investment and output growth observed throughout the same period.

Table 4. German Fiscal Policy (concluded)					
7/17/13	Article IV Report	2013 Article IV consultation for UK	EUR	External	A multi-pronged policy strategy is needed. Securing growth momentum and rebalancing the economy are vital to boost incomes and income expectations, ensure the sustainability of public debt, and support bank balance sheets.
7/25/13	2013 Euro area policies	2013 Article IV consultation	EUR	External	In terms of policy recommendation for the EA, further efforts are needed to address the twin challenges of reviving growth and creating jobs. This requires actions on multiple fronts, which are mutually reinforcing (structural reforms, banking union…).
7/25/13	2013 Euro area policies	Selected issues	EUR	External	Policies that directly support the workout of bad debt in the financial and private sectors in the euro area could yield important benefits.
8/6/13	Article IV Report	2013 Article IV consultation for Germany	EUR	External	The small projected loosening of the fiscal stance is appropriate and fiscal overperformance should be firmly avoided in the current growth environment. Over the medium term, efforts to raise the German economy's growth potential need to be sustained.
9/17/13	IMF Policy Paper	Reassessing the Role and Modalities of Fiscal Policy in Advanced Economies	EUR	External	The crisis has revealed the challenges involved in establishing credible medium-term budget frameworks and fiscal rules to underpin fiscal policy that are also sufficiently flexible to respond to cyclical fluctuations.

33. Of course, the reports also place strong emphasis on headwinds posed by impairment of balance sheets across the Eurozone, including public, private and bank debt. (For example, Box 2 on page 10 of the 2013 euro area Policies report notes that when the public, households and corporate sectors all have high debt, the negative impact on growth is particularly significant.) And in contrast to any perception that the IMF single-mindedly advocated more expansionary fiscal policy, the IMF also gave great emphasis to the important stabilizing influence of strong German balance sheets on the rest of Europe. For example, p. 21 of the 2013 Article IV report for Germany notes how strong national balance sheets allow it to perform a stabilizing role for the rest of Europe. It is worth noting the contrast of the IMF's advice with the case of the UK, where the IMF used the argument that impaired domestic balance sheets implied a higher fiscal multiplier because more households would be credit constrained.

34. Perhaps the IMF's reputation for fiscal advocacy comes from multilateral surveillance reports such as the September 2013 paper "Reassessing Fiscal Policy," which points to recent academic research suggesting that fiscal policy may be more effective when monetary policy is at the zero bound on interest rates. Again, however, this paper is quite nuanced in also emphasizing the risks of high public debt, and the importance of maintaining the ability to credibly backstop large private sector debts. Perhaps more directly contributing to the perception that the IMF favored much more aggressive fiscal policy are its Article IV reports for the UK, which strongly emphasized the importance of moderating fiscal retrenchment. This advocacy was particularly evident around the time of the April 2013 spring meetings of the IMF. The Fund, of course, later notably toned down its position as UK growth outperformed later in 2013. (Of course, the much greater openness of the UK economy compared to the U.S. economy might have suggested that the growth effects would be smaller, and the positive international spillover effects proportionately larger, than for a more closed economy like the United States, controlling of course for size.) Lastly, this paragraph would be incomplete without mentioning that in addition to the various reports covered in this review, the IMF's position is sometimes defined by press interpretation of speeches by management. Some might argue that this is the case for German fiscal policy. Again, we emphasize the point that it is healthy for differences of interpretation to be expressed in different publications outlets, but communication should always acknowledge these internal differences and uncertainties where possible.

35. Table 4 lists some of the critical Article IV and multilateral surveillance reports dealing with German fiscal policy. Overall, the IMF advice appears to have been reasonably consistent across modalities, and by and large quite balanced though the huge political debate surrounding European policy may have at times exaggerated the extent to which the IMF actually engaged in strong advocacy of more proactive fiscal policy in Germany, as it clearly did in the case of the United Kingdom. The IMF certainly cannot be accused of taking a crude Keynesian view, given the considerable emphasis its reports gave to policy uncertainty, debt burdens, and the need for structural reform in Europe (particularly for a more complete banking union). Of course, given the contentious and polemic debate surrounding fiscal policy in Europe, and the press incentives for framing issues in political terms, it cannot be said that the IMF's views on German fiscal policy were always represented accurately in the popular media.

RESOURCES AND TRACTION

36. Although the main focus of this review is on the consistency of Fund surveillance between its bilateral and multilateral modalities, it would be difficult to conclude without commenting on the sea change that has taken place in the allocation of Fund time and resources, especially since the global financial crisis. Only a decade ago, the overwhelming proportion of Fund surveillance activities were concentrated on bilateral surveillance, particularly the Article IV country missions that are enshrined in the Fund's articles of agreement. Multilateral surveillance played an important role, particularly through the analysis and views expressed in the Fund's twice yearly *World Economic Outlook*. The WEO's sister publication, the *Global Financial Stability Report*, had just recently been launched, and the *Fiscal Monitor* had not yet come into existence. Yet, by any accounting, multilateral surveillance occupied only a small fraction of staff time. Today multilateral surveillance activities, including many new products, have grown sharply, accounting for about 26 percent of total staff hours (excluding capacity building, see Table 5). There are many good reasons for this change. The global economy has become increasingly interconnected, with national policies having important spillover effects, especially the policies of large and systemically important economies. Indeed, this note has illustrated several examples.

Table 5. The Share of Main Activities in Total Staff Years, FY07-FY14, (in percent)*

	FY07**	FY10	FY14
Multilateral surveillance	15	21	26
Regional surveillance	…	5	5
Bilateral surveillance	30	33	35
Oversight of global system	…	17	15
Lending	…	25	20
Total without capacity building	…	100	100

* The data presented in the table covers only the five area departments and selected functional departments (FAD, MCM, RES, SPR, and STA).

** TSR staff team estimate. Value for Multilateral Surveillance in FY07 is estimated by adding 50 percent of staff time for TRS codes that would be best classified as research, analysis, policy development to Multilateral Surveillance as reported in TRS in that year. The other 50 percent is unallocated. Values for bilateral surveillance for FY07 are as reported in the TRS system, FY10 as converted to the TRACES structure, and FY14 as reported in TRACES.

37. Nevertheless, the proliferation of reports, some based on quite technical exercises, raises important communication challenges on several levels. In the "old days," a decade ago, country authorities could expect a robust discussion and analysis surrounding the annual Article IV consultation. The *World Economic Outlook* and later the *Global Financial Stability Report* would weigh in with independent views, influenced by the bilateral discussions, and taking more complete account of cross-country issues and comparisons. Discussions and reports for program countries would, of course, often be more frequent.

38. Today, country authorities receive IMF views on an almost continual basis, sometimes filtered through quite complex modeling exercises. This raises two questions. First, is the IMF overloading its "bandwidth" with senior country authorities through a huge proliferation of information? During the immediate aftermath of the financial crisis, regular crisis updates and issue discussions were no doubt greatly appreciated. But this is not necessarily the case in calmer times. We leave that as an open question. Second, some of the new multilateral products require significant investment of time to absorb and assess, even for trained country economists. One might ask whether more effort needs to be expended on communicating results to research analysts in member central banks, finance ministries (and perhaps even in universities), as these are the ones most likely to be called upon to assess whether the most senior policymakers should devote time and attention to the results. This kind of communication could be facilitated either through staff missions, or perhaps conferences and programs at the IMF Institute. (The *Global Financial Stability Report* does have a few missions along these lines, but focused mainly on the GFSR, of course.) As things stand, this author's assessment is that there is an oversupply of multilateral products, and an undersupply of communication modalities. The large and continual supply of products is one of the reasons why maintaining consistency has become more difficult in recent years. This is not simply a matter of adding micro blogs, but of more sharply differentiating products, and channeling communications accordingly. This is not an easy task, particularly in a world where all the best efforts at balanced communication strategies can be frustrated by disinformation promulgated in blogs and media. We might add that the Fund's excellent working paper series plays an important role in underpinning Fund advice, analysis and credibility, and should be protected, if necessary by changing the imprimatur to more clearly delineate that these papers are essentially individual and not institutional products.

CONCLUSIONS

39. This study has looked at Fund surveillance through the lens of four important and topical issues: the Fed's quantitative easing strategy and especially the taper, Abenomics in Japan, the risk of a hard landing in China, and the spillover effects of Germany's fiscal policy. In all four cases, the Fund has provided its membership a useful and high-quality mixture of short-term conjunctural analysis and long-term policy research. The main challenge has been to calibrate an overall message on risk and concerns, both of individual regions and for the global economy as a whole. Overall, respecting the great difficulty in forecasting the global economy and global markets, the Fund's performance has been good. However, there are some issues that merit attention, arguably leading to systemic mistakes that might be addressed in the future. First, on U.S. monetary policy, there is a tendency to defer to the Fed's considerable expertise not only in making forecasts but in framing policy. The U.S. Fed is charged with representing U.S. interests, while the Fund's staff is charged with overseeing the global economy. While the Fund was certainly right to be generally supportive of quantitative easing, and while it made some trenchant observations on the risks, it perhaps might have done more to put U.S. policy in international context. U.S. and global financial conditions did call for aggressive monetary easing. And the Fund was absolutely right to emphasize the importance of fiscal policy at the zero bound in supporting monetary policy. But it gave less emphasis to structural reform in the case of the United States than it did for Europe, China and

Japan. The Fund did, of course, strongly emphasize that the U.S. needed to develop a more consistent and predictable fiscal policy framework, rather than lurching from debt limit debates to government shutdowns. And it did periodically raise the issue of tax reform, for example in the 2012 Article IV report. The issue of structural reform in the U.S. is important because, rather than simply downplaying emerging market concerns about downward pressures on the dollar, the Fund might have insisted more forcefully that the U.S. supplement its aggressive monetary policy with reforms to ensure that, over the medium term, the spillovers to emerging markets and the rest of the world would be positive. When it came to spillovers from the Fed's tapering, the Fund had done good background analysis, but was perhaps slow to calibrate its message that different economies will be affected quite differently depending on policies and vulnerability. In early 2014, the Fund has now increasingly refined its approach.

40. The Fund has generally done well in the case of giving consistent policy advice to Japan and in its response to Abenomics, stressing all along the importance of structural reforms and giving extensive ideas in this dimension. The Fund also anticipated fiscal problems that might arise over time especially if Abenomics pushes up long-term interest rates, potentially causing significant fiscal duress. However, the Fund perhaps excessively downplayed the possible global spillovers from the sharp depreciation in the yen, and perhaps did not do enough to insist that "third arrow" reforms would not only help Japan in the long run, but also help give stronger justification to Japan's policies from an international perspective, helping to ensure that the long-run spillovers would be positive, even if the initial sharp yen depreciation might cause short-run issues for some of Japan's competitors. Perhaps even more importantly, the Fund has arguably downplayed the international spillover risks that will arise should interest rates in Japan begin to rise more quickly, either in response to rising inflation expectations, or if markets come to share the Fund's concerns about the long-run sustainability of fiscal policy.

41. On China, the Fund has been quite candid about risks to China in many of its Article IV reports. In its multilateral surveillance, however, it has perhaps not done enough to highlight risks to the many countries that have become very dependent on continuous high growth in China. Indeed, good discussion of the risks can be found sprinkled throughout multilateral products and exercises, but often these discussions are found mainly in more technical chapters and reports. It is understandable that the Fund does not want to ruffle feathers by seemingly needless alarmism, but at the same time China has simply become too important in the global economy to downplay the effect its economic cycles might have.

42. On the Fund's advice on German fiscal policy, the long trail of Article IV and multilateral surveillance products suggests that the Fund's advice was quite nuanced, far more so than is sometimes portrayed. The Fund certainly did not strongly endorse the view that German fiscal policy expansion would have large spillover effects to the rest of the Eurozone, and at the same time it did emphasize how strong German balance sheets helped perform a stabilizing role in Europe. If one believes that the Fund should have pushed Germany much harder on fiscal expansion, then of course this would be another example of deference to a large member. My own assessment is that the Fund's view on German fiscal policy as expressed in written reports was quite nuanced. One could argue that perhaps the Fund should have argued more forcefully for Germany

to use its strong balance sheets to directly aid the highly indebted periphery countries, but there is no space to take up this issue systematically here.

43. In conclusion, over the four main issues studied here, the Fund by and large did a good job of blending viewpoints and making its bilateral and multilateral messaging consistent. The Fund has been right to offer different nuances in different reports, and to try to explain and clarify the main uncertainties. This tolerance of diversity is a strength that protects the Fund and its membership from sticking too long to old views that should be superseded by new ones. Nevertheless, despite this overall excellent performance, there is room for improvement, particularly in balancing the concerns of its largest members with the concerns of the membership as a whole.

44. The substantial increase in staff resources devoted to multilateral surveillance has helped sharpen the Fund's insights on many systemic issues. But the corresponding massive proliferation of multilateral products also arguably crowds the Fund's bandwidth in communications with its members, and makes maintaining message consistency more difficult. As the Fund continues to experiment with new products and modalities, it will need to be prepared to streamline as well as to enhance. At the same time, enhanced communication between Fund staff and technically-trained counterparts in member states will help policy authorities better absorb messages from some of the newer products.

References

Elekdag, Selim and Dirk Muir, October 2013, "Trade Linkages, Balance Sheets, and Spillovers: the German-Central European Supply Chain," IMF Working Paper 13/210 (Washington).

International Monetary Fund, February 2010, "Exiting from Crisis Intervention Policies" (Washington).

________, 2011a, "Global Financial Stability Report", April (Washington).

________, 2011b, "Global Financial Stability Report", September (Washington).

________, 2011c, "2011 Consolidated Spillover Report" (Washington).

________, 2012a, "Euro Area Policies" (Washington).

________, 2012b, "Global Financial Stability Report", Spring (Washington).

________, 2012c, "Germany Article IV Report" (Washington).

________, 2012d , "Indonesia 2012 Article IV Report" (Washington).

________, 2012e, "Managing Director's Global Policy Agenda" (Washington).

________, 2012f, "Meeting of G20 Ministers and Central Bank Governors, Mexico City" (Washington).

________, 2012g, "2012 Spillover Report" (Washington).

________, 2012h, "South Africa 2012 Article IV Report" (Washington).

________, 2012i, "United Kingdom Article IV Report" (Washington).

________, 2012j, "United States Article IV Report" (Washington).

________, 2012k, "World Economic Outlook", April (Washington).

________, 2012l, "World Economic Outlook", October (Washington).

________, 2013a, "Australia Article IV Report" (Washington).

________, 2013b, "Unconventional Monetary Policies: Recent Experience and Prospects" (Washington).

________, 2013c, "Brazil Article IV Report" (Washington).

________, 2013d, "Chile Article IV Report" (Washington).

________, 2013e, "China Article IV Report" (Washington).

________, 2013f, "Euro Area Policies" (Washington).

________, 2013g, "Euro Area Policies – Selected Issues" (Washington).

________, 2013h, "German Economy Fares Well but Reform Agenda Still Unfinished", IMF survey Online (Washington).

________, 2013i, "Germany Article IV Report" (Washington).

________, 2013j, ‘German–Central European Supply Chain Cluster Report” (Washington).

________, 2013k, “Global Financial Stability Report”, April (Washington).

________, 2013l, “Global Financial Stability Report”, October (Washington).

________, 2013m, “Global Impact and Challenges of Unconventional Monetary Policy” (Washington).

________, 2013n, “Indonesia Article IV Report” (Washington).

________, 2013o, “Japan Article IV Report” (Washington).

________, 2013p, “Japan – Selected Issues” (Washington).

________, 2013q, “Pilot External Sector Report” (Washington).

________, 2013r, “Russia Article IV Report” (Washington).

________, 2013s, “Reassessing the Role and Modalities of Fiscal Policy in Advanced Economies” (Washington).

________, 2013t, “Regional Economic Outlook – Asia and Pacific”, Spring (Washington).

________, 2013u,”South Africa Article IV Report” (Washington).

________, 2013v, “Turkey Article IV Report (Washington).

________, 2013w, “2013 Spillover Report” (Washington).

________, 2013x, “United Kingdom Article IV Report” (Washington).

________, 2013y, “United States Article IV Report” (Washington).

________, 2013z, “World Economic Outlook”, April (Washington).

________, 2013, “World Economic Outlook”, October (Washington).

________, 2013, “Zambia Article IV Report” (Washington).

Ivanova, Anna and Sebastian Weber, September 2011, “Do Fiscal Spillovers Matter?” IMF Working Paper 11/211 (Washington).

Lagarde, Christine, August 2013, “The Global Calculus of Unconventional Monetary Policies”, speech (Jackson Hole).