BANK OF CANADA
BANQUE DU CANADA

Working Paper/Document de travail
2007-37

A Vision for IMF Surveillance

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Bank of Canada Working Paper 2007-37

June 2007

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ISSN 1701-9397

Acknowledgements

We would like to thank Tiff Macklem, John Murray, Larry Schembri, Graydon Paulin, Don Coletti, Robert Lafrance, Denise Côté, and seminar participants at the Banco de Espana, De Nederlandsche Bank, Sveriges Riksbank, and Swiss National Bank, for helpful comments.

Abstract

The ongoing review of the IMF, initiated in 2005 by Managing Director De Rato, presents an excellent opportunity to re-examine the role, functions and governance of the Fund. In particular, the objective, scope and conduct of IMF surveillance have been identified as a key area for renewal. In this paper, we offer a new vision for IMF surveillance. There are two main parts to our proposal. First, we develop "*Guidelines for Economic Policy Frameworks*" that outline the objective and scope of surveillance. They delineate the benchmarks against which members economic policy frameworks can be assessed. The *Guidelines* also serve to clarify the principles under which surveillance is conducted, and reaffirm members' commitments to the surveillance process under their Article IV obligations. The second element of our proposal is a "*Surveillance Remit*". The *Remit* defines the aim of surveillance and the obligations of the Fund to pursue this goal. As such the *Remit* creates a mechanism to hold the Fund accountable. An important implication of the *Remit* is that it requires the Fund to become more independent in its day-to-day operations. In addition, we propose procedures for communicating surveillance and for assessing the Fund's conduct of surveillance. Taken together, the various elements reinforce each other, providing a clear role for the IMF, as well as its member countries, in the surveillance process. This principles-based approach can bolster the credibility and legitimacy of surveillance, and ultimately its effectiveness, to the benefit of all members.

JEL classification: F33
Bank classification: International topics; Financial stability

Résumé

La réflexion sur le mandat du Fonds monétaire international (FMI) lancée par son directeur général, Rodrigo de Rato, offre une excellente occasion de revoir le rôle, les fonctions et la gouvernance de cette institution. En particulier, les objectifs, l'étendue et la conduite des activités de surveillance du FMI ont été désignés comme des éléments prioritaires de la réforme. Dans cet article, les auteurs proposent une nouvelle vision pour la fonction de surveillance exercée par le Fonds. Leur proposition se divise en deux grands volets. Premièrement, les auteurs établissent des lignes directrices relatives à la conduite des politiques économiques, qui explicitent les objectifs et le champ des activités de surveillance ainsi que les critères sur lesquels se fondera l'évaluation des cadres de conduite des politiques économiques des pays membres. Les lignes directrices ont également pour objet de clarifier les principes qui guideront la fonction de surveillance et de réaffirmer l'intérêt particulier des membres pour le processus de surveillance aux termes de leurs obligations au titre de l'Article IV. La seconde composante de la proposition est l'établissement d'un mandat (*remit*) en matière de surveillance. Celui-ci précise l'objectif de la surveillance et les obligations que doit respecter le Fonds dans la poursuite de cet objectif, ainsi que le mécanisme par lequel l'institution devra répondre de la qualité de la surveillance exercée. Ce mandat a pour importante implication d'obliger le Fonds à devenir plus indépendant dans la conduite de ses activités courantes. Enfin, les auteurs proposent des procédures pour communiquer les résultats de la surveillance et pour évaluer la façon dont le Fonds s'acquitte de cette responsabilité. Ces divers éléments se renforcent mutuellement et définissent clairement le rôle que le FMI et ses pays membres doivent jouer à l'égard de la fonction de surveillance. Cette approche fondée sur des principes est susceptible de rehausser la crédibilité et la légitimité – et par le fait même l'efficacité – du Fonds en tant qu'organisme de surveillance, et ce, au bénéfice de tous les États membres.

Classification JEL : F33
Classification de la Banque : Questions internationales; Stabilité financière

1 Introduction

The ongoing review of the IMF, initiated by Managing Director De Rato, presents an excellent opportunity to re-examine the role, functions and governance of the Fund. In particular, IMF surveillance has been identified as a key area for reform (King 2006a, Dodge 2006, Adams 2005). Improved surveillance is in the interest of all members, as it strengthens the Fund's efforts to maintain external stability, promote orderly adjustment, and prevent crises. This is reflected by the growing recognition that the Fund should shift its efforts from crisis resolution towards crisis prevention, which is particularly important for emerging markets, as these are the most vulnerable to adverse economic events. But while most agree that the IMF is *the* institution charged with maintaining a well-functioning international financial system, there has been less agreement about how IMF surveillance should be reformed to achieve this goal.

The impetus for reform proposals has come from several sources, including the Bank of England (King 2006a) the U.S. Treasury (Adams 2005), and the IMFC (2006). The latter for example, has emphasized the need for greater focus on multilateral issues, and consideration of a surveillance *Remit*.[2] At the same time, the IMF's Strategic Review identified surveillance as a key area of reform (De Rato 2005), IMF staff have been exploring the merits of revising the *1977 Decision on Surveillance over Exchange Rate Policies* and the adoption of a *Remit.* Moreover, these issues have been discussed at meetings of the IMF's Executive Board.[3] These are clearly important steps forward, and to support these efforts, the Bank of Canada has been actively promoting the discussion on surveillance reform (Dodge 2006).

In this paper, we offer a new vision for IMF surveillance that is very much in the spirit of the current proposals. There are two main parts to our proposal. First, we put forward "*Guidelines for Economic Policy Frameworks*" that outline the objective and scope of surveillance. The *Guidelines* can be viewed as the general principles on which a revised *1977 Decision* should be based. They delineate the benchmarks against which members' economic policy frameworks can be assessed. Specifically, to make surveillance more focused, the IMF should assess the overall coherence of exchange rate, monetary, fiscal and financial policies, with a view to analyzing their effects on external stability. The *Guidelines* also serve to clarify the principles under which surveillance is conducted, and reaffirm members' commitments to the surveillance process under their Article IV obligations.

Having defined the scope of surveillance through the *Guidelines,* the second element of our proposal is to develop an institutional framework that supports the conduct of surveillance. Specifically, we aim to create an IMF that is more accountable, more transparent, and that has greater operational independence. The mechanism to achieve these objectives is a "*Surveillance Remit*". The *Remit* defines the aim of surveillance and the obligations of the Fund to pursue this goal. An important implication of the *Remit* is that in order to assess the effects of Fund surveillance, it needs to disclose its surveillance

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[2] The purpose of the Remit is to provide guidance for the IMF's surveillance efforts, and a mechanism for holding the Fund accountable (Lomax 2006)

[3] See IMF press release, November 30, 2006.

activities through greater transparency. Hence, the *Remit* encourages greater candor in the surveillance process.

Completing our proposal are procedures for communicating surveillance and for assessing the Fund's conduct of surveillance. Taken together, this vision clarifies the roles and responsibilities of the IMF and its member countries in the surveillance process. We believe that this principles-based approach can bolster the credibility and legitimacy of surveillance, giving the Fund greater influence on the economic policies of members. Also, under our framework surveillance is more even-handed and objective, as members can hold the Fund accountable. A reform along the lines we propose would improve the overall conduct of surveillance, and the quality of the policy advice given by the Fund.

The paper is organized as follows. In the next section we illustrate how changes in the global economy require the Fund to give renewed emphasis to its surveillance function. In section 3, we outline our proposal for a new vision of IMF surveillance. Section 4 offers conclusions.

2 Surveillance in a Changing World

2.1 A changing economic landscape

The *de jure* basis for the current surveillance framework is the obligations of members under Article IV of the IMF's *Articles of Agreement* and the new Surveillance Decision, which builds on the *1977 Decision on Surveillance over Exchange Rate Policies.*[4] While Article IV provides general goals and guidelines for surveillance, more specific measures were spelled out in the *1977 Decision*.

In the aftermath of the collapse of the Bretton Woods system, the focus on exchange rate stability was understandable since few countries had truly flexible exchange rates. Since then, the world has evolved considerably (Lomax 2006). First, the global economy is increasingly interdependent and market-based, and flexible exchange rates have become more prominent. Second, as the world has become more integrated, countries have also become more vulnerable to cross-border shocks and policy spillover effects. Third, there is a growing number of emerging market economies that are systemically important and these countries, owing to their relatively less developed institutional environment, are more likely to be the cause of, or subject to, crises and contagion. Fourth, the breadth and scope of the crises experienced today are very large compared to the scope of Fund resources.[5] Lastly, many large emerging markets that could be potential Fund borrowers have reserves rivaling the Fund's total lending resources.

The consequence of these developments in the world economy is that surveillance is now viewed as the primary means by which the Fund pursue its goal of a well-functioning international financial system (King 2006a, Dodge 2006). In particular, Governors King and Dodge argue that the Fund should shift from focusing on crisis resolution to crisis

[4] We refer to the "*1977 Decision on Surveillance over Exchange Rate Policies*" as the "*1977 Decision*".
[5] Note that even if the IMF possessed sufficient resources, it is not clear that it should use them for large-scale interventions. Large-scale interventions would exacerbate concerns about moral hazard, and the distortions that lending can cause with respect to debt renegotiations (Haldane and Kruger 2001).

prevention. Within the Article IV consultation process, IMF surveillance has, to some extent, changed to reflect these evolving circumstances. But Fund surveillance has also been characterized by mission creep, as witnessed by its continued involvement in microeconomic and structural issues that are often unrelated to external stability. In the next section, we take a closer look at IMF surveillance and the challenges it faces.

2.2 IMF surveillance: Practice and challenges

The IMF defines its surveillance activities as "all aspects of the Fund's analysis of, scrutiny over, and advice concerning, member countries' economic situations, policies, and prospects" (Crow et al. 1999). One can distinguish between bilateral and multilateral surveillance:

- Bilateral surveillance refers to the surveillance of individual countries and is conducted through Article IV consultations, program reviews associated with the IMF's financial assistance, and *the Financial Sector Assessment Program.*
- Multilateral surveillance refers to the surveillance of economic linkages between countries and international developments, including the global implications of policies pursued in individual member countries. Multilateral issues are discussed among members in multilateral consultations (International Monetary Fund 2007), and are taken up in various publications, such as the semiannual *World Economic Outlook* (WEO) and *Global Financial Stability Report* (GFSR), as well as other staff reports (Mussa 1997).

Multilateral and bilateral surveillance are closely linked; multilateral surveillance often draws on country-specific information obtained from bilateral surveillance. At the same time, the broader insights obtained from multilateral surveillance should ideally feed back into discussions with individual countries in the context of bilateral surveillance.

2.3 Challenges in the IMF's surveillance framework

Over the past decades, IMF surveillance has often identified important deficiencies in member countries' economic policies, and its policy advice has contributed to resolving these weaknesses. Consequently, the Fund has helped to improve the resilience of many members' economies to domestic and external shocks. Still, past successes notwithstanding, there are a number of concerns in the current approach to surveillance:

- Surveillance remains overly focused on country-based, bilateral analysis.
- Bilateral surveillance suffers from mission creep. Article IV consultations often cover a broad range of issues, many of which are not relevant for countries' external stability (Adams 2005).
- Inadequate emphasis is placed on the linkages between the real and financial sectors (IMF Independent Evaluation Office 2006).
- Multilateral issues addressed in the *WEO* and *GFSR* are not sufficiently integrated (IMF Independent Evaluation Office 2006), and a formal consultation procedure to deal with them is lacking.

- Emerging market countries are not always treated equally, and that the quality of advice can differ greatly between countries (Akyüz 2005, IMF Independent Evaluation Office 2007)
- The Fund is "failing to fully meet its core responsibility" of surveillance over exchange rate policies (IMF Independent Evaluation Office 2007).

Concerns have also been raised that the institutional framework of the Fund does not adequately support candid and effective surveillance:

- Political interference in the Fund's daily operations compromises the objectivity of its surveillance (Cottarelli 2005)[6]
- Countries often vet Article IV surveillance reports, and since the staff knows that members may resist a truly candid assessment, surveillance reports may be self-censored. Also, staff lacks the proper incentives from senior management and the Executive Board to produce high quality surveillance (IMF Independent Evaluation Office 2007).
- Article IV reviews are still not always published (International Monetary Fund 2005).[7]
- Staff tend to want to present a unified view; internal disagreements are generally not revealed to the Board (Crow et al. 1999).[8]
- The respective roles of the Fund and its members in the surveillance process are unclear (IMF Independent Evaluation Office 2007) and thus there is a concern that members may lose sight of their commitments to Article IV (Balls 2003)

It is with these challenges in mind that we propose a new vision for the reform of IMF surveillance. Our proposals are inspired e.g. by the Bank of England (King 2006a, King 2006b), the U.S. Treasury (Adams 2005), the IMFC (2006) and parallel efforts by the IMF. Specifically, as part of the review of the IMF's Medium-Term Strategy, the Fund has adopted a new Surveillance Decision in June 2007, and is exploring the possibility of a *Remit* (see box 1). These are clearly important steps forward. However, given that the reform process proceeds along various workstreams, it is not always clear how the different reform proposals fit together. By providing a coherent, integrated vision for IMF surveillance, we intend to set out the goalposts for the ongoing policy debate.

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[6] An example of political interference in the Fund's daily operations is that the Executive Board discusses *every* country's Article IV consultation. In our view, the Board should concentrate on the Fund's strategic framework, rather then "micro-manage" the work done by Fund staff.

[7] Over 20 percent of reviews for emerging markets were withheld from publication in 2005, with much higher rates for countries in Asia, the Middle East and the Western Hemisphere, where most systemically important emerging markets are found (International Monetary Fund 2006a). Publication lags for emerging markets are considerable, with the average report being published nine months after completion of the initial staff document. And of those made public, nearly a fifth are published with significant deletions.

[8] The Fund rarely uses existing procedures to discuss policies inconsistent with Article IV obligations. For instance, the *1977 Decision* contains the possibility to engage in special consultations, but in practice such consultations are never undertaken (International Monetary Fund 2006b).

3 A New Vision for IMF Surveillance

In order for the Fund to fulfill its role of maintaining a well-functioning international monetary system, surveillance must have clearly defined objectives and must be properly focused. Moreover, surveillance needs to be supported by a suitable institutional framework, including the commitment of its members to the surveillance process, and sufficient credibility and legitimacy to implement it. Ideally, the institution (i) is transparent, (ii) has sufficient operational independence, and (iii) is held accountable for its actions (Maier and Santor 2007). In what follows, we offer reforms that seek to address these challenges.

Box 1: The ongoing IMF Strategic Review

The IMF's Managing Director De Rato discussed a review of the Fund's *Medium Term Strategy* at the IMF Annual Meeting in 2005 (De Rato 2005). On surveillance, the review acknowledges that the IMF has to improve its analysis of risks to international economic stability, including trade and payments imbalances, currency misalignments, and financial market disturbances. Consequently, the IMF staff has explored the merits of revising the *1977 Decision* and the adoption of a *Remit*. These issues have been discussed at meetings of the IMF's Executive Board, and on June 15, 2007, the Board approved the New Surveillance Decision.

More specifically, the Executive Board has (i) exchanged views on the launch of multilateral consultations for addressing global imbalances, (ii) explored reviewing the *1977 Decision on Surveillance over Exchange Rate Policies*; (iii) participated in a seminar taking stock of the treatment of Exchange Rate Issues in Bilateral Surveillance, and (iv) discussed setting a new *Surveillance Remit* (see the IMF press release on November 30, 2006).

3.1 An operational proposal

Our framework consists of three mutually reinforcing parts: the *Guidelines for Economic Policy Frameworks,* the *Remit*, and a *Framework for Assessing Surveillance*, part of which is related to how the Fund should communicate surveillance.

1. The *Guidelines for Economic Policy Frameworks* establish the objectives and scope of IMF surveillance, and the criteria by which member's economic policy frameworks will be evaluated. They also outline members' obligations to the surveillance process. The *Guidelines* can be viewed as the general principles on which surveillance should be based.
2. The *Remit* sets out the IMF's obligations in the conduct of surveillance. It establishes the priorities for surveillance and a procedure to hold the Fund accountable.
3. As per the *Remit*, the IMF will be held directly accountable for conducting surveillance. As an important part of surveillance is communication, we include procedures to ensure a candid and transparent process in our *Framework for Communicating and Assessing Surveillance*. These set out the criteria on which assessment of IMF surveillance will be conducted.

This framework does not create new obligations for members. The framework will achieve two main goals. First, we create a process for surveillance by consolidating existing commitments of members in a single document (the *Guidelines for Economic Policy* Framework). Second, we limit the focus of IMF surveillance by requiring that policy advice is restricted to areas relevant for external stability. This reduces the areas covered by IMF surveillance, and limits the conditions members have to meet during the surveillance procedure. In particular, surveillance over domestic policies will not become an obligation for members, as domestic policies will only be considered as they relate to external stability. In what follows, we discuss the three parts of the framework in turn.

3.2 Guidelines for members' economic policy frameworks

The *Guidelines* are the key to our vision, as they set out the core principles by which surveillance should be conducted. There are four main elements to the *Guidelines for Economic Policy Frameworks*: obligations of members, objectives, scope, and how surveillance should be conducted.

A. Obligations of Members

The *Guidelines* are a restatement of each member's general commitments under Section 1, Article IV of the IMF's Articles of Agreement. Article IV contains both the objectives of Fund surveillance and the obligations for members. Specifically, the Articles and the consultations that the IMF conducts encourage members to "direct their economic and financial policies towards … fostering orderly economic growth with reasonable price stability" and to "avoid manipulating exchange rates or the international monetary system … to prevent effective balance of payments adjustment". These obligations remain as valid today as they were in 1944. However, the objectives, principles, and obligations of members (and the guidelines by which they objectives will be achieved) have been adapted to reflect the current and likely future global economic environment.

B. Core objective for economic policy frameworks

The core objective of surveillance under the *Guidelines* is for members to maintain economic policy frameworks that support external stability and promote orderly adjustment, and thus contribute to a stable and efficient *market-based international financial system*. A market-based international financial system is one in which the allocation of resources is primarily determined by market mechanisms.

This core objective has both a positive and a normative element. First, it reflects that in today's world, financial markets are *de facto* the principal means of allocating resources within and across economies (regardless of the degree to which market forces act in local economies). Second, from a normative perspective, it recognizes that the creation of more complete financial markets, i.e. deep and liquid markets free of non-market distortions, is the best means of facilitating allocative efficiency and diversification of risk across markets and time. By promoting the creation of complete markets and international financial stability, the IMF helps to facilitate the exchange of goods, services and capital among countries, which ultimately increases economic welfare.

C. Guidelines for economic policies: the scope of surveillance

Having defined this core objective, IMF surveillance should aim to address policies that affect external stability, prevent orderly adjustment, undermine the creation of complete markets, or that create negative spillovers between countries. This restricts the focus of surveillance to policies relevant for achieving these objectives. We can identify four key policy areas: exchange rate, monetary, fiscal and financial policies. Governments' economic policy frameworks in these four areas should be jointly consistent, and directed towards contributing to external stability, by removing existing distortions to market adjustment mechanisms, and by promoting policies that serve to complete markets.[9]

The focus on the four core macro policy areas implies that less attention will be devoted to domestic policies or structural issues, such as a country's health care system, liberalization of the energy sector, pension reform or flexibility of labour markets. While sound policy in these areas may be important to create economic growth, they should not be the focus of IMF surveillance, if they are not directly relevant to the maintenance of external stability.[10] To make this operational, a set of *Guidelines for Economic Policy Frameworks* are contained in Annex A.

While the objectives set out in the *Guidelines* are, in many ways, best practice standards, IMF surveillance must take into account country-specific circumstances in its analysis and policy commentary. The membership of the IMF is heterogeneous in terms of the level of development, market completeness, and the technical capacity to implement specific policy frameworks. Consequently, it is unlikely that many low and middle-income countries will be able to abide immediately by the policy frameworks set out in the *Guidelines*. The IMF will thus need to be sensitive to local conditions in the conduct of surveillance. Nevertheless, as low-to-middle income members develop, they should strive towards achieving best practice for exchange rate, monetary, fiscal and financial policy frameworks. IMF surveillance should facilitate this process by enhancing the movement of these economies along the development path and their transition into the international monetary system.

D. The Conduct of Surveillance

Having defined benchmarks to evaluate members' economic policy frameworks, the conduct of bilateral surveillance should proceed as follows. Countries are free to choose their preferred economic policy frameworks. For instance, they can choose a fixed or flexible exchange rate, depending on their circumstances, including their level of economic development. Countries are encouraged to self-identify their policies and report them to the IMF. Such self-identification of policies would represent best practice, but the Fund can assist countries in the identification process, if desired. Member self-identification bolsters the legitimacy of surveillance, since it creates a benchmark against

[9] This approach differs from a model-based assessment of exchange rates. By examining the mechanisms underlying real adjustment, it no longer requires calculation of "equilibrium exchange rates".

[10] For example, the 2006 Article IV consultation for Canada explored issues such as female labour participation, unemployment insurance programs, and immigration policies. None of these issues are linked to Canada's external stability. This is not to encourage countries to adopt inefficient domestic policies. However, other institutions like the OECD or the World Bank are better suited for advice on policies to generate economic growth.

which members can be held accountable. The use of these policy frameworks as benchmarks makes the process more transparent, and ensures that the specified frameworks recognize the different economic circumstances and policy preferences of each country.

Based on the self-identified policy frameworks, the IMF assesses whether the policy frameworks are consistent, and whether they are, in fact, being implemented. Under the *Guidelines*, a surveillance issue would arise if, for example, a country attempts to maintain a fixed exchange rate, free capital flows and an autonomous monetary policy at the same time. Further surveillance efforts are only required if i) actual policies are not consistent with the self-identified framework and may lead to external instability, [11] ii) a particular combination of policies leads to negative spillovers or is not compatible with promoting an efficient and stable market-based international financial system, or iii) the member fails to adhere to its obligations in the surveillance process.

In conducting multilateral surveillance, the IMF provides members with information on external risks or spill-over effects of policies, and provides recommendations for policy action. Where coordinated policy actions are required, it performs time-limited multilateral or bilateral (special) consultations to discuss the policies of a country or group of countries posing a risk to the financial system. Moreover, the risks identified by multilateral surveillance can feed back into the bilateral surveillance process, making countries aware of potential problems, or how they may be contributing to them.

As an institution, the IMF has a comparative advantage in the conduct of multilateral surveillance relative to markets, since it has considerable expertise in analyzing and modeling the world economy and has a longer policy horizon.[12] If surveillance is conducted based on these guidelines, the Fund identifies and makes recommendations to mitigate market-distorting policies. This approach promotes the development of more complete markets, while acknowledging and accounting for the reality that members may be at different points on the transition path of economic development. Having set out the objectives and scope of surveillance, we now turn to discussing the obligations of the Fund for the conduct of surveillance.

3.3 The Remit

The *Remit* is a directive from the IMF's members to the Managing Director and the Staff that specifies the general principles under which surveillance is conducted. The *Remit* serves several fundamental purposes:

- stating the obligations of the IMF for the conduct of surveillance;
- clearly defining the objective of surveillance and delineating its scope through reference to the *Guidelines*;

[11] A case for further investigation could exist if, for instance, countries pursue a set of exchange rate policies that inhibit real exchange rate adjustment.

[12] For instance, apart from the models employed at the FED Board of Governors, the IMF's *Global Economic Model* is perhaps the most advanced model of its kind in the world. Clearly, economic models have limitations and should not be the only source of policy assessment. Still, the fact that similar types of models simply do not exist in the private sector is an indication of the IMF's comparative advantage in analyzing multilateral issues.

- reaffirming members' commitments under their Article IV obligations, on a regular basis (e.g. every 1-3 years);
- setting the priorities for multilateral surveillance, and updating them regularly;
- promoting independence in the IMF's daily operations, while holding the Fund accountable for the conduct of surveillance;

As the institutional basis of a renewed commitment between members and the Fund, the *Remit* emphasizes the importance of existing obligations by setting them within a formal framework. It creates a symmetric relationship between the obligation of the Fund to conduct surveillance, and the responsibility of members to facilitate the surveillance process. In essence, members charge the Fund to conduct surveillance and, in return, agree to recognize its role and respond to the policy advice it has generated. This renewed commitment underscores the notion that Fund surveillance is effective only if all members actively participate in the process.

The *Remit* bolsters the effectiveness of IMF surveillance through several channels. First, by giving the Fund a clear mandate for surveillance, the *Remit* increases the IMF's accountability. Put simply, the obligation of the Fund to fulfill its mandate and the duty of members to hold it to account aligns the incentives of all parties. Second, by clearly identifying the obligations of all parties and the process by which Fund surveillance will be conducted and evaluated, the *Remit* augments (and in fact requires) transparency. Third, the *Remit* underscores the importance of operational independence: greater accountability and transparency are only meaningful if the Fund has the freedom to carry out its surveillance activities unimpeded by political considerations. Operational independence also helps to ensure the objectivity of the Fund's analysis, and increases the traction of surveillance on the economic policies of members. Also, as the scope of surveillance is reduced to policies relevant for external stability, all members will be treated equally. Hence, IMF surveillance would become more even-handed.

Finally, the *Remit* incorporates the delineation of the scope of IMF surveillance as presented in the *Guidelines*. The *Remit* highlights the importance of multilateral surveillance and its interaction with bilateral surveillance. How the IMF communicates surveillance, and thus also held accountable, is discussed in the following sections.

3.4 A Framework for Communicating and Assessing Surveillance

As per the Remit, the MD and, indirectly, IMF senior management and the staff, are accountable to the Executive Board for the conduct of surveillance. In order to hold them accountable, one needs easily verifiable, objective criteria to assess their actions and their effects. However, it is difficult to measure the effects of surveillance– e.g. "a well-functioning international financial system" is not an operational criterion – and thus the assessment of surveillance cannot focus exclusively on economic outcomes (Duignan and Bjorksten 2005). Therefore, we propose a *Framework for Communicating and Assessing Surveillance* that emphasizes qualitative measures as the basis of assessment.

Let us start by looking at communication. To evaluate surveillance, transparency about the Fund's actions and recommendations is needed. Clear communication is also an important element for making surveillance more effective. We propose two significant changes: greater transparency in communicating surveillance, and a process for cases in which members are not meeting their obligations to the surveillance process. Each will be considered in turn.

Communicating surveillance

To increase the effectiveness of surveillance, the incentives for national authorities to pay attention to the policy recommendations needs to be increased. Past experience has shown that the peer pressure exerted through meetings of the IMF's Executive Board may not be sufficient (Fischer 1999). We propose that the IMF is obligated to communicate its surveillance activities in a complete, timely and transparent manner. As a result, publication of Article IV reports – the main channel of bilateral surveillance – should be considered best practice. Similarly, multilateral surveillance efforts should be openly conveyed through the *WEO* and *GFSR*.

Regular communication and transparency will permit early identification of problems, and help to avoid situations in which the IMF is reluctant to be transparent for fear of triggering a crisis. This enhances the effectiveness of surveillance through public disclosure. Clear communication will also help to avoid mission creep, since IMF surveillance activities are easily monitored.

While a majority of countries are likely to comply with their obligations, there might be instances where policy frameworks are inconsistent and entail negative spillovers, and thus have negative implications for the international financial system. Similarly, cases could arise where members persistently fail to honour their obligations. In such an instance, the IMF may want to implement a policy in which the Fund will gradually increase the level of transparency of its surveillance findings to provide countries with incentives to address IMF concerns.[13] This mirrors schedules used by financial regulators when dealing with problematic banks.[14] For instance, one could think of a clearly outlined sequence of actions, beginning with a confidential expression of concern to the authorities, gradually progressing to special consultations, and ultimately leading to full public disclosure of the Fund's analysis. An example of such a schedule with "escalating transparency" is discussed in Annex C.1. By specifying a pre-announced sequence of information releases, the IMF gives local authorities time to react and to implement policy reforms. Moreover, it provides guidance to financial markets in judging the Fund's concerns.[15]

[13] According to the *1977 Decision*, the IMF can consult with the countries if they fail to comply with its advice. If such consultations do not resolve the issue, the IMF might bring the issue to the Executive Board. Throughout this process, however, confidentiality is the overriding principle. Note that the *1977 Decision* contains provisions to deal with non-complying members (such as a procedure to call "*Special consultations*"), but in practice they are not invoked.

[14] See the "*Guide to Intervention for Federal Financial Institutions*" of the Office of the Superintendent of Financial Institutions (downloadable at www.osfi-bsif.gc.ca).

[15] A necessary condition for increased transparency to affect financial markets is that the Fund actually produce useful information. If IMF surveillance does not "add value", countries and financial markets will ignore its findings. At the same time, if the Staff is wrong in its assessment, incorrect signals to markets could cause unwarranted economic disruption and weaken the Fund's credibility. To mitigate these issues, it is important that the Fund be held accountable for conducting and communicating surveillance.

Assessing surveillance

To ensure that our communication procedures will be followed by the Fund, they are part of the *Framework for Assessing Surveillance*. In order to hold the MD and the staff accountable, they will be assessed on whether they have, ex ante, identified the correct priorities and taken the right steps in the conduct of surveillance, including effective communication and the appropriate degree of transparency. Additionally, one could examine whether the correct set of procedures has been followed when conducting bilateral and multilateral surveillance.

To this end, our *Framework for Assessing Surveillance* (see annex C.2) includes criteria focusing on the quality of the Fund's economic analysis, the advice given, and the communication procedure. A transparent assessment process will also help to address the potential problem of political considerations influencing the conduct of surveillance. Lastly, the IEO could perform periodic assessments based on these criteria.

3.5 The benefits of surveillance reform

Taken together, the three elements of our vision for IMF surveillance reform create an integrated process, which should ultimately lead to improved surveillance and better policy advice. These reforms are beneficial for all members, but particularly so for emerging market economies. Emerging economies are generally more vulnerable to adverse global developments, and the reaction of financial markets to negative news can be difficult to predict. Improving their resilience to negative shocks is therefore an important goal for IMF surveillance. More specifically, emerging markets are vulnerable to two important types of negative spillovers:

- first, adverse global economic events (such as a disorderly unwinding of global imbalances);
- second, negative spillovers, for instance when other emerging markets find themselves in a difficult situation.

Our vision for IMF reform yields improvements on both aspects: first, by setting up a clear process, all countries will be treated equally. This means that all countries receive the same candid and transparent assessment. Clarity about potentially adverse economic developments triggered by systemically important economies may help reduce the likelihood of negative global events. And second, surveillance reform along our proposals will help financial markets to better distinguish between emerging markets. A thorough and unbiased surveillance process, identifying those members implementing good policies, helps financial markets in their assessment, if negative shocks were to occur. Consequently, countries are less likely to experience sudden reversals of capital flows when potentially damaging spillovers are mitigated by good policies. And lastly, our principles-based *Guidelines* have emphasized the need for flexibility as the core objective for economic policy frameworks. As indicated before, countries can decide to peg their exchange rate, if they wish. However, by taking into account a broad set of indicators to see whether countries allow real adjustment, the *Guidelines* go beyond a pure model-based assessment of exchange rates.

4 Conclusion

Policymakers and the IMF are currently engaged in efforts to reform IMF surveillance. We have argued that the objectives, scope and conduct of IMF surveillance are neither sufficiently well-defined, nor sufficiently focused on external stability and multilateral issues. Furthermore, a lack of transparency, accountability and operational independence does not provide the proper incentives for the conduct of surveillance. In order for the Fund to play a key role in crisis prevention, reforms of IMF surveillance must address these issues.

To this end, we propose a set of *Guidelines for Economic Policy Frameworks* for members that serve a dual purpose: first, as a set of best practice guidelines for members' economic policy frameworks, and second, as a benchmark for the conduct of surveillance. We also propose a series of reforms to ensure that the IMF becomes more transparent, and is held accountable for its actions. Our reforms are principles-based, that is, they go beyond the question whether one (relatively arbitrary) variable is beyond a certain threshold. Instead, by focusing on fostering a market-based international financial system as the core objective of IMF surveillance, our list of indicators in the *Guidelines* is closely linked to addressing policies undermining external stability, preventing orderly adjustment, or creating negative spillovers between countries.

These reforms, we would argue, are in the interest of all members, since they can expect to receive focused, high quality bilateral and multilateral surveillance in a transparent and candid manner. Special benefits arise for emerging market economies, since effective multilateral surveillance will help to protect them from being side-swiped by adverse global economic events. They should also benefit from the fact that our reform proposals will ensure that surveillance is conducted in an even-handed and consistent manner for all members, implying that external stability of developed and developing will be assessed on the basis of the same criteria.

That said, a number of caveats should be mentioned. The effectiveness of surveillance hinges critically upon members' level of commitment. IMF surveillance will only be able to influence national economic policies if all countries recognise the value of a stable and efficient international financial system, and the IMF's role in achieving this goal. Such cooperation is vital for the success of any international institution. IMF surveillance must also be forward looking and flexible, to accommodate and encourage the ongoing development of an increasingly market-based international financial system. In particular, IMF surveillance should continue to adapt to a world in which emerging markets are playing an ever-increasing role, and be ready to re-examine its role in light of these trends. This will help to ensure that its efforts are successfully directed towards minimizing risks and vulnerabilities, and generating sustainable global economic growth.

The ultimate test of whether surveillance is effective is whether it leads to better policies and preserves the stability of the international financial system. This requires the IMF to be in a position to provide candid, open, and even-handed surveillance. To bring about this change, implementing these proposals would be a great step forward.

Annex A: Guidelines for Economic Policy Frameworks

1. Core objective and principles

1.1 Objective

In light of their Article IV obligations, members *agree* to maintain economic policy frameworks that support a stable and efficient market-based international financial system, thus promoting the IMF's objective of contributing to global economic prosperity by facilitating the exchange of goods, services and capital among countries.

1.2 Principles

To achieve this *objective, members agree* to establish frameworks for their exchange rate, monetary, fiscal and financial sector policies. In formulating their policies, members shall take into consideration the *Guidelines for Member's Policy Frameworks*. Upon request, the Fund shall assist members in the identification of their frameworks. Members will establish policies that:

- are jointly consistent;
- are consistent with obtaining external stability, promoting orderly external adjustment, and reasonable price stability;
- take into account the interdependence of member countries in order to limit and mitigate any negative spillovers from their policy framework on other members.

Given these principles, in carrying out *bilateral surveillance*, the IMF shall:

- evaluate whether member's exchange rate, monetary, fiscal and financial policy frameworks are adequately specified, jointly coherent and are consistent with external stability;
- assess whether members are following their identified policies;
- evaluate the international spillover effects of any deviations from their exchange rate arrangements and policy frameworks;
- assess the implications for the member of the external risks and spillovers identified through multilateral surveillance and propose policy recommendations

In carrying out *multilateral surveillance*, the IMF shall:

- provide members with information on external risks or any spill-over effects of policies in systemic countries and provide recommendations for policy actions;
- allow the Fund to call time-limited multilateral or bilateral (special) consultations to discuss the policies of a country or group of countries posing a risk to the international financial system.
- address the priorities for surveillance the next year as set out in the annex to the *Remit*

2. Members' obligations

In support of the above stated objective and principles, members agree to

- identify their respective policy frameworks to the IMF and update them annually;
- implement policies that are consistent with these frameworks;
- allow the IMF to independently assess whether members are following their stated policy frameworks and evaluate the international spillover effects of any deviations from their stated policy frameworks;
- permit the publication of IMF Article IV reports that will include these assessments and evaluations;
- allow the IMF to conduct special bilateral or multilateral consultations with respect to the assessment and evaluation of the member's policy framework;
- cooperate fully with any special bilateral or multilateral consultations and permit the publication of the proceedings.

3. Policy Frameworks

This section describes the guidelines for the respective exchange rate, monetary, fiscal and financial policy frameworks that each member country reports to the IMF. Each of the four economic policy frameworks should be jointly consistent with each other.

3.1 Exchange Rate Framework

i) members can choose an exchange rate regime that they feel is suitable to their own economic circumstances;

ii) the exchange rate regime should consist of a unified exchange rate that is convertible for current account transactions;

iii) regardless of the exchange rate regime chosen, economic policies must facilitate effective balance of payments adjustment by allowing real exchange rate adjustment over the medium-term;

iv) in accordance with (iii), countries should not engage in prolonged large scale sterilized intervention in one direction.

3.2 Monetary Policy Framework

i) members shall ensure that their exchange rate and monetary policies are jointly consistent;

ii) monetary policy should aim to achieve reasonable price or nominal exchange rate stability (depending on the choice of exchange rate regime) over the medium term;

iii) the central bank should be given sufficient independence to achieve these alternative goals, for which it will be held accountable;

iv) the goals and implementation of monetary policy should be communicated transparently, in accordance with the standards and codes developed on Monetary Policy Transparency.

3.3 Fiscal Policy Framework

i) fiscal policy should strive to manage public resources in an efficient and sustainable manner;

ii) public debt sustainability over the medium-term should be a key principle of fiscal policy;

iii) public deficit financing should be debt-based and consistent with the member's monetary and exchange-rate policy;

iv) members should work towards the development of a transparent fiscal policy, in accordance with the standards and codes on Fiscal Transparency.

3.4 Financial Policy Framework

i) financial sector policies should aim to promote a stable and efficient financial system;

ii) administrative measures (e.g. capital controls) that attempt to reconcile inconsistent monetary, exchange rate and fiscal policies by limiting the impact of market forces, should be eliminated over the medium term;

iii) members should aim to work towards meeting the standards and codes on Financial Policy Transparency;

iv) members should aim to participate in and allow the publication of Financial Sector Assessment Programs (FSAPs) and Reports on Standards and Codes (ROSCs);

v) financial system regulation and supervision should be given sufficient independence to pursue a preventative approach to maintaining domestic financial stability.

Annex B: Annual remit for IMF surveillance

Under Article IV it is recognized that a stable and efficient international financial system is a joint responsibility of the IMF and its member countries. The role of the Fund is to oversee the effective operation of this system. In turn, members have the obligation to implement external and domestic economic policies that are consistent with this objective. The IMF is tasked with monitoring member's adherence to such policies, just as it is the obligation of members to collaborate with the Fund and each other to ensure effective surveillance.

To re-affirm this mutual commitment, members agree to provide the IMF with a mandate, or remit, to carry out bilateral and multilateral surveillance. The following principles define this mandate:

i) The purpose of IMF surveillance is to promote a stable and efficient international financial system;

ii) Surveillance shall be implemented according to the *Guidelines for Surveillance*;

iii) Surveillance over all members shall be conducted in an objective and even-handed manner;

iv) Members shall cooperate fully and actively with the Fund as it conducts its surveillance activity.

In addition, for *bilateral surveillance*, it is established that:

i) Members shall re-affirm their Article IV commitments to implementing economic policies that are consistent with external stability;

ii) Members shall grant the Fund a mandate to carry out surveillance over their economic policies to ensure their adherence to their Article IV commitments.

Moreover, for multilateral surveillance, the IMF

i) Shall address the priorities for multilateral surveillance as set out in the annex to this remit;

ii) Call multilateral consultations if required.

The Managing Director shall report to the Executive Board and be held accountable for the conduct of surveillance against this remit. The Executive Board has the obligation to assess the effectiveness of the Fund's surveillance. The Fund must provide the Executive Board with all the information necessary for the assessment of its performance in a complete and timely manner. The evaluation of surveillance shall be based on the criteria set out in the *Framework for Assessing Surveillance*. The Executive Board must indicate areas in which the Managing Director has not fulfilled his surveillance mandate and recommend action. The assessment of surveillance should be reported annually to the IMFC and periodically to the Board of Governors. The conduct of surveillance will also be the subject of an independent assessment.

Annex to the *Remit*: Examples for Priorities for Multilateral Surveillance

The following priorities have been identified by members as key objectives for multilateral surveillance:

1 The orderly resolution of global payments imbalances;

2 External stability in the context of a potential rise in world interest rates; and

3 External stability in a context of high oil prices and possible oil market shocks.

Members shall assess the Fund's implementation of these surveillance priorities at the end of the assessment period. In doing so, they will evaluate whether these issues were addressed in an efficient and timely manner, the content of the Fund's analysis, and the Fund's communication of its analysis and recommendations.

Annex C: A Framework for Communicating and Assessing Surveillance

C.1: Communicating surveillance

The following principles will guide the IMF's communication of surveillance:

Commitment to transparency. The IMF has an obligation to communicate its surveillance in a complete, timely and transparent manner.

Full publication. The publication of Article IV reports, the main channel of bilateral surveillance, is mandatory, as is the publication of any multilateral surveillance critical to implementing the surveillance remit.

Prudence. The timing of public disclosures should take into account the potential for negative market reaction. However, full disclosure of surveillance must occur within a relatively short period.

Escalating transparency. The communication procedure for dealing with members in breach of their obligations follows a fixed and public schedule:

1. **Confidential expression of concern:** the Fund confidentially indicates to the member that it perceives a violation of obligations and discusses remedial steps.
2. **Confidential Board discussion:** If authorities do not address the Fund's concerns, the issue will be brought to Executive Directors for a confidential discussion.
3. **Special consultations:** The Fund publicly announces that it is sending a special mission to gather more information and to formally consult with authorities. At this stage, it is not necessary to expose details of the mission.
4. **Public communiqué on special consultations:** The Fund comments on the results of the consultations. If an agreement cannot be reached, the Fund will make its concerns public. In either case, the Fund provides markets with a synopsis of the issue at hand.
5. **Publication of IMF analysis:** A detailed analysis is released to the public, explaining the Fund's concerns and the authorities' reluctance to address them. If authorities are clearly collaborating with the Fund at this stage, publication could be withheld until a full evaluation of the country's proposed corrective action is completed.
6. **Publication in the *WEO* or the *GFSR*:** A synopsis of the analysis in step 5 could be made available to a much wider audience, time permitting.
7. **Discussion at the IMFC:** This measure represents an expression of deep concern to global authorities. It should be based on the published analysis in step 5.

C.2: Assessing Surveillance

Criteria by which the IMF will be assessed under the surveillance remit include:

1 General: Did the IMF
   - i) conduct surveillance in an even-handed and unbiased manner?
   - ii) conduct surveillance using state-of the art economic techniques and appropriate methodologies?
   - iii) clearly publish inputs used for its assessment and reveal assumptions underlying its analysis?
   - iv) communicate its surveillance findings following the Communication procedure (see annex C)?
   - v) conduct surveillance on the special issues indicated in the remit?
   - vi) devote the needed resources to surveillance?

2 Bilateral Surveillance: Did the IMF
   - i) conduct surveillance over the internal consistency of members' stated and actual economic policy frameworks (exchange rate, monetary, fiscal, financial)?
   - ii) identify policy framework inconsistencies?
   - iii) identify spillovers?
   - iv) provide appropriate advice to members?
   - v) in the case of non-compliance, invoke the process of escalating transparency?
   - vi) identify countries at risk of a crisis and their possible spillovers?

3 Multilateral Surveillance: Did the IMF do the following
   - i) identify appropriate and relevant multilateral surveillance issues?
   - ii) provide suitable policy advice?
   - iii) call multilateral consultations as needed?
   - iv) consult the appropriate set of countries?

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