

Renewing IMF surveillance: Transparency, accountability, and independence

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Received: 27 January 2008 / Accepted: 27 June 2008 /
Published online: 22 August 2008
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Abstract In this paper, we present a vision for IMF surveillance that seeks to produce a more accountable, transparent, and independent surveillance process. First, to make surveillance more focused, the IMF's assessment should be principles-based; that is, the Fund should assess the overall coherence of exchange rate, monetary, fiscal and financial policies, with a view to analyzing their effects on external stability. Second, the IMF should have a governance structure that increases incentives to support candid, transparent assessments of surveillance. In practice, this entails a different role for the Executive Board: the Board will set out the Fund's strategic framework for surveillance; the Managing Director and the staff will conduct surveillance. These reforms clarify the roles and responsibilities of the IMF and its member countries in the surveillance process. Also, our proposed reforms aim at making surveillance more even-handed and objective. 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.

Keywords International Monetary Fund · Surveillance

JEL Classification F33

1 Introduction

The IMF's former Managing Director (MD) Rodriguez de Rato launched a review in mid-2004 of the Fund's role, and presented a medium-term strategy at the IMF Annual Meetings in September 2005. This review of the IMF presents an 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 by many policymakers,

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including the Bank of England (King 2006a), the Bank of Canada (Dodge 2006), the U.S. Treasury (Adams 2005), and the IMFC (2006). The recent approval of the *2007 Decision on Bilateral Surveillance* (henceforth: *2007 Decision*)—which replaced the *1977 Decision on Surveillance over Exchange Rate Policies*—is a clear sign that the IMF has recognized the importance of surveillance reform. But while most agree that the IMF is *the* institution charged with surveillance of the international financial system, it is less clear how the *2007 Decision* will contribute to this goal in practice.

In this paper, we argue that the new *2007 Decision* is an important step towards better surveillance, but that additional reforms are needed. First, to make surveillance more focused, a principles-based approach is needed. Specifically, 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. However, the effectiveness of surveillance relies not just on its technical application, but more generally, on the existence of an appropriate incentive structure. Specifically, incentives should be put in place to ensure candid, transparent assessments of surveillance. An important element of this, for example, is to establish procedures that evaluate, and hold to account, the staff's and MD's performance in implementing the *2007 Decision* (i.e. did they conduct surveillance in an even-handed and unbiased manner; did they restrict surveillance to those issues related to external stability, and avoid discussion of unrelated structural issues). Moreover, the IMF should have a governance structure that supports these incentives. Simply, we aim to promote an IMF that is more accountable, more transparent, and that has greater operational independence.

In practice, this vision for IMF surveillance entails a different role for the Executive Board. We propose that the Board sets out the Fund's strategic framework for surveillance, and staff should be given sufficient operational independence to conduct surveillance. By clarifying the roles and responsibilities of the Executive Board and the staff, respectively, the Fund can be held accountable for the conduct of surveillance. We believe that this approach can bolster the credibility and legitimacy of surveillance, giving the Fund greater influence on the economic policies of members. Also, our framework makes surveillance more even-handed and objective, as members can hold the Fund accountable. This improves the overall conduct of surveillance. While we do not expect the Fund's policy advice to be perfect in all cases, our proposal would ensure that the right incentive structure is in place to increase its overall quality.

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 *2007*

Decision on Bilateral Surveillance. The 2007 *Decision* exemplifies how the IMF has recognized the need to keep its instruments up to date. The previous framework, as embodied in the 1977 *Decision on Surveillance over Exchange Rate Policies*,¹ emphasized that surveillance preserve a system of stable exchange rates.² 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. But in a world where more and more countries adopt flexible exchange rates, a system of stable exchange rates is no longer a suitable objective for surveillance. Similarly, the 1977 *Decision* was in need of an overhaul in that it dates back from a time when crises were primarily balance of payment-crises, with limited economic spillovers. Since then, the world has become more integrated, and countries have become more vulnerable to cross-border shocks and policy spillover effects. Crises in both developed (i.e. the U.S subprime crisis) and developing (i.e. the Asian crisis) countries can lead to contagion in financial markets and impact real economic growth. The consequence of these developments in the world economy is that surveillance is now the primary means by which the Fund pursues its goal of a well-functioning international financial system (King 2006a; Dodge 2006).

2.2 Defining Surveillance: Practice and Challenges

IMF surveillance can be defined 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). Note the difference between bilateral and multilateral surveillance:

- Bilateral surveillance refers to the surveillance of individual countries and is conducted through Article IV consultations³, 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 2007b), 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 feed back into discussions with individual countries in the context of bilateral surveillance.

¹ We refer to the 1977 *Decision on Surveillance over Exchange Rate Policies* as the 1977 *Decision*.

² The Bretton Woods system allowed for the orderly adjustment of exchange rates.

³ During the so-called Article IV consultations, IMF staff analyses and assesses a country’s economic development and the economic policy. At the end of the consultation, the IMF presents a report to its Executive Board for discussion. Article IV consultations are conducted on a periodic basis.

2.3 Challenges in the IMF's Surveillance Framework

There are a number of concerns with the current approach to surveillance:

- Surveillance remains overly focused on country-based, bilateral analysis, and 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).

The new 2007 *Decision* will be able to address many of these weaknesses (see Box 1). But the weaknesses of Fund surveillance go deeper: Concerns have also been raised that the institutional framework of the Fund does not adequately support candid and effective surveillance:

Box 1: The ongoing IMF Strategic Review

Former IMF Managing Director De Rato discussed a review of the Fund's *Medium Term Strategy* at the IMF Annual Meeting in 2005 (De Rato 2005). The review acknowledges that the IMF has to improve its analysis of risks to international economic stability. Consequently, IMF staff has explored the merits of revising the 1977 *Decision*, and the adoption of a "Statement of Surveillance Priorities and Responsibilities."^a 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.

The 2007 *Decision* "outlines the scope of bilateral surveillance and the basis for carrying it out. It reaffirms that surveillance should be focused on promoting countries' external stability. The Fund will examine whether a country's exchange rate and domestic economic and financial policies are consistent with this objective, implying that IMF surveillance will only look at policies that can significantly influence prospects for external stability" (International Monetary Fund 2007a).

The 2007 *Decision* also emphasizes the need for surveillance to be candid, even-handed, and based upon "persuasion" and "dialogue." Other Board discussions on surveillance have been aimed at (a) exchanging views on the launch of multilateral consultations for addressing global imbalances, (b) participation in a stock-taking seminar on the treatment of Exchange Rate Issues in Bilateral Surveillance, and (c) setting a new *Surveillance Remit* (see the IMF press release on November 30, 2006).

^a The "Statement of Surveillance Priorities and Responsibilities" is roughly comparable to our Surveillance Performance Agreement (see Section 3.3)

- Political interference in the Fund's daily operations compromises the objectivity of its surveillance (Cottarelli 2005; Fratzscher and Reynaud 2007).⁴

⁴ 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 than "micro-manage" the work done by Fund staff.

- 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).⁵
- Staff tend to prefer a unified view; internal disagreements are generally not revealed to the Board (Crow et al. 1999).⁶
- 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.⁷

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 (a) is transparent, (b) has sufficient operational independence, and (c) is held accountable for its actions (Maier and Santor 2008).

3.1 An Operational Proposal

Our vision consists of three mutually reinforcing parts: the *2007 Decision*, guidance notes for the conduct of surveillance, and mechanisms to ensure accountability and transparency. They are summarized below:

1. The *2007 Decision* outlines the broad scope and objectives of surveillance.
2. The *Guidance Notes* operationalize the *2007 Decision* by establishing criteria for the Fund staff when evaluating members' economic policies.
3. Procedures, including a "Surveillance Performance Agreement," to ensure transparency, candidness, and accountability in the conduct of surveillance.

⁵ Over 20% 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.

⁶ 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).

⁷ Our proposals are inspired e.g. by the Bank of England (King 2006a, b), the U.S. Treasury (Adams 2005), the IMFC (2006) and parallel efforts by the IMF (see Box 1).

Taken together, our proposals are in line with the new *2007 Decision*, and will help implement it. However, we take a different perspective than the *2007 Decision* on one main issue: our proposals align the incentives and interests of members and the Fund alike. In what follows, we discuss the three parts of our vision for IMF surveillance.

3.2 “Guidance Notes” for the Conduct of Surveillance

While the new *2007 Decision* sets out the objective of surveillance, staff is lacking a practical framework to evaluate members’ economic policies. Our *Guidance Notes* set out the core principles by which surveillance should be conducted, based on the IMF’s Articles of Agreement and the new *2007 Decision*. To translate them into practical policies, and to provide a benchmark against which members’ policies can be judged, the *Guidance Notes* clarify the objectives of members’ economic policies, and the scope and conduct of surveillance.

A. Core Objective for Economic Policy Frameworks

Each member’s general commitments are given in Section 1, Article IV of the IMF’s Articles of Agreement: 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 commitments remain as valid today as they were in 1944. To make surveillance operational, however, members’ commitments need to be restated in terms of economic policies. We propose that the core objective of surveillance is for members to maintain economic policies 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.⁸

B. Guidance Notes: The Scope of Surveillance

Having defined this core objective, IMF surveillance should aim to address policies that affect external stability, prevent orderly adjustment, or that create negative spillovers between countries. This restricts the focus of surveillance to policies relevant for achieving these objectives. We identify four key policy areas: exchange rate, monetary, fiscal and financial policies. Governments’ economic policies in these four areas should be jointly consistent,⁹ and contribute to domestic, as well as external, stability.¹⁰

⁸ Ultimately, IMF surveillance should be consistent with the idea 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.

⁹ The term “jointly consistent” means that the different macroeconomic policies all contribute to the same goal. A classical example of an *inconsistent* policy mix is pursuing an independent monetary policy, while aiming to maintain a fixed exchange rate and preserving free movement of capital.

¹⁰ 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.”

The focus on these four core macro policies 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 primary focus of IMF surveillance, unless they are directly relevant to the maintenance of external stability over the medium term.¹¹ For example, the 2006 Article IV consultation for Canada explored issues such as female labor participation, unemployment insurance programs, and immigration policies. None of these issues are linked to Canada's external stability. Likewise, most Article IV reports for members of the Euro Area, while providing many policy recommendations on domestic structural issues, fail to adequately address external stability. To make this operational, an example of the *Guidance Notes* is contained in Appendix A.

While the objectives set out in the *Guidance Notes* 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 all countries will be able to abide immediately by the policy recommendations set out in the *Guidance Notes*. The IMF will thus need to be sensitive to local conditions in the conduct of surveillance. Nevertheless, as countries develop economically, they should strive towards achieving best practice for exchange rate, monetary, fiscal and financial policies. 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.

C. The Conduct of Surveillance

Having defined benchmarks to evaluate members' economic policies, it is desirable that the conduct of bilateral surveillance proceeds as follows. Countries are free to choose their preferred set of economic policies—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 increases the legitimacy of surveillance, since it creates a benchmark against which members can be held accountable. The use of these self-identified policies as benchmarks makes the process more transparent, and ensures that the specified policies recognize the different economic circumstances and policy preferences of each country. Lastly, in order to ensure that the information the IMF uses for surveillance is reliable and consistent across all countries, members

¹¹ There is no a priori list of what issues can be discussed in an Article IV report. Rather, our point is that surveillance, in order to be effective, needs to be focused on issues relevant for 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.

must agree to abide by the standards set out in the Special Data Dissemination Standard (SDDS).¹²

Based on the self-identified set of economic policies, the IMF assesses whether the policies are (a) jointly consistent; (b) being implemented; and (c) whether they contribute towards external stability. Thus, policies that may be jointly consistent but have strong negative externalities or potentially detrimental consequences for external stability would be subject to a critical report. For example, the current economic policies of oil exporters would be reviewed critically. Specifically, in the face of a strong positive terms-of-trade shock, many oil exporters are currently following fixed exchange rate regimes, and are heavily sterilizing their interventions. This is leading to large current account surpluses (and hence deficits with oil importers), but also a lack of real exchange rate adjustment. Ultimately, this lack of adjustment prevents external stability. Further surveillance efforts are only required if (a) actual policies are not consistent with the self-identified policies and may lead to external instability,¹³ (b) 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 (c) the member fails to adhere to its obligations in the surveillance process. In these cases where countries' policies fail to meet the surveillance criteria set out by the IMF (for example, the massive build-up of reserves induced by a fixed exchange rate regime) the Fund has to be a "ruthless truth-teller," if surveillance is to be effective.

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 both bilateral and multilateral surveillance, relative to markets. Commercial institutions, such as large banks, have incentives to focus on the very short-run. The IMF has the resources to send mission teams to countries for extended periods of time, and to conduct analysis over a longer policy horizon. Fund analysis can also be more objective than private institutions, since large banks, for example, may be reluctant to criticize their current or future clients. IMF surveillance can also provide the benchmark for private sector analysis, since the Fund is one of the few institutions that can collect and analyze economic data across countries and across time in a consistent way. And lastly, the IMF has important expertise in analyzing and

¹² The SDDS sets out benchmarks for data quality and integrity amongst the IMF's members.

¹³ A case for further investigation could exist if, for instance, countries pursue a set of exchange rate policies that inhibit real exchange rate adjustment.

modeling the world economy.¹⁴ If surveillance is conducted based on these guidelines, the Fund can make an important contribution by identifying market-distorting policies, and making recommendations to correct their detrimental effects.

Having described the scope and objectives of surveillance, we now turn to institutional devices to make surveillance more effective. The effectiveness of surveillance relies not just on a clarification of its scope, but also requires an appropriate incentive structure. We propose to create an IMF that is accountable and transparent in the conduct of surveillance.

3.3 Accountability, Transparency and Communication

The current governance structure of the Fund does not contribute toward accountability, transparency, and the effective communication of surveillance. To address these issues, we propose several reforms (see also Maier and Santor 2008). To improve accountability, there needs to be a clear delineation between the role of the Executive Board and the staff, respectively, in the surveillance process. To avoid blurred responsibilities, the Executive Board should set the overall strategic direction of surveillance, and staff should be given operational independence to conduct surveillance. To demonstrate this division in functions, we propose a *Surveillance Performance Agreement*. This is a directive from the Executive Board to the Managing Director and the staff, which specifies the general principles under which surveillance is conducted. The *Surveillance Performance Agreement* also creates a mechanism to hold the Fund to account. It will have the following aspects:

- The *Surveillance Performance Agreement* states that the Executive Board holds the staff accountable for the *conduct* of surveillance. This is a pre-condition to giving the MD/staff effective independence in its daily conduct of operations, which helps to address the governance issues discussed in Section 2.3;
- Members reaffirm members' commitments under their Article IV obligations, on a regular basis (e.g. every 1–3 years);
- The *Surveillance Performance Agreement* contains the priorities for multilateral surveillance. Members update them regularly.

Note that the *Surveillance Performance Agreement* does not hold the Fund accountable for the *outcome* of surveillance, as members can decide not to follow the Fund's advice. Therefore, the Fund cannot be “blamed” if members do not follow its advice. However, the Fund can—and should!—be held accountable for giving the right advice.

The *Surveillance Performance Agreement* increases the effectiveness of IMF surveillance through several channels. First, the obligation of the Fund to conduct

¹⁴ For instance, apart from the models employed at the FED Board of Governors and the Bank of Canada, 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.

surveillance and the duty of members to hold it to account aligns the incentives of all parties. Second, by identifying the obligations of all parties and the process by which Fund surveillance will be conducted and evaluated, the *Surveillance Performance Agreement* augments (and in fact requires) transparency. Third, the *Surveillance Performance Agreement* underscores the importance of operational independence: greater accountability and transparency are only meaningful if the Managing Director and staff have the freedom to carry out its surveillance activities unimpeded by political considerations. That is, the MD and the staff can only be held accountable if they have the necessary operational independence to do their job. 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.

Lastly, as the surveillance priorities of the *Surveillance Performance Agreement* are updated every 1–3 years, members reaffirm their commitment to the surveillance process on a periodic basis. This underscores the notion that Fund surveillance is effective only if all members actively endorse the process. How the IMF communicates surveillance, and is thus also held accountable, is discussed in the following sections.

3.4 Communicating and Assessing Surveillance

As per the *Surveillance Performance Agreement*, the Managing Director and, indirectly, IMF senior management and the staff, are accountable to the Executive Board for the conduct of surveillance. To hold them accountable, one needs verifiable, objective criteria to assess their actions and their effects. As it is not straightforward to measure the effects of surveillance—e.g. “a well-functioning international financial system” is not an operational criterion—the assessment of surveillance cannot focus exclusively on economic outcomes (Duignan and Bjorksten 2005). Therefore, we propose qualitative, instead of quantitative, measures as the basis of assessment.¹⁵

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.

3.4.1 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

¹⁵ Similar criteria can be applied to evaluate the quality of financial supervision, see Hüpkes et al. (2005); Quintyn and Taylor (2002).

communicate its surveillance activities in a complete, timely and transparent manner. As a result, we believe that publication of Article IV reports—the main channel of bilateral surveillance—should be mandatory. 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.¹⁶ 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 remind members of basic obligations in the surveillance process confidentially, and provide a clear timeline of when the Fund will publish its surveillance report. This timeline will necessarily be short, since there is little to gain in delaying the assessment.

3.4.2 Assessing Surveillance

We propose qualitative measures for assessing surveillance: the Managing Director and Fund staff 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, it can be examined whether the correct set of procedures has been followed when conducting bilateral and multilateral surveillance.

To this end, our *Assessing Surveillance* (see Appendix 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. It will also allow the Executive Board to hold the MD and staff, if and when there are errors in the conduct of surveillance. We do not expect perfection from the Fund, but wish to have the right incentives in place that will maximize the likelihood of good policy advice. Lastly, the IEO could perform periodic assessments based on these criteria.

3.5 Reform Proposals and the Articles of Agreement

An important consideration for our reform proposals is whether or not they will require changes to the IMF's Articles of Agreement. Simply, getting political support for changing the Articles of Agreement is not easy.

¹⁶ 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.

The bulk of our reform proposals (i.e. clarifying the roles and responsibilities of the Executive vis-à-vis the MD/staff) do not require a change in the Articles of Agreement. Likewise, clarifying the scope of surveillance through “Guidance Notes” would not require formal amendments to the Articles (in fact, the IMF provides guidance notes to staff for the conduct of surveillance on an ongoing basis). The most important issue is the mandatory and timely publication of Article IVs: while not necessarily requiring a change to the Articles of Agreement per se, mandatory and timely publication of Article IVs would require the broad support of the membership. In practice, this would probably entail that a supermajority of 85% of the membership endorses the reform.

3.6 The Benefits of Surveillance Reform

Taken together, the elements of our vision for IMF surveillance reform create an integrated process, which should ultimately lead to improved surveillance and better policy advice. 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. Second, by aligning the interests of members and the Fund alike, we create incentives to provide candid surveillance assessments. Third, surveillance reform along our proposals will help financial markets to better process market information. Clarity about potentially adverse economic developments triggered by systemically important economies may help reduce the likelihood of negative global events. A thorough and unbiased surveillance process, identifying those members implementing good policies, helps financial markets in their assessment, if negative shocks were to occur.

4 Conclusion

Policymakers and the IMF have come a long way recently towards improving IMF surveillance. The new *2007 Decision* has the potential to markedly improve the conduct of surveillance. In the past, the objectives, scope and conduct of IMF surveillance were neither sufficiently well-defined, nor sufficiently focused on external stability and multilateral issues. However, even under the new *2007 Decision*, a lack of transparency, accountability and operational independence does not provide the proper incentives for the Fund to conduct surveillance in a candid manner. Reforming IMF surveillance must go beyond the technical implementation; it also requires an appropriate set of incentives. In order for the Fund to play a key role in the international monetary system, further reforms of IMF surveillance must address these issues.

First, on the basis of current legal obligations, we describe the scope and objectives of surveillance, through a set of *Guidance Notes*, as a benchmark for the conduct of surveillance. By focusing on promoting a market-based international financial system as the core objective of IMF surveillance, our list of indicators in the *Guidance Notes addresses* policies undermining external stability, preventing orderly adjustment, or creating negative spillovers between countries. Second, we propose reforms to ensure that the IMF becomes more transparent, and is held

accountable for its actions. We clarify the roles and responsibilities of the Executive Board and the Managing Director, respectively, in the conduct of surveillance. We argue that the role of the Executive Board is to set the *strategic* direction of surveillance. Then, the Managing Director and the staff are given operational independence in the conduct of surveillance. In this way, the Executive Board, the Managing Director, and the staff can be held accountable for their respective responsibilities. 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.

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 recognize 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 an important step forward.

Acknowledgments We would like to thank Tiff Macklem, John Murray, Graydon Paulin and Larry Schembri, and seminar participants at the Dutch National Bank, Sveriges Riksbank, and Swiss National Bank, for helpful comments. The views expressed are those of the authors and need not reflect those of the Bank of Canada or its staff.

Appendix A: Guidance Notes for the Surveillance of Members' Economic Policies

1. Core objective and principles

1.1 Objective

In light of their Article IV obligations, and the *2007 Decision*, members *agree* to maintain economic policies 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 exchange rate, monetary, fiscal and financial sector 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 economic policies;
- 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 [Appendix](#) to the *Surveillance Performance Agreement*.

2. Members' obligations

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

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

3. Economic Policies

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

3.1 Exchange Rate Policy

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

- (b) the exchange rate regime should consist of a unified exchange rate that is convertible for current account transactions;
- (c) 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;
- (d) in accordance with (iii), countries should not engage in prolonged large scale sterilized intervention in one direction.

3.2 Monetary Policy

- (a) members shall ensure that their exchange rate and monetary policies are jointly consistent;
- (b) 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;
- (c) the central bank should be given sufficient independence to achieve these alternative goals, for which it will be held accountable;
- (d) 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

- (a) public debt sustainability over the medium-term should be a key principle of fiscal policy;
- (b) public deficit financing should be debt-based and consistent with the member's monetary and exchange-rate policy;
- (c) members should work towards the development of a transparent fiscal policy, in accordance with the standards and codes on Fiscal Transparency.

3.4 Financial Sector Policy

- (a) financial sector policies should aim to promote a stable and efficient financial system;
- (b) 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;

Appendix B: Surveillance Performance Agreement

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, by the Executive Board, 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 to carry out bilateral and multilateral surveillance, defined by the following principles:

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

Surveillance shall be implemented according to the 2007 Decision and the *Guidance Notes for the Surveillance of Members' Economic Policies*

- (b) Surveillance over all members shall be conducted in an objective and even-handed manner;
- (c) Members shall cooperate fully and actively with the Fund as it conducts its surveillance activity.

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

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

- (a) Shall address the priorities for multilateral surveillance as set out in the [Appendix](#) to this *Surveillance Performance Agreement*;
- (b) 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 *Surveillance Performance Agreement*. 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.

[Appendix](#) to the *Surveillance Performance Agreement*: 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 ongoing turbulence in global credit markets
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.

Appendix C: 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 Performance Agreement*.

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.

C.2 Assessing Surveillance

Criteria by which the IMF will be assessed under the *Surveillance Performance Agreement* include:

1 General: Did the IMF

- (a) conduct surveillance in an even-handed and unbiased manner?
- (b) conduct surveillance using state-of the art economic techniques and appropriate methodologies?
- (c) clearly publish inputs used for its assessment and reveal assumptions underlying its analysis?
- (d) communicate its surveillance findings following the Communication procedure (see Appendix C)?
- (e) conduct surveillance on the special issues indicated in the *Surveillance Performance Agreement*?
- (f) devote the needed resources to surveillance?

2 Bilateral Surveillance: Did the IMF

- (a) conduct surveillance over the internal consistency of members' stated and actual economic policies (exchange rate, monetary, fiscal, financial)?
- (b) identify policy inconsistencies?
- (c) identify spillovers?
- (d) provide appropriate advice to members?
- (e) in the case of non-compliance, invoke the process of escalating transparency?
- (f) identify countries at risk of a crisis and their possible spillovers?

3 Multilateral Surveillance: Did the IMF do the following

- (a) identify appropriate and relevant multilateral surveillance issues?
- (b) provide suitable policy advice?
- (c) call multilateral consultations as needed?
- (d) consult the appropriate set of countries?

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