



BANK OF CANADA
BANQUE DU CANADA

Discussion Paper/Document d'analyse
2009-10

Strengthening IMF Surveillance: An Assessment of Recent Reforms

by Robert Lavigne and Lawrence Schembri

Bank of Canada Discussion Paper 2009-10

July 2009

Strengthening IMF Surveillance: An Assessment of Recent Reforms

by

Robert Lavigne and Lawrence Schembri

International Economic Analysis Department
Bank of Canada
Ottawa, Ontario, Canada K1A 0G9
Corresponding author: rlavigne@bankofcanada.ca
lschembri@bankofcanada.ca

Bank of Canada discussion papers are completed research studies on a wide variety of technical subjects relevant to central bank policy. The views expressed in this paper are those of the authors. No responsibility for them should be attributed to the Bank of Canada.

Acknowledgements

The authors would like to thank their colleagues at the Bank of Canada for helpful feedback: Robert Lafrance, John Murray, Paul Masson, Timothy Lane, and Eric Santor.

Abstract

The authors assess the potential impact of recently approved reforms to International Monetary Fund (IMF) surveillance; namely, the “2007 Decision on Bilateral Surveillance Over Members’ Policies” and the “Statement of Surveillance Priorities” (SSP). They conclude that these complementary reforms have the potential to create a comprehensive and coherent framework for IMF surveillance. If implemented properly, the reforms could strengthen the effectiveness of surveillance and thus enhance the IMF’s ability to prevent crises and maintain a stable international financial system. Moreover, the impact of the reforms would be increased with a few refinements to the application of the 2007 Decision – in particular, a focus on real exchange rate adjustment, rather than exchange rate misalignment – and some evolutionary amendments to the SSP. In addition, surveillance reforms would be more effective if they were supported by changes to the surveillance review process and by governance reforms that enhance the IMF’s accountability framework and improve member co-operation.

JEL classification: F33

Bank classification: International topics

Résumé

Les auteurs évaluent l’incidence que pourraient avoir les réformes de la mission de surveillance du Fonds monétaire international (FMI) qui ont été récemment adoptées, soit la « Décision de 2007 sur la surveillance bilatérale des politiques des États membres » et la « Déclaration des priorités de la surveillance ». Ils concluent que ces réformes complémentaires ont vocation à créer un cadre exhaustif et cohérent de surveillance. Si elles sont menées à bien, ces mesures pourraient augmenter l’efficacité des activités de surveillance et, partant, rendre le FMI mieux à même de prévenir les crises et de sauvegarder la stabilité du système financier international. Les auteurs notent qu’il serait possible d’accroître l’impact des réformes en affinant la mise en œuvre de la Décision de 2007 – en particulier grâce à une priorité donnée non plus au désalignement du taux de change réel mais à son ajustement – et en favorisant des révisions graduelles de la Déclaration des priorités de la surveillance. Ces réformes seraient également renforcées si elles s’accompagnaient d’une modification du processus d’examen de la surveillance et d’une amélioration de la gouvernance qui viendraient parfaire le cadre de responsabilité du Fonds et faciliter la coopération entre les pays membres.

Classification JEL : F33

Classification de la Banque : Questions internationales

1 Introduction

The ongoing global financial crisis has highlighted the need to improve the effectiveness of the surveillance activities of the International Monetary Fund (IMF, or the Fund).¹ Member countries are demanding that surveillance become more focused on crisis prevention, global financial stability, and international spillover effects.² They have signalled their commitment to reform by adopting the “2007 Decision on Bilateral Surveillance Over Members’ Policies” (IMF 2007). The Decision updates the earlier “1977 Decision on Surveillance over Exchange Rate Policies” (IMF 1977); it aims to upgrade IMF surveillance to current best practices, and in doing so to increase the effectiveness of the Fund’s analysis and policy advice. Members also endorsed the first “Statement of Surveillance Priorities” (SSP) (IMF 2008a), which sets the key priorities for surveillance over the 2008–11 period and establishes a mechanism for holding the IMF accountable for their implementation.

Acceptance of these surveillance reforms, however, has not been universal. Some countries, perhaps motivated by their not-always-favourable experiences with the Fund in the past, have expressed concerns about the implementation of the 2007 Decision.³ Moreover, questions remain about the purpose of the SSP and its effective role in the surveillance process.

Some of these concerns may be linked to the lack of analytical work on the relationship between the 2007 Decision and the SSP. Our paper attempts to fill this gap by explaining how these two reforms are complementary and can be used to lay the foundations for a new surveillance framework that is better suited to face the challenges of global integration. To increase the effectiveness of these reforms, we suggest several measures that are based in part on the framework that Lavigne, Maier, and Santor (2007) propose to improve IMF surveillance. In particular, a compelling case can be made for strengthening the Fund’s accountability mechanisms to better align institutional incentives for improved surveillance, thereby enhancing the IMF’s ability to promote a stable international monetary system.

The paper proceeds as follows. In section 2, we review the IMF reform process to date and outline the key characteristics of the 2007 Decision and the 2008 SSP. Section 3 elaborates on the conceptual framework set out in Lavigne, Maier, and Santor (2007), updating it in light of recent reforms. In section 4 we assess the reforms, discussing their strengths and weaknesses and suggesting some improvements. Section 5 examines how other reform efforts, notably in the area of IMF corporate governance, could enhance the effectiveness of the recent surveillance procedures. Section 6 concludes.

1. IMF surveillance activities are defined as “all aspects of the Fund’s analysis of, scrutiny over, and advice concerning, member countries’ economic situations, policies, and prospects” (Crow, Arriazu, and Thygesen 1999).

2. See IMFC communiqués (2006a, b).

3. For a sample of the concerns expressed by countries, see the International Monetary and Financial Committee statements on behalf of India (Chidambaram 2006), Belgium (Quaden 2006), Argentina (Miceli 2006), Brazil (Mantega 2006), and China (Zhou 2006).

2 An Overview of the Reforms

In 2005, IMF Managing Director De Rato and Fund staff launched the Medium-Term Strategy Review (MTSR) to reassess the way the Fund operates (IMF 2006). Three broad areas of reform were identified to bolster the Fund's role in safeguarding the stability of the international financial system: governance, lending, and surveillance. Significant progress has been achieved in all three areas. After two years of negotiations, the system of quota allocation was modified in August 2007 to help ensure that the Fund's external governance structure better reflects the relative economic importance of each member in the world economy, notably in the case of emerging-market countries. This reallocation is critical for maintaining the IMF's legitimacy, as are ongoing efforts to ensure that quotas continue to reflect members' evolving roles in the global economy. Just as important is corporate governance reform, which aims to improve the Fund's internal decision-making apparatus. The Fund is currently debating governance reforms recommended in reports by the Independent Evaluation Office (IEO 2008), and the Managing Director-mandated Committee on IMF Governance Reform (IMF 2009b).

The reform of lending aims to strengthen the Fund's crisis-prevention efforts and shift the focus of lending away from crisis resolution. The IMF's Executive Board recently approved a new precautionary lending instrument called the Flexible Credit Line, designed for pre-qualifying countries that have sound economic policies and fundamentals. More generally, the IMF is in the process of reviewing all of its lending facilities (IMF 2009a). Concurrently, efforts are under way to ensure that adequate financing is available for these programs via quota increases and an augmentation of the Fund's capacity to borrow from members (G-20 2009).

Surveillance reform, the focus of this paper, aims to increase the effectiveness of the Fund's main crisis-prevention tool. Two key measures were endorsed in the MTSR: the revision of the 1977 Decision, and the introduction of the SSP.

2.1 The 2007 surveillance decision

The 2007 Decision replaces the 1977 Decision, which was designed in an era characterized by relatively inflexible exchange rate regimes and pervasive capital controls. The 1977 Decision was intended to be temporary, reflecting the uncertain period following the collapse of the Bretton Woods System, but it was never fundamentally updated. Over the years, the actual conduct of surveillance diverged significantly from the precepts of the older Decision, such that it eventually ceased to provide meaningful guidance to staff.⁴ The new Decision aims to rectify this situation by establishing principles for effective surveillance in the current environment of widespread floating exchange rates and integrated financial markets. The 2007 Decision:

4. In practice, surveillance branched out into many diverse policy areas with little or no formal guidance from members. Meanwhile, regarding exchange rate surveillance, the one area where staff had specific Board instructions, the Fund usually downplayed its analysis due to the sensitive nature of the topic.

- (i) Clearly defines the objective of surveillance as the maintenance of external stability.⁵
- (ii) Redefines the focus and scope of IMF surveillance, broadening its focus beyond exchange rates⁶ to domestic macroeconomic and financial policies, while limiting the scope of Fund analysis to core policies directly related to external stability.
- (iii) Updates the principles for the guidance of members in the conduct of their exchange rate policies. It specifies that countries should avoid exchange rate policies that cause external instability.⁷
- (iv) Brings greater clarity and specificity to how exchange rates should be assessed in surveillance. Notably, the Fund staff are required to evaluate whether members' exchange rates are "fundamentally misaligned," which involves analysis of the extent of real exchange rate over/undervaluation. The application of this label is one of the potential triggers of IMF special consultations, a measure that has been rarely used in the past because of stigma concerns.⁸ The label of "currency manipulator" is also introduced.⁹
- (v) Specifies that surveillance should be candid and even-handed, taking into consideration country specifics as well as the level of development. It also underscores the co-operative nature of surveillance, which must be based on dialogue and persuasion rather than the strict policing of obligations.

2.2 The statement of surveillance priorities

The SSP is a statement by the Fund's Executive Board that sets out the strategic surveillance priorities for the next three years (IMF 2008a). It establishes four high-level economic priorities,¹⁰ as well as four operational priorities¹¹ based on the findings of the Triennial

5. External and domestic stability are defined and discussed later in the text.

6. The 1977 Decision focused almost exclusively on exchange rates, but, in practice, was not closely followed, since Fund surveillance usually considered a broad range of issues, some of which were not directly related to external stability.

7. The four principles for members' exchange rate policies are: (i) a member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to gain an unfair competitive advantage over other members; (ii) a member should intervene in the exchange market if necessary to counter disorderly conditions, which may be characterized inter alia by disruptive short-term movements in the exchange rate of its currency; (iii) a member should take into account in its intervention policies the interests of other members, including those of the countries in whose currencies it intervenes; and (iv) a member should avoid exchange rate policies that result in external instability.

8. The Decision also specifies a set of indicators of "cause for concern" and thus the need for the Fund to initiate discussion with a member regarding a possible fundamental misalignment of its exchange rate.

9. The Decision specifies that "currency manipulation" is carried out through intervention policies that are aimed at securing an undervalued exchange rate for the purpose of increasing net exports. Note that the Exchange Rate and Economic Coordination Act of 1988, a key means for the U.S. Congress to apply punitive trade sanctions, bases itself on the IMF's definition of "currency manipulator" (Henning 2008).

10. The economic priorities are: (i) resolve financial market distress; (ii) strengthen the global financial system by upgrading domestic and cross-border regulation and supervision; (iii) adjust to sharp changes in commodity prices; and (iv) promote the orderly reduction of global imbalances.

11. The operational priorities are to improve the following aspects of surveillance: (i) risk assessment, (ii) financial sector surveillance and real financial linkages, (iii) multilateral perspective, and (iv) analysis of exchange rates and external stability risks (integrate clearer and more robust exchange rate analysis, underpinned by strengthened methodologies, into the assessment of the overall policy mix).

Surveillance Review (TSR).¹² The SSP is a stand-alone document (it was, however, released in tandem with the TSR) that has received an appropriately high profile, as well as an endorsement by the International Monetary and Financial Committee (IMFC 2008).¹³

An important aspect of the SSP, which has received somewhat less attention than the medium-term priorities, is its role in laying the foundation of a sound accountability structure for assessing the implementation of the priorities. In particular, it specifies the responsibilities of the Fund and the Executive Board in pursuing the priorities, and establishes lines of accountability, reporting, and evaluation.

3 A Conceptual Framework

To evaluate the potential impact of the 2007 Decision and the SSP, it is useful to first formulate a model of how a renewed surveillance framework would ideally work. We base our conceptual framework on the “vision” of IMF surveillance provided in Lavigne, Maier, and Santor (2007), hereafter referred to as LMS. For the purposes of this paper, we update the LMS framework, which was elaborated before the passage of the surveillance reforms, to incorporate recent developments.

In the LMS model, the interaction between the 2007 Decision and the SSP establishes the basis for a cohesive framework designed to make surveillance more effective and oriented towards crisis prevention. In essence, the Decision specifies the principles for surveillance, and the SSP – by promoting accountability, clarifying responsibilities, and setting priorities – is a means of ensuring the effective implementation of the Decision. The role of the Decision in the LMS framework is to clarify the objective of surveillance, define the scope of the Fund’s analysis, and establish the principles that guide the manner in which surveillance is conducted. The SSP, in turn, acts as a supporting mechanism to ensure that the new Decision is implemented by all parties, and that it remains relevant over time. To do so, the SSP fulfills three functions:

- (i) clarify the responsibilities of members, the Executive Board, and the Fund in the surveillance process;
- (ii) allow members, via the Board, to set the medium-term priorities for surveillance;
- (iii) act as an accountability mechanism to hold the Fund responsible to the Board for implementing the Decision and the surveillance priorities.

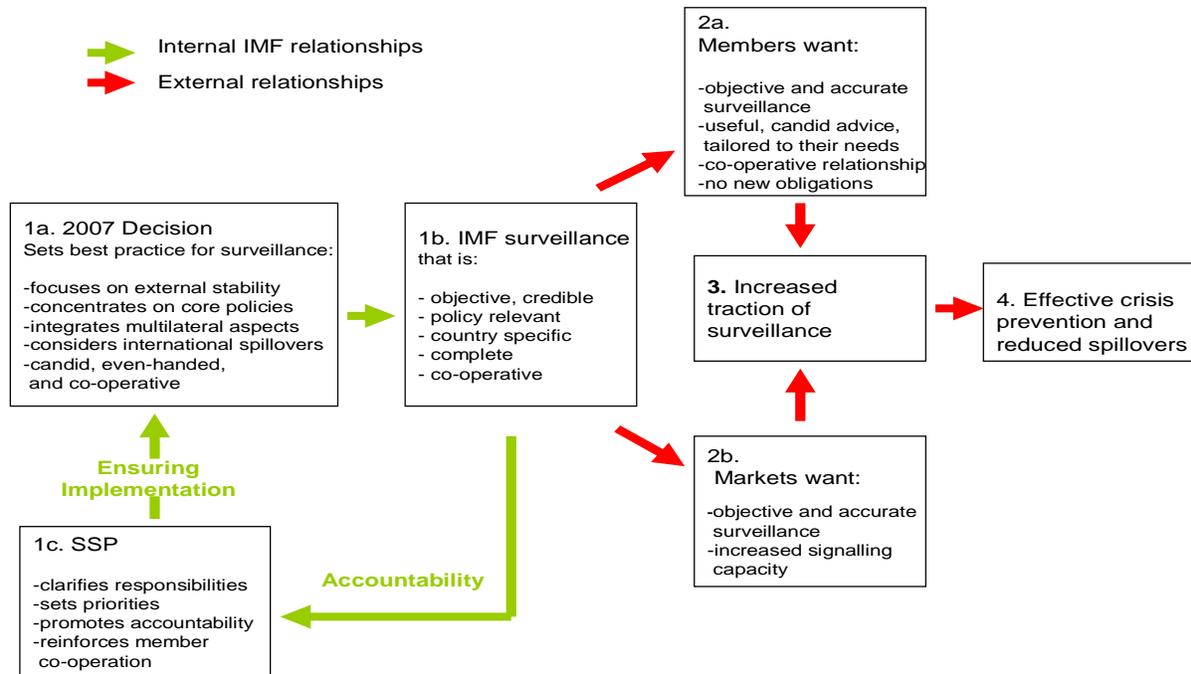
Chart 1 summarizes the operation of the LMS framework. Steps 1a, 1b, and 1c represent the interaction between the Decision and the SSP. In step 1a, the Decision sets the standards and

12. The TSR is a periodic self-assessment process during which the IMF staff evaluate their surveillance performance. Until recently, a surveillance review was typically carried out every two years (the last one being in 2004 [IMF 2004]), but the frequency has been decreased to three years. The first TSR was carried out in the fall of 2008 and was used as a basis to generate the operational priorities in the first SSP. See IMF (2008b).

13. The IMFC is an advisory committee to the Board of Governors (the supreme governance body of the IMF) made up of the finance ministers and the central bankers of the major members; it meets biannually.

principles for surveillance that meet current best practices, which should provide IMF staff with the guidance and incentive to improve their country analysis (step 1b). In step 1c, the SSP would hold the Fund accountable to the Board for implementing the Decision. It would also reiterate the need for member co-operation, which is essential if the Fund is to achieve its goals. In this way, the SSP would align the incentives of the Fund and its members.

Chart 1
A Complete Surveillance Framework



Increased accountability is the linchpin of the LMS framework. Through regular reports and periodic evaluations, the effectiveness of surveillance can be maintained and, hopefully, improved. Independent assessments of surveillance ought to occur at scheduled intervals; these should have real consequences for the Fund’s management, to ensure that the incentives for sound surveillance are always present. Of course, the Fund can be evaluated only on the quality of its surveillance, not on the basis of actual outcomes. After all, Fund surveillance is merely one of the many inputs into government policies and market behaviour, and its impact is often difficult to ascertain.

In order for the Fund to be held accountable for abiding by the SSP, the IMF’s management and staff would require a certain degree of operational independence from members, at least enough to achieve the goals established by the Executive Board (i.e., in the Decision and in the surveillance priorities). In fact, the LMS framework is designed to provide institutional support for objective, unbiased IMF monitoring and analysis, which is an essential prerequisite for

credible, and therefore influential, surveillance. The accountability structure proposed here is similar to the remits accorded to independent central banks, which are also responsible for surveillance, albeit on a national level (Maier and Santor 2008).

We believe that the framework shown in Chart 1 would provide the IMF with the necessary means to undertake high-quality surveillance. Equipped with a clear mandate and objectives, motivated by increased accountability, and backed by the regular renewal of member commitments to the surveillance process, the framework should help shield IMF staff from political pressures that may have compromised the impartiality of bilateral surveillance in the past.

The Fund has natural advantages over other sources of international economic analysis.¹⁴ These include its unique multilateral perspective, its mandate for preserving systemic stability, and its universal membership. However, in the past, perceived political bias may have diluted the effectiveness of Fund surveillance, hampering the IMF's capacity to have a greater influence on policies and perceptions.

Hence, the importance of strengthening the perceived objectivity of IMF surveillance cannot be overstated. The LMS framework would support and highlight the Fund's inherent advantages by strengthening the Fund's credibility and legitimacy, enabling its surveillance to acquire greater traction over (i) country policies and (ii) market expectations.

(i) Policies. First and foremost, bilateral surveillance aims to foster country policies that are supportive of domestic and external stability. To ensure that surveillance has the greatest potential to influence member policies, it should be accurate, candid,¹⁵ and unbiased, and not impose any additional compliance obligations (step 2a, Chart 1).¹⁶ Moreover, surveillance must be of practical use to authorities, in the sense of being policy relevant and tailored to country-specific situations. Finally, effective surveillance should be based on a co-operative relationship with member countries, one where information and analysis are freely shared.

(ii) Markets. Another aim of the framework is to increase the value of Fund surveillance in the eyes of market participants, by helping them to assess risks and expected returns (step 2b, Chart 1). Surveillance should help international investors discriminate across countries, thereby providing the market discipline that is often key to ensuring that national policies are consistent

14. Private sector agents that provide services akin to surveillance typically have a narrower focus, primarily centred on market-relevant information. Moreover, in certain cases, such as investment banks, conflicts of interest may arise. Governments also have comparable analytical capacity, but the focus of their surveillance would primarily reflect national interests.

15. Greater candour would not, as some have argued, lead to an erosion of the Fund's role as a trusted adviser to authorities. This misguided argument results from a misunderstanding of the value of confidential advice. In fact, the Decision should bolster the Fund's role as trusted adviser by helping the IMF preserve its analytical objectivity in the conduct of bilateral surveillance.

16. This point is worth underscoring: since the type of high-quality surveillance we envision should achieve greater influence on country policies solely through the force of sound economic analysis, no additional commitments by members would be required to make the framework operational.

and sound. Thus, it is important that surveillance be perceived as accurate and unbiased (from the undue influence of local authorities), and that the mechanisms of surveillance be procedurally transparent.

Greater traction over country policies and market expectations (step 3, Chart 1) provided by the LMS framework would allow the Fund to play a proactive role in helping to prevent crises and limit negative spillovers across borders (step 4). Increased influence of surveillance would be positive both for the specific countries benefiting directly from the Fund's enhanced policy advice and for members in general that would enjoy the positive externality of a more stable international monetary system. Members that are the most vulnerable to international crises – particularly those that are small, open, and lack macroeconomic and financial resilience – would reap the greatest benefit.

There is, we believe, significant international support for this type of surveillance model. In the next section, we examine the extent to which the actual 2007 Decision and the SSP are able to fulfill the requirements of the LMS framework.

4 A Comparison of the Reform Proposals with the LMS Conceptual Framework

4.1 The surveillance decision

The principal purpose of the Decision in the LMS framework is to act as a benchmark for bilateral surveillance against which the Fund's analysis can be assessed. It is our view that the actual 2007 Decision effectively meets this requirement, adequately spelling out the objective, scope, and principles of surveillance. That is not to say, however, that certain aspects of the Decision could not be improved.

4.1.1 The objective of surveillance

A clear objective is critical to ensure that the IMF's surveillance is focused and effective. It should be closely linked with the Fund's overall goal of preserving global financial stability, be compatible with Article IV of the Fund's Articles of Agreement, and be precise enough to provide the Fund with an appropriate degree of operational guidance.

The 2007 Decision's objective of maintaining *external stability* is compatible with these requirements. External stability occurs when a country's current and capital account balances are not in excessive disequilibrium, thereby making them less vulnerable to abrupt changes in capital flows or exchange rates.¹⁷ In other words, external stability refers to a balance-of-payments

17. By excessive disequilibrium we mean current or capital account imbalances that are not sustainable and present a significant risk of impending correction.

position that is not likely to generate disruptive real exchange rate movements.¹⁸ This objective appropriately focuses surveillance on the external dimensions of member economies, striving to evaluate countries' economic impact and linkages in the global economy. It also encompasses the specific examination of international spillover effects and ensures that bilateral surveillance is well integrated within a multilateral framework. Importantly, the Decision specifies that external stability is a forward-looking concept that demands an assessment of domestic as well as external risks and vulnerabilities.

In response to the concern among some members that the objective of external stability might overshadow their commitments to maintaining domestic stability, the 2007 Decision appropriately clarifies that these two types of stability are compatible and mutually reinforcing. Moreover, in situations of conflict, the objective of external stability will not compromise the domestic obligations established in Article IV of the IMF's Articles of Agreement, namely the pledge by members to foster orderly economic growth with reasonable price, monetary, and financial stability. Indeed, the Decision explains that domestic policies are central to the evaluation of external stability, since the latter can be achieved only via policies that are conducive to growth and price stability.¹⁹

One potential drawback of the Decision's definition of external stability lies in its explicit link to the real exchange rate. It would be unfortunate if the Decision were interpreted narrowly so as to give the impression that it is only through exchange rates and the balance of payments that domestic stability can affect external stability.²⁰ In implementing the Decision, it will be important to clarify that all core policies (monetary, fiscal, exchange rate, and financial sector) could have a direct effect on external stability, without necessarily being reflected in large real exchange rate (RER) movements.

4.1.2 The scope of surveillance

The 2007 Decision specifies the areas of economic policy that are to be examined in IMF surveillance: exchange rate, monetary, fiscal, and financial sector policies. These areas, because they are critical to external stability, are to be routinely covered by surveillance, regardless of whether there are impending signs of external imbalance (in this manner, the basic aspects of internal stability will always be considered). The Decision specifies, however, that other policy spheres, dealing with, for instance, structural or developmental issues, do not fall under the purview of IMF surveillance unless a case can be made that the link to external stability is of

18. For more details, see IMF (2009c).

19. The challenge for IMF staff will be to ensure that the external dimension of policies is brought to the fore in the Article IV discussions, and at the same time adequately address domestic issues of importance to authorities.

20. Such a definition would essentially miss the crux of the current global financial turmoil when analyzed from the U.S. perspective. Indeed, the main impact of the U.S. financial turmoil on the rest of the world has been directly through financial markets, with the U.S. dollar remaining relatively stable and its balance-of-payments situation remaining largely unperturbed (if anything, the current account deficit has improved). Yet, clearly, financial instability in the United States has provoked global external instability.

critical importance.²¹ These clarifications are critical for keeping surveillance centred on what the Fund does best, namely short- to medium-term macroeconomic analysis.

Two aspects of the scope of surveillance under the Decision merit particular attention: exchange rate analysis and the focus on the set of macroeconomic and financial sector policies critical to the maintenance of external stability.

(i) Exchange rate surveillance

Within the set of core policies specified in the 2007 Decision, exchange rate policy is clearly the “first among equals,” with the Decision taking firm steps to restore the importance of exchange rate analysis in IMF surveillance. The tendency over the past three decades was for IMF staff to shy away from firmly pronouncing itself on exchange rate policy, since this area was deemed to be politically sensitive in many countries. However, this approach was at odds with the IMF’s Articles of Agreement, which call for the Fund to exercise “firm surveillance” over members’ exchange rate policies. The new Decision has made analysis of the extent of over/undervaluation of exchange rate levels an essential part of Article IV reviews. In particular, the determination of whether a country’s exchange rate is “fundamentally misaligned” is to be a key aspect of surveillance.

While this renewed emphasis on the exchange rate is an improvement, it is clear that evaluating the appropriateness of exchange rate *levels* poses a number of technical and political difficulties. On the technical side, such calculations are necessarily based on estimated equilibrium rates, which have large margins of error and occasionally generate conflicting results. What is more, the assessments of exchange rate levels are not always compatible with the indicators of “cause for concern” that are specified in the Decision (see Part II, section D.15 of the Decision).²² And from a political viewpoint, the first year of the Decision’s application has demonstrated that the contentious “fundamental misalignment” label has encountered considerable resistance from the Executive Board.²³ The regular application of these labels may ultimately be incompatible with the co-operative and persuasive nature of surveillance that is required under the institution’s current governance structure. Moreover, even the potential use of these labels could weaken the candour and the timeliness of surveillance, complicating its communication and generally detracting from frank analysis and dialogue.²⁴

21. These are also the conclusions on the scope of surveillance reached by Crow, Arriazu, and Thygesen (1999) in their external evaluation of surveillance.

22. For instance, in the Article IV reports of certain oil exporters and large reserve accumulators, the IMF staff judge that the real exchange rate is correctly valued even though the country is running large current account imbalances and actively engaged in prolonged, one-sided sterilized intervention (theses are all indicators that trigger cause for concern in the Decision).

23. The label has not yet been accepted by the Board in any Article IV report, and there have been extensive delays in the consultation processes of countries with potentially misaligned currencies.

24. In response to these difficulties, the IMF has recently revised its internal guidelines for implementing the 2007 Decision (IMF 2009d). It is no longer mandatory for the staff to use specific terms such as “fundamental misalignment” when analyzing exchange rates in Article IV reviews.

It is our view that the effectiveness of the Fund's exchange rate surveillance would be greatly improved if, rather than calculating equilibrium exchange rate levels and the degree of potential misalignment, IMF staff were to focus on the *direction* and *speed* of RER adjustment and on the extent to which policies are permitting the RER to adjust. IMF surveillance should stress the importance of movements in the RER, rather than its level per se, because it is RER adjustment that is critical to maintaining external stability. Indeed, failure to allow gradual, market-driven RER adjustment is often at the heart of external imbalances and crises. Our suggested approach has several benefits. First, it allows for more nuance in RER evaluations, making possible a wider spectrum of verdicts than the present binomial choice (misalignment or not). This would put the focus on the analysis, not the label. Second, by concentrating on RER movements, surveillance avoids the politically controversial issue of judging the choice of nominal exchange rate regime, which will always remain a sovereign decision. Third, this approach does not require estimating highly uncertain equilibrium real exchange rates, and instead relies on market forces to drive RER adjustment to external imbalances. Finally, it also has the advantage of making policy prescriptions fairly straightforward and transparent.

(ii) Macroeconomic and financial sector policies

Surveillance under the Decision, given its objective and scope, will naturally focus on evaluating whether a country's core macroeconomic and financial sector policies are conducive to the promotion of external stability. Surveillance should not examine policies in isolation, but rather consider the coherence of the four core policies and their combined effect on external stability.

One shortcoming of the Decision is that it does not specifically focus on policy frameworks. By frameworks we mean the system of policy objectives, time frames, instruments, and contingent responses that anchor expectations regarding current and future policy stances.²⁵ Ideally, the 2007 Decision would (i) specify that surveillance should assess the internal consistency of these frameworks (i.e., can policy tools achieve their policy goals?), (ii) evaluate whether they are consistent with each other (e.g., is inflation targeting consistent with a fixed exchange rate?), and (iii) assess their combined effect on external stability. The gravity of this shortcoming depends on how the Decision is applied.²⁶ Indeed, the Decision states that surveillance "will, to the extent possible, be placed in the context of an examination of the member's medium-term objectives and the planned conduct of policies, including possible responses to the most relevant contingencies" (IMF 2007, paragraph 11). There is sufficient flexibility in this definition to incorporate the consistency and coherency of policy frameworks, should the IMF staff choose to do so.

25. Examples of frameworks include inflation targeting and flexible exchange rates.

26. For an analysis of the Decision's implementation since 2007, see Lavigne and Vasishtha (2009).

4.1.3 The principles of surveillance

Members and independent evaluators (Crow, Arriazu, and Thygesen 1999) have called for surveillance that is procedurally transparent, frank in its assessments, and symmetric in its application across countries. The new Decision has taken these recommendations to heart.

(i) Even-handedness

There is a perception among many members of a fundamental asymmetry in surveillance. They maintain that, while IMF surveillance has little impact on advanced countries, it can potentially have significant effects on emerging-market economies and on other smaller members. While it is clear that this problem cannot be eliminated solely via changes to surveillance policy, the Decision aims to reduce the perceived asymmetry as much as possible. In fact, the equitable treatment of all members is at the heart of the new surveillance framework, which stresses the critical importance of taking into consideration the different economic circumstances of countries.

The Decision levels the playing field through several channels. First, it focuses on a narrower set of issues that are relevant to all members (such as external stability and spillovers). Second, it examines a common (and limited) set of core macroeconomic policies in all countries, favouring equality of treatment. Third, by expanding the scope of analysis beyond exchange rates, the Decision will make Fund surveillance more relevant for advanced countries, most of which have floating exchange rates. Indeed, by also considering the core domestic policies that affect external stability, it is hoped that the new Decision will increase the traction of IMF advice on industrialized economies. Fourth, the new framework will give IMF staff the incentive and the latitude to shift surveillance away from its current focus on emerging-market economies and towards countries, whether developing or advanced, posing systemic risks to external stability. Indeed, improved surveillance will not mean greater scrutiny of developing countries.

(ii) Candour

The Decision underscores how frank discussions and analysis with members and the Board are critical to effective surveillance, as is clear and focused communication with the public. Greater candour is all the more necessary given that surveillance is essentially a process of persuasion and dialogue.

4.2 Statement of surveillance priorities

In the LMS framework, the purpose of the SSP is to help implement the principles of the Decision. It has three objectives: (i) set medium-term priorities, (ii) clarify surveillance responsibilities, and (iii) promote accountability. The actual SSP that was approved in 2008 focuses primarily on the priorities, but contains sufficient elements of the latter two aspects to play an important role as an accountability mechanism for surveillance.

4.2.1 Setting priorities

An important role of the SSP is to set the strategic and operational priorities for IMF surveillance; all in all, the document performs this function well. These medium-term directives, established by the Board every three years, aim to improve surveillance in several respects. Clear priorities will sharpen the focus of surveillance, help coordinate activity across the Fund, improve the integration of bilateral and multilateral surveillance, underpin policy discussions with members, and act as benchmarks to assess the effectiveness of surveillance. Moreover, the medium-term nature of the priorities will assist in bridging the gap between the strategic direction provided by the Decision and the detailed country-specific work plans for bilateral surveillance. Finally, the priority-setting exercise embedded in the SSP will also provide an avenue for smaller countries to express clearly their views regarding the direction of surveillance.²⁷

The priorities are specific enough to provide real guidance, but not overly prescriptive so as to detract from priorities in bilateral surveillance agendas. The SSP is not a strict monitoring tool – the priorities should be viewed as general guidelines that are flexible enough to adapt to a country’s circumstances.

4.2.2 Clarifying responsibilities

For there to be effective accountability in IMF surveillance, the roles of the Fund, the Board, and members need to be clearly defined. The SSP assists in this function by acting as an institutional means of regularly renewing the responsibilities of the Fund’s management and the Board in the surveillance process. The SSP specifies that:

- (i) The Board is responsible for setting surveillance priorities, as well as conducting, guiding, and evaluating surveillance to ensure their achievement.
- (ii) The Fund’s management and staff are responsible for implementing the operational surveillance priorities established in the SSP, and for providing the analysis and advice to members pertinent to the strategic priorities. These obligations cover not only the content of surveillance, but also the way it is communicated to members, the Board, and the public. The Fund is also responsible for reporting on any factors that might impede progress in meeting the SSP. This should safeguard staff independence.²⁸

This system of responsibilities builds upon the Fund’s existing surveillance framework. The Board will continue to play a central role in surveillance; the SSP will simply enable it to perform its surveillance oversight role more effectively. Indeed, the statement provides the Board with a direct means of guiding the Fund’s surveillance activities. It opens up an institutional

27. Concerns that the process will be dominated by the G-7 are misplaced, especially since these large countries are much more likely to set the agenda in the current type of informal priority-setting environment.

28. This aspect could be further bolstered by making reference to Article XII, section 4c, which specifies the obligation of members to respect the independence of the Fund staff as the staff carry out their duties.

window to ensure that surveillance is reviewed, at least summarily, once a year.²⁹ In addition, the SSP will provide a means of rationalizing some of the existing reporting and evaluation processes, which would save on staff and Board time.

On the issue of clarifying responsibilities, the SSP differs from the LMS framework in that it does not mention the surveillance responsibilities of member countries – the SSP has chosen to focus exclusively on the responsibilities of the Fund and the Board.³⁰ The LMS model framework highlights the importance of member responsibilities, in recognition of the fact that surveillance requires political support to be credible and effective. Ideally, members should have a means of directly endorsing the SSP on a regular basis, since this would significantly bolster both the profile of the document and the credibility of the Fund, as well as potentially strengthen country ownership of bilateral surveillance.

The absence of member responsibilities in the SSP is most likely driven by concern that this might be perceived as implying new obligations for members. This view would be incorrect, however. From a legal perspective, the Decision and the SSP merely acknowledge Article IV obligations, and do not represent in any sense an expansion of them. Far from increasing member obligations, the new framework may actually decrease the cost of meeting existing commitments. Indeed, the reduced scope of surveillance in the revised Decision ensures that all countries are evaluated on a similar, narrower basis, and thus it limits the Fund's involvement in many structural policy areas that are currently the object of surveillance and conditionality in developing countries. The framework would recognize the primary role of local governments in these sensitive policy areas, which must always be tailored to national needs and priorities.

We are not of the view, however, that the lack of reference to member responsibilities critically undermines the value of the SSP, since, at its core, the statement is an accountability mechanism to hold the staff/management responsible to the Board. There are other, less formal ways to periodically reaffirm member commitments to surveillance, such as the IMFC communiqué that endorsed the SSP after the 2008 TSR (IMFC 2008). This kind of indirect method will need to suffice for the moment, but, as experience is acquired with the framework, it may be useful to specify a clear role for members in the SSP process. Future versions of the SSP could indicate that members are responsible for co-operating with the Fund to ensure that surveillance remains an effective tool for crisis prevention. This could be accomplished via an opening paragraph recognizing the commitment of members to their Article IV obligations, the principles of the Decision, and the collaborative nature of surveillance.

29. This would be no small feat, since the busy schedule of Executive Directors means that there may not always be a timely opportunity for Board members to review the Fund's surveillance output on a regular basis.

30. There is also no mention of the IMFC in the text.

4.2.3 Promoting accountability

The SSP contains specific accountability links that require the Managing Director to report annually to the Board on the extent to which the SSP priorities have been met, and more thoroughly every three years in the context of the TSR. The SSP also indicates that the Executive Board will be responsible for evaluating the extent to which the priorities have been achieved.

It is our view that the SSP lays the groundwork for strengthening the accountability of surveillance. That said, the SSP does differ from the LMS framework in one important aspect: the SSP does not require the Fund to report specifically on the implementation of the 2007 Decision. However, it does indicate that the 2007 Decision plays a role in establishing the framework for surveillance within which the SSP is to operate. This relative lack of explicitness with respect to the link between the SSP and the Decision may reflect the sense among members that there is already an adequate mechanism to evaluate the Decision's implementation: the TSR (we will return to this point in the next section). If the TSR is to be the only formal process for assessing the Decision, it will be important to expect regular updates on the Decision's implementation in the annual SSP reports of the Managing Director.

It would also be desirable that the details surrounding the Board's responsibility to evaluate the SSP's implementation be clearly specified. To strengthen accountability, the Board's evaluation should be regular and public, as with the SSP itself. Without a proactive and engaged supervisory mechanism, the incentive structure embedded in the SSP will lose its potency, and the SSP could risk evolving into a pro-forma operation.

On the whole, the SSP's shortcomings are not critical. Indeed, a major advantage of the SSP is that, unlike the 2007 Decision, its contents will be reviewed regularly. Consequently, members and the Fund have the opportunity to adjust the SSP as they gain experience with the new surveillance framework.

5 Complementary Reforms

The IMF is considering other types of reforms that will have a direct bearing on its surveillance, most notably reforms in IMF corporate governance and in the design of the TSR. In this section, we provide a brief overview of the reforms being proposed and their likely impact on the new surveillance framework.

5.1 Corporate governance reform

The 2007 Decision and the SSP are designed to operate within the existing IMF corporate governance structure. Their impact on the effectiveness of surveillance could, however, be enhanced by wider internal governance reforms aimed at improving the decision-making apparatus of the Fund. The Independent Evaluation Office report on IMF corporate governance

(IEO 2008) identifies four major avenues for governance reforms, all of which are relevant to surveillance:³¹

- (i) clarify the roles and responsibilities of management, the Board, and the IMFC;
- (ii) establish a clear framework for holding the Managing Director accountable for their own performance;
- (iii) shift the Board towards a more supervisory role, emphasizing strategy and implementation;
- (iv) establish more active and systematic ministerial-level involvement in setting broad strategic goals and in overseeing performance.

These reforms can improve the surveillance framework by strengthening the credibility of the staff's analysis at the operational level. All four recommendations contribute to this goal by solidifying the IMF's accountability framework. If the staff were to become more accountable for their actions, they would need to have larger scope for operational independence in their fields of activity (e.g., lending, technical assistance). Greater staff independence would enhance the Fund's perceived objectivity, complementing the surveillance reforms.

The first two recommended reforms speak directly to accountability. Indeed, a clarification of the roles and responsibilities of the IMF's governance bodies is a prerequisite for allocating responsibilities, drawing lines of accountability, and more generally increasing transparency. The Managing Director's performance agreement is directly analogous to the SSP, except that it applies to the whole of the Fund's activities.

Reforms to reorient the Board towards a supervisory role would likely require Executive Directors to shift their focus away from the Fund's day-to-day activities and concentrate on a more strategic level of oversight. This would bolster the accountability of surveillance in several ways. Reduced Board involvement in operational issues would enable the staff's analysis to be clearly differentiated from the views of Directors. A stronger Board focus on strategic issues would probably also mean that more responsibility would need to be delegated to management. In addition, a greater supervisory function would place the Board in a much better position to evaluate the staff's performance under the SSP. Indeed, as it now stands, because the Board is often enmeshed in the Fund's operational activities, it is difficult for the Board to evaluate IMF surveillance without also reviewing its own performance. Moving the Board towards more arm's-length supervision, with a clearer focus on strategic issues, would raise the visibility of the SSP, because the Board's evaluation would become more meaningful.³² For further development of these ideas, see Santor (2006).

31. These reforms are broadly similar to those proposed by the Committee on IMF Governance Reform (IMF 2009b).

32. Furthermore, the staff may be able to use their accountability to a more focused Board (with higher expectations) to offset pressure from individual members to modify aspects of their bilateral surveillance, helping to ensure unbiased analysis.

Finally, greater ministerial involvement, whether via the creation of a council with formal powers (to replace the IMFC) or simply through a strengthening of the IMFC's de facto influence, would enhance the role of members in assessing the Board's performance. This change, which is complementary to the first and third reforms, would contribute to making the Board more effective, and generally support a more efficient surveillance process.

More ministerial involvement could potentially bolster the effectiveness of surveillance in several other ways. First, it could increase the commitment of countries to collaborate in the surveillance process, an aspect that the SSP presently underplays. Co-operation with the IMF would become more valued by countries, because direct involvement by policy-makers would enhance the legitimacy of the organization, lending more weight and prestige to the Fund's activities. Second, greater ministerial involvement could strengthen the traction of the Fund's surveillance on country policies. If the IMFC/council is transformed into a forum for frank discussion among policy-makers, it would be an ideal venue at which to present the Fund's multilateral surveillance, as well as an opportunity to gain greater leverage from ministerial peer pressure.

5.2 TSR reform

The TSR gets its mandate from the 2007 Decision (paragraph 21), which requires the Executive Board to review the Decision and the general implementation of bilateral surveillance. For the TSR process to adequately support the framework established by the 2007 Decision and the SSP, its focus and independence would need to be enhanced.

5.2.1 More independent evaluation

The TSR is essentially an IMF staff self-assessment. While self-assessment is a valuable tool that should be continued, it may not have the impact of an independent evaluation. Again, objectivity is a key consideration, for no matter how impartial Fund staff attempt to be in their review, markets and governments may feel that there is an inherent bias in any system where the evaluator and the evaluated are one and the same. We believe that the Fund should consider including elements of independent evaluation in the TSR, to enhance the assessment's credibility.³³

5.2.2 Focus on implementing the 2007 Decision

Past reviews have not systematically assessed surveillance against the 1977 or the 2007 Decisions. While it is true that the 2008 TSR made steps in the right direction, it did not formally use the Decision as its benchmark. Evaluating the implementation of the Decision should

33. To a certain extent, this was begun in the 2004 review (IMF 2004), and enhanced in the 2008 TSR, with the use of an independent consultant to conduct one of the case studies.

become part of the official mandate of the TSR, because, absent our proposed changes to the SSP, it currently represents the only formal mechanism for assessing surveillance.

6 Conclusion

The IMF's "2007 Decision on Bilateral Surveillance Over Members' Policies" and the "Statement of Surveillance Priorities" are complementary reforms that, provided they are implemented properly, have the potential to strengthen the effectiveness of IMF surveillance and help prevent crises. The ongoing financial crisis clearly demonstrates that a stable international financial system is in the interest of all members, especially emerging-market and developing economies, which are often the most dependent on trade and financial openness and the least resilient to global financial instability. The effectiveness of these reforms would be enhanced if the implementation of the Decision were refined (i.e., refocusing on real exchange rate adjustment and policy frameworks) and some evolutionary adjustment to the SSP were to occur (i.e., strengthening member responsibilities and the link to the 2007 Decision). Moreover, the surveillance reforms would be significantly bolstered if they were supplemented by changes to the surveillance review process as well as by corporate governance reforms aimed at enhancing the IMF's accountability framework and improving member co-operation.

References

- Chidambaram, P. 2006. "Statement on Behalf of Bangladesh, Bhutan, India, Sri Lanka." International Monetary and Financial Committee. Singapore. 17 September.
- Crow, J., R. Arriazu, and N. Thygesen. 1999. "External Evaluation of IMF Surveillance." Report by a Group of Independent Experts, International Monetary Fund.
- G-20. 2009. "London Summit – Leaders' Statement." 2 April. Available at <http://www.wcoomd.org/files/1.%20Public%20files/PDFandDocuments/Highlights/G20_Final_London_Communique.pdf>.
- Henning, C. R. 2008. *Accountability and Oversight of US Exchange Rate Policy*. Washington, D.C.: Peterson Institute for International Economics.
- Independent Evaluation Office. 2008. "Governance of the IMF: An Evaluation." Independent Evaluation Office of the International Monetary Fund. Washington, D.C.
- International Monetary and Financial Committee (IMFC). 2006a. "Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund." 22 April.
- . 2006b. "Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund." IMF Press Release No. 06/203. 17 September.
- . 2008. "Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund." 11 October.
- International Monetary Fund (IMF). 1977. "Surveillance over Exchange Rate Policies." Decision No. 5392-(77/63). 29 April. Available at <[http://www.imf.org/external/pubs/ft/sd/index.asp?decision=5392-\(77/63\)](http://www.imf.org/external/pubs/ft/sd/index.asp?decision=5392-(77/63))>.
- . 2004. "Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision – Modalities of Surveillance." SM/04/212, Supplement 1. 2 July.
- . 2006. "The Managing Director's Report on Implementing the Fund's Medium-Term Strategy." 5 April.
- . 2007. "IMF Executive Board Adopts New Decision on Bilateral Surveillance Over Members' Policies." Public Information Notice No. 07/69. Available at <<http://www.imf.org/external/np/sec/pn/2007/pn0769.htm>>.
- . 2008a. "Surveillance Priorities for the International Monetary Fund, 2008–2011." Available at <<http://www.imf.org/external/np/pdr/surv/2008/index.htm>>.

- International Monetary Fund (IMF). 2008b. "Triennial Surveillance Review, Background Information and Statistical Appendix." 2 September. Available at <<http://www.imf.org/external/np/pp/eng/2008/090208D.pdf>>.
- . 2009a. "Review of Fund Facilities – Analytical Basis for Fund Lending and Reform Options." 6 February. Available at <<http://www.imf.org/external/np/pp/eng/2009/020609A.pdf>>.
- . 2009b. "Committee on IMF Governance Reform: Final Report." 24 March. Available at <<http://www.imf.org/external/np/omd/2009/govref/032409.pdf>>.
- . 2009c. "IMF Surveillance – The 2007 Decision on Bilateral Surveillance." IMF Factsheet. Available at <<http://www.imf.org/external/np/exr/facts/surv07.htm>>.
- . 2009d. "The 2007 Surveillance Decision: Revised Operational Guidance." 22 June. Available at <<http://www.imf.org/external/np/pp/eng/2009/062209.pdf>>.
- Lavigne, R., P. Maier, and E. Santor. 2007. "A Vision for IMF Surveillance." Bank of Canada Working Paper No. 2007-37.
- Lavigne, R. and G. Vasishtha. 2009. "Assessing the Implementation of the IMF's 2007 Surveillance Decision." Bank of Canada Discussion Paper No. 2009-6.
- Maier, P. and E. Santor. 2008. "Reforming the IMF: Lessons from Modern Central Banking." Bank of Canada Discussion Paper No. 2008-6.
- Mantega, G. 2006. "Statement on Behalf of the Constituency Comprising Brazil, Colombia, Dominican Republic, Ecuador, Guyana, Haiti, Panama, Suriname, and Trinidad and Tobago." International Monetary and Financial Committee. Singapore. 17 September.
- Miceli, F. 2006. "Statement on Behalf of Argentina, Bolivia, Chile, Paraguay, Peru, Uruguay." International Monetary and Financial Committee. Singapore. 17 September.
- Quaden, G. 2006. "Statement by the Hon. Guy Quaden, Governor of the Fund for Belgium, at the Joint Annual Discussion." Press Release No. 45. Boards of Governors 2006 Annual Meetings of the IMF and the World Bank Group. Singapore. September.
- Santor, E. 2006. "Governance and the IMF: Does the Fund Follow Corporate Best Practice?" Bank of Canada Working Paper No. 2006-32.
- Zhou, X. 2006. "Statement on Behalf of China." International Monetary and Financial Committee. Singapore. 17 September.