



FUND SURVEILLANCE

The Fund is entrusted with overseeing the effective functioning of the international monetary system. Its mandate under the Articles of Agreement is to exercise firm surveillance over the exchange rate policies of individual members and to adopt specific principles for the guidance of all members with respect to those policies. The Fund fulfills these obligations by analyzing the appropriateness of a member's macroeconomic and related structural policies, since these are the basis of the member's exchange rate policies. Surveillance involves examining the policies of individual countries, encouraging countries to adopt policies that enhance the functioning of the international monetary system, and, at the same time, assessing the consequences of individual country policies for the operation of the global system.

The main avenues for conducting surveillance are the annual consultations with member countries under Article IV of the Fund's Articles and the review of economic developments and policies in the context of the twice-yearly Board discussions of the World Economic Outlook. These are supplemented by regular informal Board sessions on significant developments in selected countries and on world economic and market developments. Board reviews of developments in international capital markets also contribute to surveillance. In addition, the Fund's Managing Director takes part in some of the policy discussions of the Group of Seven major industrial countries and provides the Fund's views on the international repercussions of these countries' policies.

In the financial year 1995/96, the Fund adopted several measures to make surveillance more continuous and more effective—with closer policy dialogue with countries and increased focus on countries that were seen to be at risk and where financial tensions were likely to spill over to other countries. These measures are summarized in Box 3. The Board's discussions of a number of other aspects of Fund surveillance are described below. The Fund continued to take steps to make its activities more transparent (Box 4).

Review of Policies Under the Madrid Declaration

The Interim Committee, at its meeting in April 1995, followed up on its Declaration on Cooperation to Strengthen the Global Expansion issued at its October 1994 meeting in Madrid and endorsed a strengthening of Fund surveillance (*Annual Report, 1995*, pages 207–10). At its October 1995 meeting, it reaffirmed that the Madrid Declaration continued to be a useful guide for policy.

In the financial year 1995/96, the Board on a number of occasions reviewed policies implemented under the Madrid Declaration and, more generally, in the context of Fund surveillance.

In September 1995, in the first six-monthly review of the implementation of Fund policy advice in Article IV consultations, the Board analyzed economic developments in industrial, developing, and transition countries. The principal conclusions corresponded closely with the views expressed during Directors' September 1995 review of the World Economic Outlook (see the section with that title, above).

In March 1996 Directors again reviewed members' policies in the light of earlier Board recommendations. Four topics drew particular attention.

- *The threat of overheating in several emerging market economies.* Recognizing that rapid structural changes in fast-growing economies had made it more difficult to estimate potential output and to assess the risk of imminent overheating, Directors emphasized the importance of accurate and timely indicators, particularly of output gaps, and the need for vigilance, including through regular discussions with the Fund. Most Directors agreed that fiscal tightening was the most appropriate means of reducing the threat of overheating in many of the rapidly growing economies, although several Directors pointed out the limits to fiscal tightening in countries with budget surpluses, especially in view of infrastructure and social needs. Many Directors suggested that greater upward flexibility in

Box 3

INITIATIVES TO STRENGTHEN SURVEILLANCE

The Mexican crisis led to important efforts to strengthen Fund surveillance in 1995/96. These efforts have crystallized around three main themes: the provision of economic data, the continuity of surveillance, and the focus of surveillance.

Provision of Economic Data

The quality of surveillance depends critically on the timely availability of reliable data. Thus, the Fund has put additional emphasis on members' data provision for surveillance purposes. A core set of indicators has been identified, which all members are encouraged to report monthly to the Fund. Data issues have also figured more prominently in the annual consultations with members. Where shortcomings in data provision have been identified, a cooperative strategy between the Fund and the members has been devised to remedy them. The Fund is providing technical assistance to members to improve their ability to compile and report economic data.

The timely provision of reliable data to the markets is also of great importance. This issue has been addressed by the Fund, leading to the establishment of a Special Data Dissemination Standard (SDDS) for members having or seeking access to international capital

markets. The more general standard for other countries will be established by the end of 1996. The issue of data standards is discussed in the next section.

Continuity of Surveillance

The globalization of international capital markets and the rapidity of developments in these markets following changed perceptions of a country's economic fundamentals put a premium on the continuity of Fund surveillance. Thus, the Fund has taken a number of initiatives to make its surveillance more continuous:

- For some members, annual consultations have been supplemented with interim staff visits. In several cases, Fund management has followed up on the Board's annual consultation discussions with letters to country authorities on important policy issues.
- The frequency of informal meetings, in which Directors review major recent developments in selected member countries, has been increased to once a month; these are designed to facilitate the early identification of emerging financial tensions through focusing on potential problems and providing additional factual material.
- Biannual Board discussions of members' policies in the context of sur-

veillance have been instituted to review the principal issues repeatedly surfacing in consultations with members; a report of these discussions is transmitted to the Interim Committee, thus providing a bridge between the Board's daily work on surveillance and the Committee's oversight role.

Focus of Surveillance

The evolution of the world economy calls for greater attention to new issues and risks. At the same time, traditional areas of surveillance should not be neglected. To make these competing objectives compatible, the following principles have been agreed upon:

- Article IV consultations will concentrate on core topics directly linked to the Fund's statutory mandate to exercise "surveillance over exchange rate policies of members."
- Greater attention will be paid to capital account developments.
- Countries where developments have potential spillover effects on others will be more closely followed.
- Where important economic policies are formulated at a supranational level, with a potential impact on several national economies, the Fund will continue to strengthen its focus on regional surveillance.

the exchange rate, in line with the fundamentals, might be appropriate. The importance of monitoring closely the sources and composition of capital inflows in selecting the appropriate policy response was noted by Directors. Directors agreed that controls on capital inflows should not substitute for needed economic policy adjustments.

- *Exchange rate issues.* The frequent and candid treatment of such issues in surveillance discussions was welcomed by Directors. A number of Directors felt that the Fund's assessment of exchange rate misalignment among the major currencies in early 1995 had been timely and that the related policy advice had been appropriate. Other Directors, emphasizing the importance of domestic policy considerations in the determination of exchange rate policy, noted that the effectiveness of Fund surveillance over exchange rate policies would be put to the test when the confluence of domestic and external requirements was less apparent. It was generally agreed that the Fund should con-

tinue its analytical work on exchange rates against the goals of internal and external balance, and also that, in conveying its conclusions, it should avoid any impression of exchange rate targeting or of defining equilibrium exchange rates.

- *Monetary policy framework.* Directors agreed that price stability should be the overriding objective of monetary policy. Some Directors considered that inflation targeting had been a useful framework for monetary policy, particularly in cases where greater credibility had to be established. Other Directors pointed out that formal inflation targeting had not been in place over a full economic cycle, and more experience was needed before its merits could be assessed. Increased transparency in monetary policy, irrespective of the framework in which it is conducted, was welcomed by many Directors.

- *Unemployment.* Board members considered that high unemployment represented a key challenge for the industrial countries, particularly in Europe. They

Box 4

INITIATIVES IN OPENNESS

In its surveillance activities, the Fund encourages countries to be open in disseminating economic information and in explaining reforms fully to the public. It also encourages them to promote debate and discussion of policies and consensus building for policy choices. Better understanding of economic policies by the public enhances the credibility and acceptability of policies and also ensures accountability on the part of governments.

Similarly, in recent years the Board has increasingly supported greater transparency in the Fund's policies and activities, opening up the work of the institution to more intensive public scrutiny. In all such initiatives, issues have been debated carefully, balancing the desire to promote improved public awareness and understanding of the Fund's responsibilities and of the benefits of economic reforms with the need to take account of the critical importance of maintaining confidentiality in the Fund's relations with members so as not to jeopardize the frankness, can-

dor, and content of the Fund's policy discussions with members.

Release of Information

Greater openness has implied a wider range of information on the Fund being provided to a broader audience. In July 1994 Directors approved the release of background reports on recent economic developments and related matters that are prepared for the Fund's Article IV consultations with members. In the 1995/96 financial year, 136 reports were released (see Appendix IV). The Fund has also encouraged countries to disclose details of their Fund-supported adjustment programs by releasing the letter of intent and, when such a document is drawn up, the policy framework paper prepared in close collaboration with staff of the World Bank as well as of the Fund. In recent years, the coverage of the *Annual Report* has increased considerably, including an expansion of information on Article IV consultation discussions with individual members:

23 countries were covered in the 1993 Report, and 34 in this year's Report. The Fund's publications program has also grown substantially, with publication of a larger number of analytical papers discussed by the Board. For the first time, in early 1996 the Fund issued a "Green Paper" soliciting reactions from market participants and policymakers in preparation of its initiative on developing standards for data dissemination.

Public Access

As part of the ongoing efforts toward greater openness, in January 1996 the Board agreed to grant access by the public, on request, to documentary materials held in the Fund's archives that are over 30 years old, subject to certain provisions. Documents originally classified as "secret" or "strictly confidential" will be released upon the Managing Director's consent to their declassification, which is expected to be granted in virtually all instances.

thought that implementation of Fund advice in that area had been less than complete, which could be attributed to the political difficulties of introducing far-reaching labor market reforms in these countries. Nevertheless, many Directors thought that the Fund should continue to address labor market issues and advise member countries. In this effort, the Fund should draw on research done by other organizations, especially the OECD.

At its April 1996 meeting, the Interim Committee received and welcomed a report based on the Board's discussion of members' policies implemented in the context of surveillance, which it saw as a useful bridge between the Board's regular work on bilateral surveillance and the Interim Committee's surveillance role.

The Fund's Statistical Policy and Provision of Data for Surveillance

High-quality, timely, and comprehensive statistics are essential both for countries to formulate their own economic policies and for the Fund to meet its responsibilities for surveillance over members' exchange rate policies. In April 1995, in the course of its previous review of surveillance, the Board had examined a range of issues related to the provision of data to the Fund. In particular, Directors had noted that recent events

had highlighted some shortcomings in surveillance because of deficiencies in the data reported to the Fund by a number of member countries. The Interim Committee, in its April 1995 communiqué, had stressed the importance of regular and timely provision by all members of economic data to the Fund and of the timely publication by members of comprehensive data in order to make their economic policies more transparent and had requested a report on these subjects.

As a first response to this request, in June 1995 the Board held a discussion on the Fund's statistical policy. Directors emphasized the critical importance of timely, comprehensive, and reliable data for the effective discharge of the Fund's mandate. They stressed the need for setting standards for data provision. The Board noted that the provision of data on a timely and accessible basis was in the self-interest of all member countries.

The Board agreed that it was imperative for the Fund, as well as for member countries, to improve the quality of data in terms of their coverage, methodology, and consistency. It also agreed that deficiencies and problems in data reporting and quality should be brought to the Board's attention to alert Directors to be cautious in interpreting data or to point out difficulties in cooperation between the member country and the Fund.

Directors suggested providing targeted technical assistance to member countries where data problems had arisen because of inadequacies in statistical infrastructure. Directors generally agreed that the different types of technical assistance provided by the Fund—including multisectoral statistical missions, outside experts, and short- and long-term technical advisors—had been effective and suggested systematic follow-up reviews of such assistance. They considered training to be a necessary and integral part of technical assistance and acknowledged the contribution of the Fund's statistical publications in providing economic and financial information to the international community.

In a follow-up discussion in July 1995, Board members focused on data provision to the Fund for surveillance. Directors reiterated their views on the importance of timely and comprehensive data for effective surveillance and their concerns that deficiencies in information provided to the Fund could have serious adverse consequences. They encouraged all member countries to improve the quality and timeliness of their basic statistical data.

For continuous surveillance between staff visits to member countries, the Board agreed to a list of 12 categories of data—exchange rates, international reserves, the central bank balance sheet, reserve money, broad money, interest rates, consumer prices, external trade, the external current account balance, external debt/debt service, the fiscal balance, and GDP/GNP—as needing to be provided in a regular and timely fashion. This list would be supplemented in many cases by data required for surveillance on a country-specific basis. Directors also suggested further work to define the appropriate coverage and periodicity of data and the timeliness of provision of information to the Fund. Directors observed that timely data on the core surveillance indicators were available for a large proportion of the membership. They nevertheless expressed concern that for a significant minority of members the lag in data provision was unduly long. They expressed their strong wish for members to continue to improve their data provision to the Fund and stressed that all countries should be expected at least to maintain current levels of reporting. Directors reiterated their support for a graduated approach to resolving difficulties with data provision, based on a cooperative dialogue between the Fund and its members.

The July 1995 Board discussion provided the basis for the report that the Interim Committee had requested in April. This report was endorsed by the Interim Committee in October 1995.

Other Issues in Surveillance

The Board discussed a number of other matters related to surveillance during the year. These included its reviews of a wide range of issues associated with the

transition to Economic and Monetary Union (EMU) in Europe; of the growing trend toward capital account convertibility and its implications for Fund policy; and of the importance of banking system soundness for macroeconomic stability and the efficient conduct of stabilization policies. In addition, there was an increasing focus on issues related to governance.

Progress Toward Economic and Monetary Union

In March 1996 Directors considered issues associated with progress toward EMU among members of the European Union. They observed that these issues—relating both to managing the EMU process and the policies of European Union countries—were important for Fund surveillance, and they expressed the strong interest of the Fund and of the global community in a successful process of economic and monetary integration.

In the view of Directors, convergence requirements under the Maastricht Treaty—in the areas of public finance, inflation, long-term interest rates, and the exchange rate—had played a central role in disciplining macroeconomic policies in many European Union countries. Directors recognized that although it was desirable that the union should proceed as envisaged in the treaty, the slowdown in Europe had made more difficult the task of satisfying the treaty's convergence requirements, particularly in the fiscal area.

The Board considered that the ongoing fiscal consolidation in European Union countries in preparation for EMU was desirable in its own right. The issue was how fast deficits should be reduced. Some Directors observed that in the higher-deficit countries fiscal consolidation could still yield significant medium-term benefits under a slower and more gradual adjustment path than that required to meet the treaty's convergence requirements in 1997, if the commitment to consolidation could be made credible to markets. Most Directors, however, favored a bold approach to consolidation: countries could gain credibility and achieve the full medium-term benefits of consolidation by substantial early progress in adjustment. Furthermore, the short-term demand effects of fiscal consolidation could be fairly quickly offset by the beneficial effects of lower interest rate premiums.

Although Directors agreed that more flexible labor markets in Europe were essential for realizing the full benefits of monetary union, views diverged on the timing and on the importance of labor market reforms. Some Directors thought that deep-seated labor market problems could weaken credibility in the transition to monetary union and suggested early action.

Another topic discussed was the assessment, planned for early 1998, of which countries would be ready to enter Stage 3 of EMU on January 1, 1999.

Directors noted the tensions between the goal of a wide participation of countries and that of the application of strict qualification criteria. In general, strict preconditions for participation in monetary union were considered appropriate. Many Directors thought that if the qualifying criteria were loosened, the initial credibility of the European Central Bank could be affected adversely. Since there had been considerable progress on convergence in inflation and interest rate differentials, satisfying the criterion for government finances was clearly the key challenge.

Most Directors thought that, after the decision to move forward with Stage 3 had been made, strong and symmetric intervention commitments to support the exchange rates of countries selected to participate would help to avoid speculation on the exchange rate at which their currencies would be locked. Many Directors noted that additional confidence could be given to the EMU process by an early agreement on a Stability Pact to guide surveillance of fiscal policies once monetary union had commenced and on exchange rate relations between the Euro and the currencies of European Union countries not participating initially in the single monetary policy.

The Board commented that the surveillance perspectives of the Fund and European Union institutions differed but were complementary: the Fund's advice centered on the operation of the international monetary system, and that of the European Union on economic and monetary integration in Europe. Nevertheless, the advice given by the two institutions to their common members had been broadly consistent and mutually reinforcing. Although there had been differences of emphasis on labor market strategies, these appeared to be narrowing, and both institutions could gain from understanding the perspective of the other.

Directors noted the importance of intensive Fund surveillance of the integration process in Europe, given the major challenges in the coming years of fostering a successful transition to monetary union, and they called for vigilance on the part of the Fund in identifying potential market tensions. To perform this task, they encouraged continued and closer contacts between Fund staff and staff of the European Union institutions. Furthermore, the Fund would increasingly need to consider policy issues pertaining to Stage 3, as well as how the establishment of the European Central Bank would affect relations between the Fund and European Union members.

Capital Account Convertibility and Implications for Fund Policy

Issues related to the movement of capital among countries are one of the central concerns of the Fund. The Interim Committee, in its Madrid Declaration in October 1994, welcomed the growing trend toward cur-

rency convertibility and encouraged member countries to remove impediments to the free flow of capital. During its biennial review of surveillance in April 1995, the Board amended the 1977 decision on surveillance to take account more explicitly of the role of private capital flows. Against this background, in July 1995 Directors reviewed the experience of the Fund's membership with capital account liberalization and discussed the role of the Fund in promoting capital account convertibility.⁷

Most Directors noted that in both developed and developing countries the trend was to liberalize capital controls and that, because of the high degree of integration in international capital markets, restrictions on capital outflows had generally not been effective. In the Board's view, controls could neither prevent the outflow of domestic saving nor allow fundamental policy adjustments to be delayed.

With increasingly liberalized capital markets and stronger efforts on the part of countries to stabilize economic growth, private capital flows had become both larger and more widespread, and Directors acknowledged the beneficial effects of such flows on growth and investment. A number of countries, however, had been affected by sudden surges in inflows, which at times had complicated macroeconomic management. Although Directors recognized that steps taken to deter capital inflows might occasionally provide breathing room to deal with market disruptions, they noted that disincentives or controls were potentially distortionary and also typically became less effective over time.

Given the limited effect of restrictions and controls, many Directors emphasized the difficulties under the present changed circumstances of a gradual approach to capital account liberalization, as had occurred in many industrial countries in past decades. The Board agreed that controls should not—and, in fact, could no longer—support inefficient policies and that capital account convertibility was intrinsically desirable. However, they emphasized that sustainable capital account liberalization required, in particular, a strong and well-supervised financial system in order to avoid costly reversals in the reform efforts.

On the sequencing of capital account liberalization, Directors noted that international capital flows were highly sensitive to yields and, therefore, that realistic,

⁷Capital account convertibility refers to freedom from exchange controls, such as quantitative controls, taxes, and subsidies, that countries apply to transactions in the capital and financial accounts of the balance of payments. The staff papers on which the Board discussion was based were published subsequently as *Capital Account Convertibility: Review of Experience and Implications for IMF Policies*, by staff teams headed by Peter J. Quirk and Owen Evans, IMF Occasional Paper No. 131 (Washington: International Monetary Fund, October 1995).

internationally competitive exchange rates and interest rates were essential. For that reason, it was desirable to develop financial market instruments either before or concurrent with liberalizing the capital account. Some speakers emphasized the catalytic effect of capital account liberalization in spurring structural adjustment and reform and in improving the supervision of the financial sector. It was important, Board members noted, to introduce and sustain firm stabilization policies as a complement to the opening of the capital account. In that connection, they also mentioned the need, in an environment of free capital flows, for adapting fiscal policy to the changing external conditions. Strengthened prudential management and information systems in the financial sector were especially important. Several countries had taken steps to improve these systems at the same time as, or before, liberalizing the capital account. Directors welcomed these efforts and advocated a stronger role for the Fund in promoting and assisting the improvement of the prudential systems.

Board members agreed that since the Fund's Articles were amended for the second time in 1978, the global economic environment had changed radically, and capital flows had assumed greater importance. They generally favored a fuller consideration of capital account issues in Article IV consultations with member countries and supported technical assistance to encourage capital account liberalization. Directors viewed such an approach as complementary to existing procedures for encouraging the transition to current account convertibility.

Banking System Soundness and Macroeconomic Policy

Since 1980, about two thirds of Fund member countries have had problems in their banking sectors, and many of the bank failures have had international repercussions. The experiences of these countries illustrate not only that a sound banking system is important for macroeconomic stability and for the efficient conduct of stabilization policies, but also that macroeconomic and structural policies have an impact on the soundness of the banking system. The Interim Committee, in both of its communiqués in 1995, had stressed that Fund surveillance should take due account of the soundness of financial sectors. In response to these requests, the Board in March 1996 examined the relationship between banking system soundness and macroeconomic and structural policies, as well as ways in which issues in bank soundness could be incorporated into Fund surveillance, Fund-supported programs, and technical assistance.⁸

⁸The staff studies on which the discussion was based will be forthcoming as a Fund publication.

Directors agreed that, given the links between banking systems and macroeconomic policies, the condition of the banking system—both as a key objective and as a constraint on policy—was an important consideration in formulating economic policy. Therefore, stabilization program targets and instruments might need to be adjusted in the light of an unsound or potentially unsound banking system. Several Directors, however, clarified that this did not imply delaying adjustment but, rather, the need for a realistic approach to policy design. They stressed the importance of a sound macroeconomic framework for underpinning an efficient banking system and urged that stabilization policies be complemented by structural reforms, such as strengthened supervision of banking systems and advancement of financial sector development and liberalization.

The Board agreed that the Fund should encourage members to adopt appropriate prudential standards, with emphasis not only on external oversight of banks but also on market discipline and internal bank governance. Most Directors concurred that in developing, emerging market, and transition economies, an independent and effective supervisory authority was needed. Given that banking problems had occurred even in countries with reasonably strong market discipline, Directors noted that in the industrial countries market discipline needed to be supplemented by effective official oversight.

In the Board's view, a sound banking environment could be ensured by a comprehensive mix of supervisory and regulatory policies, provided that the macroeconomic framework was also sound. An inadequate mix of these policies had weakened market discipline in many countries and had increased the fiscal cost of banking problems. Directors emphasized that issues concerning contingent government liabilities with respect to the banking sector deserved greater attention. National authorities should be encouraged to make such liabilities more transparent and to include them in fiscal projections.

The Board also underlined the need for coordination on banking system issues among the Fund, the World Bank, and other international agencies, with each agency concentrating on areas of core competence and complementing each other. The Fund should concentrate on the links between macroeconomic policy and banking systems and provide guidance on monetary and prudential policies in support of bank soundness. Most Directors believed that Fund surveillance of financial sectors was critically important and that the Fund should have access to appropriate data.

Although a number of Directors indicated that international cooperation in banking systems might best be left to the Basle Committee, some noted that the Basle standards were not necessarily applicable or

useful for all Fund member countries, in view of the widely differing situations countries faced. These Directors suggested that the Fund should concentrate on encouraging country authorities to strengthen their domestic systems and practices and to support regional initiatives. Noting that harmonization would not necessarily lead to homogeneous policies, they asked that the Fund also encourage members to meet international standards for financial sector reporting, regulation, and supervision.

The Board supported greater concentration on banking and financial sector issues in Fund surveillance and Fund-supported programs. Differing views were expressed on whether that could be achieved without a major redeployment of or an increase in staff resources. Many Directors stressed the importance of continued

technical assistance in the areas of bank supervision and financial sector development and underlined that such technical assistance needed to be properly integrated into Fund-supported adjustment programs and the content of structural benchmarks.

Governance Issues

In various discussions during the year, both on policies and in the context of Article IV consultations with member countries, Directors stressed the importance of good governance and transparency in promoting economic and political stability and in encouraging the efficient and effective use of resources. They also encouraged efforts to address the issue of corruption, which threatened to undermine policies to strengthen economic performance.

