

**Biennial Review of the Fund's Surveillance—Overview; Modalities of Surveillance; Content of Surveillance; and Public Information Notice on the Executive Board Discussion**

In the context of the biennial review of the Fund's Surveillance, the following documents have been published and are included in this package:

- Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Overview, July 2, 2004
- Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Modalities of Surveillance, July 2, 2004
- Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Content of Surveillance, July 2, 2004
- Public Information Notice summarizing the views of the Executive Board as expressed during its July 23, 2004 discussion.

The views expressed in these papers are those of the staff and do not necessarily reflect the views of the Executive Board of the IMF. The Executive Board's assessment is summarized in the Public Information Notice. Some country-specific or market-sensitive information may have been deleted, as allowed by the the IMF's publication policy.

INTERNATIONAL MONETARY FUND

**Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977  
Surveillance Decision—Overview**

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## I. INTRODUCTION

1. **This biennial review examines the implementation of the Fund’s surveillance over members’ exchange rate policies and considers the principles and procedures set out in the 1977 Surveillance Decision.**<sup>1</sup> This review comes in the wake of several Board discussions of surveillance, discussions of reports with a surveillance dimension such as those of the Independent Evaluation Office (IEO), and close attention to the conduct of Fund surveillance by the International Monetary and Financial Committee (IMFC) over the past two years.<sup>2</sup>

2. **This paper summarizes two companion papers, one on the content of surveillance and the other on its modalities, and proposes issues for discussion by Executive Directors.**<sup>3</sup> Specifically, it consists of the following elements: (i) a brief overview of the purposes and organization of Fund surveillance; (ii) a description of the methodology and objectives of this review; (iii) a presentation of the conclusions of the companion papers grouped around four dimensions of surveillance, namely staff analysis, policy dialogue with country authorities, communication of the Fund’s views, and assessments of the overall effectiveness of surveillance; (iv) a discussion of resource implications; and (v) issues for Board discussion, focusing on definition of priorities for surveillance activities for the next two years.

## II. PURPOSES AND ORGANIZATION OF SURVEILLANCE

3. **As required under the Articles, the Fund conducts surveillance to oversee members’ compliance with the obligations specified under Article IV, Section 1.** Regarding those obligations that relate directly to exchange rate policies, the Board adopted general principles in 1977 that continue to provide guidance to members on the performance

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<sup>1</sup> *Surveillance over Exchange Rate Policies*, DEC No. 5392-(77/63), 4/29/1977, as amended (see Appendix), available at [www.imf.org](http://www.imf.org).

<sup>2</sup> *Enhancing the Effectiveness of Surveillance—Operational Responses, the Agenda Ahead, and Next Steps* (4/10/2003; Public Information Notice No. 03/50, 4/10/2003); *Strengthening Surveillance* (9/10/2003; Public Information Notice No. 03/116, 9/10/2003); *Review of Data Provision to the Fund for Surveillance Purposes* (4/12/2004); *Evaluation of the Role of the Fund in Recent Capital Account Crises—Report by the Independent Evaluation Office* (7/28/2003); *Independent Evaluation Office—Evaluation of Fiscal Adjustment in IMF-Supported Programs* (9/9/2003); *Evaluation of Prolonged Use of Fund Resources* (9/25/2002); *Communiqués of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund* (Press Release No. 03/50, 4/12/2003; Press Release No. 03/159, 9/21/2003; Press Release No. 04/84, 4/24/2004); all above available at [www.imf.org](http://www.imf.org).

<sup>3</sup> *Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977 Surveillance Decision—Content of Surveillance*, available at [www.imf.org](http://www.imf.org); *Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977 Surveillance Decision—Modalities of Surveillance*, available at [www.imf.org](http://www.imf.org).

of these obligations. With respect to those obligations relating to the performance of domestic economic and financial policies, which are very general in nature, Fund surveillance has evolved over the years, reflecting changes in the international financial system. Members are required to provide the Fund with such information that the Fund considers necessary to enable it to conduct its surveillance activities (M,5).<sup>4</sup>

4. **The Fund exercises its surveillance mandate through Article IV consultations, which in principle take place annually, Board discussions of global developments, and maintenance of close contacts with members.** The Fund may also make use of special consultations and supplemental consultations. In practice, these procedures have rarely been used. Article IV consultations, which culminate in Board discussions, involve multiple steps and outputs, including compilation of economic and financial data, production of analytical studies, dialogue with country authorities, communications with non-officials, and written reports (M,6).<sup>5</sup>

5. **In the context of its regular Article IV consultations, discussions may often include matters that do not directly relate to the performance of members' obligations under Article IV, Section 1.** These discussions, however, are voluntary in two senses. First, the Fund is not required to discuss these matters. Second, the Fund cannot require the member to provide information respecting these issues for the purposes of surveillance (M,7).

6. **The exercise of the Fund's surveillance mandate in Article IV consultations and formal Board discussions of global developments is informed and supported by many complementary activities.** These activities, which rely on members' voluntary cooperation, include: staff visits; participation in the joint Fund-Bank Financial Sector Assessment Program (FSAP), which result in Financial System Stability Assessment reports (FSSA); participation in the standards and codes initiative, which result in Reports on Observance of Standards and Codes (ROSC); informal Board meetings on country matters; World Economic and Market Developments sessions; the quarterly vulnerability assessment exercise; publication of Article IV consultation documents, and outreach activities, such as conferences and seminars (M,8).

7. **The Executive Board has regularly reviewed the implementation of the Fund's surveillance and the 1977 Surveillance Decision.<sup>6</sup> In addition to amendments to this**

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<sup>4</sup> References in parentheses are to paragraphs of the paper on the modalities of surveillance, labeled "M", and on the paper on the content of surveillance, labeled "C".

<sup>5</sup> Article IV consultations also serve other purposes than surveillance. Article IV consultations encompass regular consultations under Articles VIII and XIV. On occasions, they are used as a vehicle for a dialogue with members on international economic issues, which is conducted on a voluntary basis consistently with the Fund's purposes (Article I(i)).

<sup>6</sup> Reviews have been conducted biennially since 1988. They were undertaken annually between 1978 and 1988.

**decision, the reviews resulted in Board conclusions on the conduct of surveillance, which were laid out in summings up and transposed in successive operational guidance notes to staff.** Notably, in the 2002 review of surveillance, Executive Directors came to the following conclusions on the coverage and focus of surveillance: (i) coverage of surveillance had expanded over the years from a relatively narrow focus on fiscal, monetary, and exchange rate policies to a broader purview encompassing external vulnerability assessments, external debt sustainability analyses, financial sector vulnerabilities, and structural and institutional policies that have an impact on macroeconomic conditions; (ii) the broader coverage of surveillance constituted a necessary and positive adaptation of surveillance to a changing global environment; (iii) individual Article IV consultations should continue to focus on key issues, and the twin objectives of breadth and focus could only be achieved by ensuring selectivity of coverage according to country-specific circumstances; and (iv) coverage of individual consultations should be guided by selection of topics based on macroeconomic relevance and, within these topics, matters at the apex of the Fund's hierarchy of concerns—i.e., external sustainability, vulnerability to balance of payments or currency crises, sustainable growth and the policies to achieve it, and, for systemically important countries, conditions and policies affecting the global or regional economic outlook (C,3).

### III. OBJECTIVES AND METHODOLOGY OF THE REVIEW

8. **This review revolves around one central question: how can surveillance be made more effective across the whole membership?** Considering the chain of activities that composes Fund surveillance and the complex relationship between the surveillance process and its ultimate economic objectives (i.e., financial stability and sustained sound economic growth), this question is approached by analyzing four different facets of Fund surveillance and related activities: the focus and depth of the Fund's economic analysis and policy advice; the nature of the policy dialogue with country authorities; communication of the Fund's policy messages, including signaling to creditors and donors in the context of surveillance; and assessments of the overall effectiveness of surveillance. Through this approach, the review seeks to answer the IMFC's call for proposals to enhance the focus, quality, persuasiveness, impact, and overall effectiveness of surveillance (M,2-3).<sup>7</sup>

9. **The review does not seek to assess whether Fund advice was right or wrong, or whether Fund surveillance was effective or ineffective, in individual cases.** Neither does the review for the most part attempt to assess whether analysis of, or policy recommendations on, a particular issue—say, short-term macroeconomic projections or medium-term fiscal targets—were generally right across the membership. Answering these questions—for a few countries or a few issues—would have necessitated in-depth country-case studies, similar to those done in the wake of financial crises, or exhaustive cross-country

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<sup>7</sup> *Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund* (Press Release No. 04/84, 4/24/2004), available at [www.imf.org](http://www.imf.org).

studies, such as those undertaken in reviews of the implementation of the 1994 Madrid Declaration.<sup>8</sup> These were beyond the scope of this review (M,17).

10. **The review consists of an in-house assessment complemented with additional perspectives.** The in-house assessment is based on a detailed survey of Article IV consultation documents covering all consultations concluded by the Executive Board between January 2003 and early March 2004, a review of multilateral surveillance documents, analysis of information on other surveillance activities (e.g., staff visits), a survey of mission chiefs, and collection and analysis of data on resource costs. The focus of all these activities was largely determined by the conclusions of the 2002 biennial review of surveillance, which identified several areas for improvement. In addition, staff explored different concepts of quality, attempted to define better the stages underlying the surveillance process, conducted a number of outreach activities to gather views external to the staff, and attempted to define monitorable objectives. Outreach activities included interviews, surveys, and workshops with country authorities (including Executive Directors), market participants, think tanks and other non-governmental entities, and the media (C,6; M,13-16).

#### IV. FOCUS AND QUALITY OF ANALYSIS

11. **Well-focused surveillance exercises and well-substantiated analyses are essential for effective surveillance.** This section presents results on the scope of Fund surveillance and aspects of the quality of its analyses in the past two years, and puts forth recommendations for further improvement.

##### A. Focus

12. **Under the expanded reach of surveillance, the challenge has been to keep individual Article IV consultations focused on key issues.** As indicated above, the Executive Board agreed that this is to be achieved by ensuring that coverage is adapted to country-specific circumstances, with selection of topics based on macroeconomic relevance and, more pointedly, on matters at the apex of the Fund's hierarchy of concerns (C,3).

13. **This review confirms that Fund surveillance has generally succeeded in embracing the wider coverage without losing focus,** a conclusion initially reached in the 2002 biennial review of surveillance. The focus of surveyed Article IV consultation reports varies substantially across countries, according to country-specific circumstances. In the view of assessors, the scope of coverage was broadly adequate—i.e., it was neither too broad nor too narrow, the focus of the consultation was clearly set out and well justified, and

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<sup>8</sup> *Mexico—Report on Fund Surveillance, 1993-94* (3/23/1995); *Review of Members' Policies in the Context of Surveillance—Lessons from Surveillance from the Asian Crisis* (3/9/1998); *Lessons from the Crisis in Argentina* (3/24/2004), available at [www.imf.org](http://www.imf.org); *Communiqué of the Interim Committee* (Press Release No. 94/69, 10/2/1994), available at [www.imf.org](http://www.imf.org); *Review of Members' Policies in the Context of Surveillance* (8/8/1996).

covered issues met the criterion of macroeconomic relevance—in more than three quarters of these reports (C,8-9).

14. **Nevertheless, there remains scope for greater selectivity in coverage of individual Article IV consultations.** Specifically, one could seek:

- **Narrower but, when necessary, deeper coverage of macroeconomically relevant issues outside the Fund’s traditional areas of expertise.** On occasions, the treatment of one or another of these issues in the Article IV consultation report was not substantive, which raised doubts about the quality of exchanges between staff and the member on this issue and, overall, the benefit from its inclusion in the coverage of the consultation (C,33,37,102,103,122; M,20). This could be remedied by (i) greater selectivity of coverage of these issues in individual consultations; (ii) greater use of information from outside experts, such as the World Bank or the OECD, on covered issues; and (iii) where information or expertise is unavailable to cover with appropriate depth an issue, acknowledgment of this situation and recommendations to remedy it (e.g., inclusion in country team’s work program, recommendation to undertake a ROSC).
- **More selective coverage of trade issues.** The coverage of trade issues has improved in the last two years, particularly for systemically important members. Nevertheless, it remains unfocused or insufficiently selective for a significant portion of the membership. In some cases, important elements, such as significant changes in regional trade agreements or sizable foreign impediments to export performance, were not highlighted. In some other cases, coverage was considered too lengthy given country specific circumstances—e.g., a largely open trade regime, no significant concern about market access, and no systemic impact of trade policies. Trade issues should be covered if they have an important influence on growth prospects or promotion of stability (C,29-30,37). Where covered, treatment of trade policies should be closely linked to discussions of other economic developments and policies.
- **Streamlined formal requirements on coverage of Article IV consultations.** Country authorities perceive that attempts to cover a large number of secondary issues in Article IV consultations are distracting. The tendency to use the Article IV consultation process as a “catch-all” vehicle to address a variety of Fund-wide issues of interest should be discouraged. A number of guidance notes on coverage of issues beyond the macroeconomic and financial areas could be cancelled or modified to reflect better the need for selectivity in coverage of individual Article IV consultations (M,28-30).
- **Provision of information to the Board through different channels than Article IV consultations.** Some information currently included in Article IV staff reports might be more efficiently provided to the Board in a different way—for example, on a designated space on the intranet, where information would be updated as appropriate and referenced in staff reports, or through omnibus reports (M,31).



15. **In addition, the focus of individual surveillance exercises could be subject to greater debate, announcement, and accountability.**

- **Debate.** As regards *bilateral surveillance*, some country authorities have expressed the desire to have exchanges of view with Fund staff on priorities for analytical work. Indeed, such dialogue has long been part of good practice. Such informal exchanges might be promoted. In addition, interdepartmental pre-brief meetings, which have become more frequent, have proven useful in surfacing different perspectives on key policy issues at an early stage. They could be used to discuss the strategic focus of consultations more systematically (M,27). As concerns *multilateral surveillance*, Executive Directors have used discussions on WEO reports and GFSRs to suggest topics that could usefully be covered in future WEO reports and GFSRs. Staff welcomes this practice, which is useful input in the staff's choices.
- **Announcement.** Country work programs, which would be articulated around limited sets of priorities and include a multi-year perspective, could be disseminated to the Board at the time of Article IV consultations (M,27).
- **Accountability.** The selection of particular topics is ultimately the responsibility of the staff, who should be held accountable for the choices made. In each staff report, inclusion of a few sentences indicating the topics selected as the main focus is therefore critical. Discussions of individual Article IV consultations, WEO reports, and GFSRs would be vehicles to consider whether these choices were appropriate, given the Fund's surveillance mandate and the priorities for surveillance activities set by the Executive Board (see paragraphs 7 and 78). At an aggregate level, subsequent reviews of surveillance would be another.

## **B. Quality**

16. The review focused on two of aspects of the quality of analysis, namely depth of coverage by topic and freshness of perspective.

### **Depth of coverage**

17. At the conclusion of the 2002 biennial surveillance review and in subsequent policy discussions, the Executive Board identified several issues whose coverage in Fund surveillance could be strengthened. These were spillover effects of policies in systemically important members, exchange rate issues, financial sector issues, external vulnerability assessments—including balance sheet analysis and debt sustainability—and sources of growth. In addition, the Executive Board decided to return to coverage of social issues in Fund surveillance and consideration of IEO suggestions on social program protection, and to review the Fund's experience with governance issues in the context of this biennial review. This section outlines the conclusions of the review of coverage of these issues in Fund surveillance over the past two years and offers recommendations for further improvement.

18. **Two main messages emanate from this review of coverage of specific issues in bilateral surveillance. First, coverage of a few areas, which have a direct bearing on matters at the apex of the Fund's hierarchy of concerns and are within the Fund's areas of expertise, should be strengthened further.** These areas include the systemic impact of the policies of the largest economies and the transmission of shocks at a global or regional level; financial sector stability; exchange rate issues; and vulnerability assessments. Some Article IV consultations already meet requirements in these areas. For others, the challenge lies in moving toward best practice. As discussed in Section VII, progress may be constrained by availability of staff resources. Second, as highlighted above (paragraph 14), **coverage of macroeconomically relevant issues outside the Fund's traditional areas of expertise has been, but could still be more, selective.**

#### *Global and regional spillovers*

19. The review considered the extent to which Article IV consultations focused on developments and risks in the global economy or in the region; and the extent to which surveillance of the G-3, which has a large impact on the world economy and a decisive influence on global financial conditions, focused on the systemic impact of these countries' policies.<sup>9</sup>

20. **The Fund's bilateral and multilateral surveillance has become more integrated over time. Nevertheless, there remains substantial room to strengthen the analysis of regional and global spillovers (C, 40-54).**

- Quantitative macroeconomic analysis is well integrated, with country teams using WEO data as inputs for quantitative work and the WEO database drawing on results of bilateral surveillance. However, most Article IV staff reports contain little explicit discussion of the impact of global economic conditions and risks. The near absence of references to global capital markets in Article IV reports is particularly striking.
- The WEO reports have provided detailed analysis of the impact of economic conditions and policies in G-3 countries on the rest of the world; and the GFSR has analyzed developments and risks in global capital markets, including transmission of (positive or negative) shocks from mature to emerging markets. These analyses have generally found limited echo in Article IV consultation reports for G-3 countries, apart from treatment of the systemic impact of their trade policies.
- Many Article IV reports refer to economic conditions in large regional trading partners, and area departments have made considerable efforts to strengthen regional surveillance. However, these activities generally get little explicit reflection in

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<sup>9</sup> The G-3 is defined as the United States, the European Union/euro area, and Japan.

Article IV staff reports, and reports with substantial coverage of regional spillovers are relatively rare.

21. In staff's views, **efforts to better integrate bilateral, regional, and multilateral surveillance** would need to focus on (C,57):

- **in bilateral surveillance of the G-3**, discussing the global consequences of their policies more fully, which would provide opportunities for a richer policy dialogue on these issues between the Fund and national (or regional) authorities;
- **in bilateral surveillance of all members**, linking past and prospective economic performance to global economic and financial conditions more explicitly; highlighting which global risks identified in the latest WEO, GFSR, or IMFC communiqué have particular relevance for the member concerned, and discussing how the member would cope if these risks materialized; and providing a more consistent analysis of regional spillovers by making fuller use of existing regional surveillance initiatives.

22. To assist these efforts, **specific mechanisms could be promoted** such as (i) strengthened procedures to facilitate exchanges of view among departments on key risks identified in the latest WEO report, GFSR, and IMFC communiqué and their implications for the focus of bilateral surveillance consultations; (ii) discussion by the Board of regional developments—which could include presentation of standardized indicators for all countries in the region and cover exchange rate issues and regional transmission of shocks—led by area departments, possibly annually; and (iii) enhancements to the elements pertaining to global capital market conditions, including in the WEO's analytical apparatus, in cooperation with ICM. In addition, greater use of alternative scenario(s), highlighting the global risk(s) of most significance to the member concerned, should be actively promoted in each Article IV consultation. To facilitate discussions of regional economic interactions, coordinating the timing of Article IV consultation discussions of neighboring countries could also be envisaged, if national calendars and staff resources make this feasible (C,58).

### *Exchange rate analysis*

23. **The Executive Board has often stressed that a thorough discussion of exchange rate issues is essential for Fund surveillance.** At the conclusion of the 2002 biennial review of surveillance, Directors called for candid treatment of exchange rate issues throughout the membership (C,66-67).

24. **Discussions of exchange rate regimes typically focus on consistency of the regime with macroeconomic policies, institutional conditions, and the external environment—**this is in line with guidance from the Executive Board. **They sometimes address management of the exchange rate regime**, particularly for countries whose regime is a managed float. The *de facto* regime is rarely identified to be different from the *de jure* regime. The sustainability of the exchange rate regime is only ever questioned for pegged

regimes. When advice on the nature or management of the regime is offered, it generally leans towards greater exchange rate flexibility regardless of the level of economic development. Important exceptions pertain to countries that maintain a hard peg or seek membership in a currency union (i.e., EU accession countries) (C,70-73).

25. **When staff advises a change in exchange rate regime** (i.e., adoption of a more flexible regime) **or in the exchange rate** (i.e., a depreciation), **country authorities tend to disagree and Executive Directors usually hold diverging views.** Authorities generally stress the benefits of the current regime for macroeconomic stability and the potential negative impact of exchange rate volatility. In these cases, a number of Directors typically share the authorities' views that the current exchange rate policy remains appropriate (C,76-77).

26. **Assessments of external competitiveness are often limited to an analysis of the evolution of a real effective exchange rate indicator; and exchange rate levels are often found to be “about right” or in line with fundamentals.** When a misalignment is identified, reports typically conclude that the exchange rate is overvalued. Cases where the exchange rate is assessed to be undervalued are rare and, in these few cases, the degree of undervaluation is typically considered slight (C,74-75).

27. **Overall, the review indicates that pointed discussions of exchange rate issues are both rare and controversial. It thus suggests that candid treatment of exchange rate issues remains a significant challenge.** Given the sensitivity of these issues, this challenge is not likely to be fully overcome. Nevertheless, to achieve a measure of progress, a few practical steps are worth pursuing: (i) identifying clearly the *de facto* regime; (ii) making more systematic use of a broad range of indicators and other analytical tools to assess external competitiveness; (iii) treating exchange rate issues (e.g., the choice of regime, the consistency between the exchange rate regime and other policies and institutional conditions) in particular depth, and presenting the policy dialogue between staff and the authorities on these issues in a comprehensive and balanced manner, when views differ between the authorities and staff (C,78-79).

28. The review also suggests that **it would be worth exploring further (i) whether the lessons of the past decade on the dangers of fixed exchange rates are applied too broadly**—in particular circumstances, as suggested by research findings, a fair degree of fixity in the exchange rate regimes may be worth considering for developing countries with limited exposure to private capital markets; **(ii) whether there may be some bias towards finding exchange rates overvalued; and (iii) what are the most promising paths to achieve a successful move towards greater flexibility,** as economies mature (C,80).

### *Financial sector analysis*

29. At the conclusion of the 2002 biennial review of surveillance, **the Executive Board emphasized that the coverage of financial sector issues needed to be brought up to par with coverage of other main areas of surveillance.** Directors were concerned that, in the

absence of an FSAP, the quality of financial sector surveillance had been uneven across countries (C,3).

30. **The coverage of financial sector issues has improved since 2002, but is not yet at par with coverage in other main areas.** Coverage varies substantially across countries: it is generally quite broad for emerging market countries, with the discussion providing substantial insights into macro-financial linkages; it is more selective for industrial countries; it is uneven for developing countries. This variance can be partly, but not fully, explained by the intensity of concerns about financial sector weaknesses. It also reflects allocation of financial sector expertise, as visible from the additional quality of coverage in consultations with substantial MFD or ICM participation, either in the form of an FSAP (jointly done with the World Bank) or of participation in the Article IV consultation. In many Article IV consultation reports, an assessment of the soundness of the financial system is presented; this assessment is not always explicitly supported by substantial data or analysis, and staff conducting this review questions how such an assessment can be made (C,26-27).

31. **Efforts need to be pursued to keep improving treatment of financial sector issues in Fund surveillance.** As indicated by Executive Directors at the conclusion of the last FSAP review, these efforts cannot be expected to rely solely on full FSAP assessments, given resource constraints and the voluntary nature of this program.<sup>10</sup> Other options—e.g., focused FSAP updates, MFD and ICM participation in Article IV missions, separate MFD or ICM missions, monitoring of financial sector developments from Fund headquarters, training of area department staff by MFD—need to be used as well to bring necessary expertise to bear on analysis of financial sector issues.<sup>11</sup> This review offers initial indications that use of these alternatives options can substantially enhance coverage of financial sector issues (C,37).

#### *Vulnerability assessments*

32. **Vulnerability to balance of payments or currency crises and external sustainability are two matters at the apex of the Fund's hierarchy of concerns.** At the conclusion of the 2002 biennial review of surveillance, Executive Directors welcomed efforts to strengthen vulnerability assessments and pointed to two issues that deserved greater attention: the private sector's balance sheet exposure to interest or exchange rate shocks, and debt sustainability (C,3).

33. **In recent years, to reinforce its capacity to identify vulnerabilities in member countries, the Fund has undertaken substantial work that is bearing fruit.** More than

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<sup>10</sup> *IMF Reviews Experience with the Financial Sector Assessment Program and Reaches Conclusions on Issues Going Forward* (Public Information Notice No. 03/46, 4/4/2003), available at [www.imf.org](http://www.imf.org).

<sup>11</sup> A forthcoming guidance note on financial sector surveillance in Article IV consultations should help further strengthen cooperation between area and functional departments in this area.

two-thirds of the reports covered in this review provided views on domestic sources of vulnerability to balance of payments, currency, or financial crisis. In most cases, these discussions were supported by relevant analyses of debt sustainability, financial and corporate sector vulnerabilities, domestic policy developments, and occasionally domestic political economy factors. Treatment of vulnerabilities was most substantive for emerging market countries. As discussed above, there was, however, less coverage of vulnerabilities identified from multilateral assessments (C,34-35).

34. **Vulnerability assessments are benefiting from initiatives to enhance coverage of balance sheet issues, including implementation of the strengthened framework for debt sustainability assessments. Balance sheet issues have received substantial attention in surveillance of both advanced and emerging market economies.** In advanced economies, the focus has been on private balance sheet vulnerabilities, particularly in connection with risks stemming from rising real estate prices and mortgage lending. In emerging market countries, staff reports have focused on the potential transmission of shocks across domestic sectors under crisis conditions, key factors contributing to resilience under such conditions, and ensuing policy advice. Nevertheless, limited data availability remains an obstacle to detailed balance sheet analysis in many instances (C,82-86).

35. **Only a limited number of reports provide an integrated assessment of crisis vulnerabilities and a clear view on the severity of these vulnerabilities.** In most cases, the discussion of vulnerabilities is distributed throughout the report and different elements of analysis are not tied together. In addition, it is not always easy to discern the intensity of staff's concerns about existing vulnerabilities (C,36).

36. Overall, the review indicates that (i) **the existing strategy to strengthen vulnerability assessments and balance sheet analysis is having a positive impact and should continue to be implemented diligently, recognizing constraints stemming from data weaknesses; and (ii) there is a need to integrate various components of vulnerability assessments better.** This work takes particular importance in the current global environment where, as stressed by the IMFC, vulnerabilities to prospective exchange rate and interest rate movements are a priority concern (C,37,91).

#### *Growth in low-income countries*

37. **Article IV consultation reports for low-income countries typically contain a broad treatment of growth objectives, their relation to poverty reduction, and potential means to achieve these objectives.** This coverage, which is part of the analysis of the medium-term outlook, can be seen to reflect recognition that, with progress on macroeconomic stability, the dominant challenge in many low-income countries is to sustain high rates of growth and to reduce poverty. For PRGF countries, PRSPs are mentioned but rarely play a central role in discussion of the medium-term outlook. A few reports reflected briefly on the country's prospects for meeting the Millennium Development Goals (MDGs) (C,21-24).

38. It is worth considering how to **reflect more fully the PRSP process and the international community's efforts to achieve the MDGs in Fund surveillance. To facilitate consideration of progress toward reaching the MDGs, an MDG table will be included in selected Article IV reports.** Article IV consultations for PRGF countries could also be used to analyze alternative macroeconomic frameworks aimed at meeting the MDGs, which could shed light on sustainable macroeconomic scenarios under different aid flow assumptions. For PRGF countries, coordination and sequencing of the PRSP process, program discussions, Article IV consultations, and *ex post* assessments pose a significant challenge; this issue merits further analysis (C,37).

39. **In addition, in surveillance of low-income countries, greater attention could be paid to external shocks than can derail growth and actions to improve resilience to such shocks.** Most Article IV consultation reports for low-income countries point to risks that can damage growth prospects, including external shocks, and jeopardize achievement of poverty reduction goals. Nevertheless, these reports rarely contain an explicit discussion of the possible quantitative impact of external shocks on the domestic economy and of reforms to minimize vulnerability to these shocks—an observation consistent with the above conclusions on the coverage of global spillovers in bilateral surveillance (C,22).

#### *Institutions and investment climate*

40. **Improving the investment climate and strengthening institutions are two overlapping elements often highlighted in growth-oriented reform agendas for low-income countries.** Other often stressed components in these agendas are structural fiscal reforms and improvements to physical infrastructure.

41. **Investment climate issues and institutional reforms also receive substantial attention in surveillance of middle-income countries.** Most Article IV consultation reports for middle and low-income countries address institutional issues, and a large share of them cover factors that affect the climate for private investment. Coverage of institutional issues is most substantial on fiscal-related aspects (e.g., fiscal transparency, efficiency of public enterprises), financial supervision and regulation, and legal and judicial reforms. Trade and customs regimes also receive substantial attention (C,96-104,116-119).

42. **The review points to two questions that deserve attention: generally weak coverage of issues outside the Fund's traditional areas of expertise, and limited follow-up on past recommendations.** Weak coverage of issues outside the Fund's areas of expertise may be explained by paucity of available information (e.g., still limited availability of ROSCs on corporate governance and insolvency and creditor rights) or limited use of outside information (e.g., reports of the World Bank and other multilateral development banks on the investment climate in individual countries). Limited follow-up on implementation of past recommendations raises the concern that the policy dialogue is not focused on sustained implementation of key reforms (C,105-109,120-122).

43. **In light of these conclusions, in addition to the above conclusion on the selectivity of coverage of issues outside the Fund’s traditional areas of expertise, it is recommended to strengthen attention to past policy recommendations, their continued validity, and implementation.** Given that, in many circumstances, institutional reforms and actions to improve the investment climate are likely to be successful only if they are pursued over a number of years, continuity in the policy dialogue between the Fund and members is crucial. In addition, to facilitate use of outside information, efforts are underway to channel information available from the World Bank, UNCTAD, and other providers to Fund country teams on a more systematic basis (C,123,140,143-144).

### *Social issues*

44. **In recent years, the Fund has paid much attention to social issues.** For many members, coverage of social sector issues may be explained by the emphasis placed on poverty reduction and achievement of social objectives in PRSPs and, generally, in the international community’s efforts to meet Millennium Development Goals. For some members, the relevance of social issues may stem from the role of social safety nets as shock absorbers to mitigate the impact of necessary policy adjustments on various sections of society and thus facilitate their implementation.<sup>12</sup> The IEO has recommended that, during Article IV consultations, staff invite country authorities to suggest what are the existing critical social programs and social services they would like to see protected in the event of adverse shocks (C,31).<sup>13</sup>

45. **More than half of Article IV consultation reports include some discussion of the macroeconomic impact of social policies.** A majority of these reports concern low-income countries, where coverage addresses incidence of poverty and human development indicators. For other members, coverage is justified by concerns about entrenched unemployment, or the macroeconomic impact of income inequality. Coverage of social issues is particularly substantive in post-conflict countries and members with endemic political and social instability. For some other countries, coverage is limited to a few passing references (C,32-33).

46. **The review suggest that, as for other issues outside the Fund’s traditional areas of expertise, coverage of the macroeconomic dimension of social issues has generally been selective, but that, at the margin, further selectivity of coverage is desirable.** This

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<sup>12</sup> For further discussion, see *Evaluation of the Role of the Fund in Recent Capital Account Crises—Report by the Independent Evaluation Office* (7/8/2003), available at [www.imf.org](http://www.imf.org).

<sup>13</sup> *Independent Evaluation Office—Evaluation of Fiscal Adjustment in IMF-Supported Programs* (9/9/2003), available at [www.imf.org](http://www.imf.org).



would allow for greater depth of treatment where needed.<sup>14</sup> As regards the IEO recommendation mentioned above, **in members where shocks could have a sizeable and sudden impact on social conditions, Article IV consultation missions—and other contacts between staff and member countries—may offer an opportunity to solicit members’ views on protection of social safety nets or of other priority expenditures in times of economic stress.** Such discussions would be conducted on a voluntary basis (C,37).

### *Governance*

47. **The guidance note on governance adopted by the Executive Board in 1997, and reviewed in 2001, promotes greater attention to governance issues in the Fund’s policy advice and technical assistance.**<sup>15</sup> The two main aspects of this work are: improving the management of public resources; and supporting the development of a transparent and stable economic and regulatory environment (C,124).

48. **Governance issues continue to be raised in a significant share of surveillance reports, with coverage focused on the development of policies, institutions, and administrative systems that embody good governance.** For the membership as a whole, the primary area of coverage is the fiscal domain, with transparency of the budget and operations of public enterprises as prominent topics. The second most common area of coverage is judicial reforms and broad-based anti-corruption measures. In developed countries, corporate governance was the issue most likely to be raised. In these countries, coverage of the “supply side” of corruption was also frequent, with references to implementation of the OECD convention against bribery of foreign official mentioned in four-fifths of members that have ratified the convention (C,129-133).

49. **Nevertheless, the review highlights two questions that deserve consideration: limited use and, on occasion, availability of relevant information; and relatively weak treatment of past and current policy recommendations.** This view logically echoes the above conclusions on coverage of institutional reforms. Apart from cases where surveillance and use of Fund resources are combined, staff appears to draw relatively little on World Bank expertise or on other outside information. Lack of information (e.g., non-availability of ROSCs) may, in some instances, hinder coverage of some governance issues. References to governance tend to be limited to descriptions of facts and of the authorities’ past or current actions; they tend to stop short of assessing adequacy of these steps or needs for further action (C,134-137).

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<sup>14</sup> It must be noted that, under Article IV, Section 3(b), it is open to the Fund to discuss such policies as background for an assessment of a member’s exchange rate policies and to discuss the implications of social policies for the member’s exchange rate policies, but not to assess the policies themselves.

<sup>15</sup> *The Role of the Fund in Governance Issues—Guidance Note (7/2/1997).*

50. Overall, **implementation of the 1997 guidance note on governance in surveillance activities has been broadly satisfactory. Further efforts could be concentrated on (i) greater use of outside information and, where needed, development of new information**—i.e. encouragement to have ROSCs on fiscal transparency or on monetary and financial transparency undertaken; **and (ii) greater attention to policy recommendations.** As noted above for institutional reforms, greater use of additional sources of information and greater focus on past and current policy recommendations would be expected to enrich the policy dialogue between the Fund and its members on governance issues (C,138-142).

### **Freshness of perspective**

51. **In April and July 2002, the Executive Board adopted several steps to ensure that Article IV consultations in members with Fund-supported programs provide a periodic reassessment of economic conditions and policies, stepping back from the program framework.** Directors endorsed guidance clarifying the role and nature of surveillance in program countries. The guidance stressed the need for the following four elements: a comprehensive assessment of recent economic developments, a candid analysis of the short- and medium-term outlook, a stocktaking of the policy strategy to date, and a candid account of the dialogue between staff and the authorities on key policy issues. Directors also took a decision allowing for greater flexibility in consultation cycles in program countries so that these consultations could be scheduled when a comprehensive assessment of economic developments, prospects, and policies was most useful. As a result, about two-thirds of Article IV consultations in program countries were conducted on a stand-alone basis or at the time of the adoption of a new arrangement. In addition, a few Article IV consultations combined with discussions of use of Fund resources were carried out differently than usual, with addition of a senior staff member to lead the Article IV consultation discussions (C,13,15).

52. **In March 2003, the Executive Board adopted a complementary measure for countries with a longer-term program engagement, namely conduct of *ex post* assessments (EPAs) and strategic forward planning in the context of Article IV surveillance.**<sup>16</sup> EPAs are expected to be prepared by an interdepartmental team prior to the Article IV consultation mission; reflect input from the World Bank; and cover an analysis of the problem facing the member, a critical and frank review of progress during the period of Fund-supported programs, and a forward-looking assessment that takes into account lessons learned and presents a strategy for future Fund engagement (C,14).

53. **This review shows that the quality of coverage of surveillance in program countries highlighted in the 2002 guidance has risen, with the most striking**

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<sup>16</sup> *IMF Concludes Discussion on Prolonged Use of Fund Resources* (Public Information Notice No. 03/49, 4/9/2003).

**improvement relating to taking stock of the economic policy strategy to date.**<sup>17</sup>

Discussions of this issue addressed, at a minimum and in broad terms, past policy implementation and the success or failure of previous programs. Most reports went into substantial detail, laying out policy objectives under past programs, identifying areas of weak implementation, discussing factors that contributed to the success or failure of the program, and shedding light on the remaining policy agenda (C,17-18).

54. **Progress was more muted regarding candid presentation of the short and medium-term outlook and candid account of the policy dialogue in Article IV consultations, particularly when undertaken at the time of a request for, or review of, use of Fund resources (UFR).** Several reports pointed to efforts to improve discussions of risks to the outlook, supported by debt sustainability analyses, presentation of alternative scenarios, or discussion of sensitivity to shocks. For a significant number of other reports, the discussion of the short-term outlook remained minimal. Regarding the policy dialogue, areas of dissension or the path to consensus often remained unclear (C,19-20).

55. Given these generally encouraging results and the still recent launch of EPAs, **it is proposed to review further progress in surveillance in program countries, once substantial experience with EPAs has been gained.** It may be noted that the above-mentioned steps to strengthen integration of bilateral and multilateral surveillance—particularly, greater use of alternative scenario(s) focused on one (or a few) key global risks—should help strengthen discussion of the economic outlook in program countries as in other countries, building on progress made through implementation of the strengthened debt sustainability framework (C,37). It may also be noted that efforts to strengthen the policy dialogue should balance the needs for a fresh perspective in surveillance and the benefits of continuity in relations between the Fund and its members (paragraphs 56-58).

## V. POLICY DIALOGUE

### A. Dialogue in Bilateral Surveillance

56. **A close and frank policy dialogue is an essential ingredient of effective surveillance. Most officials interviewed and most mission chiefs surveyed rated the quality of the policy dialogue between the Fund and members positively, but also pointed to scope to enhance it further.** In interviews with officials, three issues came to the forefront: the need for greater efforts to ensure that surveillance is conducted and perceived as a collaborative and mutually beneficial exercise, and not just an audit; the

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<sup>17</sup> Article IV consultations for program countries discussed by the Board between January 2003 and early March 2004 were reviewed to assess the impact of the steps adopted in 2002. Implementation of EPAs is too recent to allow for a review at this time.

recommendation that contacts between Fund staff and the authorities be better timed, paced, and targeted; and the strongly held views that high turnover of staff on country teams undermined the establishment of a rapport based on trust. In relation to the first of these three issues, authorities also expressed a strong interest in provision by staff of cross-country or regional analysis (M,33).

**57. The review of Article IV consultation reports points to similar conclusions.**

Assessors considered the presentation of the policy dialogue to be candid in most reports for non-program countries, though with some variance across policy areas. Where the presentation of the policy dialogue was not seen as candid, the coverage of the authorities' views was limited; in those cases, the report's section on policy discussions read more like a monologue than a genuine policy dialogue (M,34;C,11-12).

**58. Certain steps could be taken to raise the quality of the policy dialogue with the authorities (M,36,38):**

- More *cross-country comparative studies* could be prepared by staff and fed into discussions with authorities. By adding value to the discussions, this would help strengthen the sense of collaboration between the Fund and country authorities.
- *Regular contacts* outside the Article IV consultation, which are already frequent, could be intensified. They could take the form of short staff visits, exchanges of informal policy notes, and organization or participation in conferences and seminars, including regional conferences. Resident representatives are also seen as having a very useful role.
- To strengthen engagement in Article IV consultations, a *policy statement* prepared by the member and provided to staff ahead of the Article IV consultation mission could be helpful. It could cover the member's main macroeconomic, financial, structural, and institutional policies, including reactions to previous consultations.<sup>18</sup>
- At the end of Article IV consultation missions, a *one-page note targeted at senior policymakers* could be prepared, as a complement to the Article IV mission's concluding statements.
- *Mechanisms for staff rotation and mobility across countries* could be reviewed to reach greater continuity in the policy dialogue, enhance mutual trust, and build up country-specific knowledge. These objectives would have to be balanced against the benefits of bringing fresh perspectives to country work.

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<sup>18</sup> Provision of a policy statement would not determine the scope of the Article IV consultation. As indicated in paragraph 14, staff is responsible, and accountable, for the selection of topics in individual surveillance exercises.

## B. Modalities of Surveillance in Currency Unions

59. **For members of currency unions, the conduct of surveillance requires that discussions be held with representatives of relevant regional institutions,** since these institutions have responsibilities over monetary and exchange rate policies—an area at the heart of Fund surveillance (M,74).

60. **Formal procedures for surveillance of the euro area were adopted in 1998. They made discussions with regional institutions an integral part of the Article IV consultations with euro area members.** Other elements of these procedures include: twice-yearly staff discussions; an annual Board discussion based on a staff report and resulting in a summing up; and, to the extent feasible, clustering of individual Article IV consultations. These modalities have worked reasonably well in practice (M,75-78).

61. **Modalities of surveillance of the three other currency unions—the West African Economic and Monetary Union, the Central African Economic and Monetary Community, and the Eastern Caribbean Currency Union—have moved towards greater formalization.** In recent years, annual staff reports on regional discussions have been prepared and discussed by the Board for all three currency unions. Public information notices (PINs) and, in some cases, staff reports were published. The coverage of regional discussions with these currency unions was broadly comparable to that of the euro area (M,79-81).

62. **The absence of a formal regional consultation process in these three currency unions weakens the ability of the Fund to exercise surveillance. Further formalization of surveillance activities would be desirable.** The establishment of a clear framework for policy discussions with regional institutions and the explicit recognition that these discussions form part of the Article IV consultation with concerned members would strengthen surveillance over monetary and exchange rate policies, trade policies, and financial sector regulation and supervision. The modalities for more formalized consultations would need to be determined in consultation with the relevant national and regional authorities, and approved by the Executive Board (M,82-84).

## VI. COMMUNICATION AND SIGNALING

### A. Communication

63. **Communication by the Fund has been seen as a means to enhance the overall effectiveness of surveillance.** It is designed to contribute to informing economic discussions in member countries and decisions by market participants. Officials and non-officials interviewed in the context of this review linked two aspects of communication, namely general dissemination of surveillance output to the public—including direct contacts with non-government representatives—and publication of country documents, to the effectiveness of Fund surveillance (M,39).

64. **As previously stressed by Executive Directors, communication, including publication of staff reports, should not come at the expense of reduced candor in the Fund's dialogue with members and in reporting to the Board.** The majority of interviewed officials indicated that publication should remain subsidiary to the Fund's role as a provider of frank, high-quality policy advice. Some officials observed that publication is now widespread; and that fears of adverse market impact had not been realized. Some other officials said that the risks associated with publication should not be discounted. Many market participants believed that political pressures already excessively influenced published staff assessments (M,46-47).

65. **The Fund's efforts to intensify communication to the public have raised the profile of surveillance in recent years. Yet public understanding of the role of surveillance and public knowledge of the Fund's policy messages remain limited.** Those interviewed gave credit to transparency policies, more frequent outreach activities, and other innovations in mission modalities, which were tailored to each member's specific circumstances. At the same time, interviewed officials stressed that, in most cases, the nature of Fund surveillance was understood by only a narrow group of officials and its policy messages reached few people (M,40-41).

66. **To strengthen communication, various steps could be considered** (M,45,48):

- ***A general reflection on interaction with the various audiences of surveillance.*** It could assess what are the most useful forms of outreach according to members' circumstances, and who can best conduct outreach activities. It could also revisit the role and format of Board summings up. These themes could be taken up in the forthcoming review of the Fund's external communications strategy.
- ***A more active outreach program,*** including within governments, designed to explain the purposes and modalities of surveillance and disseminate the key findings of individual surveillance exercises.
- ***Enhanced contacts with local think tanks and participation in conferences in members countries.*** For instance, a local research institute could offer a platform for hearing local views, presenting the conclusions of work related to the consultation, and discussing desirable avenues for future research.
- ***Active dissemination of best practices*** (e.g., on presentation of staff reports) and information on innovations in consultations (e.g., press conferences) within the Fund. Further experimentation with the formats and styles of staff reports could also be encouraged.
- ***Encouragement to members to make greater use of the "right of reply"*** provided for in transparency policies, to increase comfort with publication while preserving candor.

## B. Monitoring and Signaling

67. **The Fund has been faced with a recurring demand for two outputs: policy monitoring at high frequency; and delivery of a clear signal on the strength of a member's macroeconomic policies.** This demand has arisen from a variety of reasons, including the need to address high crisis vulnerabilities, a desire to stress commitment to sound policies, or a need to provide assurances to donors or creditors (M,66-67).

68. **Members have expressed a demand for such services in circumstances where they could not be met with a Fund arrangement.** The Fund does provide high-frequency monitoring and a clear signal in the context of a program relationship, in addition to financing (contingent on the existence of financing needs). However, members may not wish, or be able, to follow that route (because they have limited actual or potential financing needs, or because they cannot or do not wish to commit to the conditionality of a formal program) (M,67).

69. **While flexibility in the procedures for surveillance and surveillance-related activities has allowed the Fund to respond to demands for high-frequency monitoring, efforts to establish a signaling mechanism outside a program context have met with limited success.** Several procedures were established but rarely used. Signaling SMPs were discontinued by the Board due to risks of misuse of the instrument. Recently, new proposals for signaling mechanisms did not find sufficient support in the Board (M,68).

70. **The design of a robust signaling mechanism must address a number of delicate issues.** These include incentive compatibility (to address the fact that the signal is given upfront prior to policy implementation), definition of a standard against which to assess country performance, signal clarity, assurance of country ownership, and, where relevant, acceptability to the donor community (M,70).

71. **Greater transparency has raised the potential for signaling in the context of surveillance; and there is scope to use more extensively the flexibility in existing surveillance procedures to provide more frequent and clearer signals than done so far.** With the possibility to disseminate PINs, staff reports, and assessment letters to the public, a number of avenues for signaling have been opened. **Article IV consultations could be conducted at a higher than annual frequency** to permit more frequent issuance of a Fund view (as opposed to staff's views) on a member's policies. **A member could present a home-grown quantitative economic framework, possibly complemented by a detailed and monitorable policy agenda, for use as a benchmark against which to assess performance in a surveillance context, when the policy framework itself would be evaluated.** This quantified framework and policy agenda could form the core of a policy statement that would be provided to staff in the early stages of the Article IV consultation (see paragraph 58) (M,69,71).

72. **Further work is needed to determine the most promising avenues to respond to members' demands for signals.** Executive Directors will have the opportunity to come back

to this issue in a number of forthcoming meetings, including discussions of precautionary arrangements and of the Fund's signaling role in low-income countries (M,72).

## VII. ASSESSING EFFECTIVENESS

73. **Assessing the overall effectiveness of surveillance is an essential but daunting task.** The Fund has a mandate to exercise surveillance over members' economic and financial policies and surveillance over members' exchange rate policies, and devotes substantial resources to this activity. It must be accountable to its members for the discharge of this mandate and the use of the resources spent on it. However, the relationship between the surveillance process, members' policy decisions, and the final objectives of surveillance (i.e., sustained sound economic growth with price stability, financial stability) is complex. In addition, with the broadening of the purview of surveillance and its transformation into a more public process, the chain of reactions to Fund policy advice has become even more intricate and difficult to trace (M,9-12).

74. **Interviews with officials and non-officials confirmed that assessing the effectiveness of surveillance is challenging.** Most of those interviewed considered that, overall, Fund surveillance contributes positively to decision making. However, they pointed out that its impact is far from uniform across countries, and that it occurs at different places in the results chain (i.e., the chain from policy advice (and other factors) through policy decisions to economic outcomes). Most officials found that surveillance helped stimulate the policy debate within the government; official and others thought that, in some cases, Fund advice also helped stimulate the broader domestic policy debate; and market participants tended to value most the dissemination of high-quality and standardized data (M,49).

75. **To make further progress in assessing the overall effectiveness of surveillance, the following steps could be considered (M,52-56):**

- **Making sure that, at the end of each review of surveillance, the strategic objectives for the period ahead are set out and are thus monitorable.**
- **Maintaining the requirement that Article IV consultation reports include a brief assessment of the authorities' response to the key policy challenges identified in previous consultations.** While experience with this requirement has been mixed, it is worthwhile giving staff more time to gain experience implementing it. Over time, such assessments should help identify main obstacles to effective surveillance, and increase the Fund's accountability for its surveillance activities.
- **Encouraging Executive Directors to present more detailed views on the overall effectiveness of surveillance in Board discussions of Article IV consultations, including in their written statements.** Such a practice, including comments on the staff's choice of key topics and on the authorities' response to previous Fund policy recommendations, would help generate more systematic information and views on factors that boost (or limit) effectiveness of surveillance in different circumstances.



- **Promoting identification of the priorities of individual Article IV consultations and related modalities during their preparation.** Pre-brief meetings offer one mechanism for inter-departmental exchanges of view on these questions.
- **Pursuing methodological work on assessments of effectiveness of surveillance,** including in the context of the work on performance indicators.

## VIII. USE OF STAFF RESOURCES

### A. Recent Trends

76. **Key characteristics of recent trends in use of staff resources in surveillance and related activities are as follows (M,92-97):**

- the amount of resources dedicated to surveillance grew markedly in FY2001-03, reaching 510 staff years, from an average of 410 staff years in FY1998-2000;
- this increase was concentrated in two areas, namely FSAP and ROSCs and multilateral surveillance;
- during this period, resources dedicated to traditional bilateral surveillance activities have slightly declined to around 320 staff years or 1.8 staff years per member in FY2003;
- in addition to FSAP and ROSCs, a number of initiatives have increased demands on staff time and competed with traditional surveillance activities—for instance, *ex post* assessments, which have cost around 0.2 to 0.3 staff year per assessment; and
- Fund-wide averages mask significant differences across country groups, with bilateral surveillance of the G-7 economies being the most resource intensive given their complexity and systemic importance and bilateral surveillance of low-income countries the least resource intensive.

### B. Resource Implications of the Review's Proposals

77. **The resource implications of the review's recommendations can be summarized as follows (M,98-106):**

- Implementing the recommendations of this review would entail significant costs, which staff broadly estimates at 27 to 32 staff years and, including related travel costs, US\$10 to 11 million—about 5 to 6 percent of total resources now devoted to

surveillance.<sup>19</sup> The largest element would relate to improved coverage of financial sector issues.

- The review identified a few potential sources of saving. Streamlining formal requirements and more selective coverage of issues outside the Fund's traditional areas of expertise could save some resources. There may be other sources of offset, but they are difficult to quantify and unlikely to be large enough to meet estimated needs.
- Thus, **the total net costs of the review's recommendations are large and there seems to be little scope for implementing them fully without devoting additional resources to surveillance.** It is notable that the staff resources devoted to bilateral surveillance (essentially in the area departments) have slightly declined in the past five years. At the same time, there is recognition that the surveillance process has become more complex. Area departments now feel that they have little, if any, scope to add tasks without affecting quality.
- Faced with this situation, the staff recommends (i) **giving immediate Fund-wide priorities to three of the review's recommendations, namely sharpening the focus of consultations, enhancing financial sector surveillance, and deepening the coverage of regional and global spillovers in bilateral surveillance** (both for countries where shocks originate and countries where they are felt); and (ii), as for other recommendations, priorities would have to be defined on the basis of members' circumstances.
- **The Board could discuss a potential increase in resources allocated to surveillance in the context of the next budget discussions.** Should it wish to pursue this avenue, refined cost estimates could be presented to the Board at that time. These estimates would lay the ground for proposals on reallocation of resources across surveillance activities as well as between surveillance and other areas.

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<sup>19</sup> These estimates are provided only as tentative indications of resource costs. These have been developed, in consultation with OBP, on the basis of Fund-wide averages and broad assumptions. The only exception is financial sector surveillance, where the number was derived from preliminary, country-by-country estimates provided by area departments. All estimates are of "net" resource requirements, that is, over and above resources currently devoted to these tasks. Full implementation of the review's recommendations, and the concomitant incurrence of related gross costs, would not imply that "best practice" would be achieved in all areas discussed in the review. For instance, as regards financial sector surveillance, the resource costs are those necessary to meet the minimum requirements; as regards balance sheet analysis, the review only contemplates, and costs, continued implementation of the current experimental approach; and, as concerns surveillance in low-income countries, the review points to the need for further policy work, whose eventual recommendations would have to be costed.

## IX. ISSUES FOR DISCUSSION

78. Executive Directors may wish to address the following conclusions and recommendations:

(i) ***On focus of surveillance.*** The conclusions of the 2002 review of surveillance on the coverage and focus of surveillance, which emphasize that selection of issues should be based on the criterion of macroeconomic relevance and, within these topics, matters at the apex of the Fund's hierarchy of concerns, remain valid (paragraph 7). The Fund has generally succeeded in embracing the wider coverage of surveillance without losing focus. There is scope for greater selectivity in coverage of individual consultations, with narrower (but when necessary deeper) coverage of issues outside the Fund's traditional areas of expertise, more selective coverage of trade issues, streamlined formal requirements, and provision of information through different channels than Article IV consultations (paragraph 14). The choice of focus of individual surveillance exercises should be subject to greater debate, announcement, and accountability (paragraph 15).

(ii) ***On content of surveillance in macroeconomic and financial areas.*** There remains substantial room to strengthen the analysis of global and regional spillovers (paragraphs 21-22, 39). Candid treatment of exchange rate issues remains a significant challenge (paragraphs 27-28). The coverage of financial sector issues has improved but efforts need to be pursued to keep strengthening treatment of these issues in Fund surveillance (paragraph 31). The current strategy to strengthen vulnerability assessments and balance sheet analysis is having a positive impact, but there is a need to integrate various components of vulnerability assessments better (paragraph 36). There may be scope for fuller reflection of the PRSP process and international community's efforts to achieve the MDGs in Fund surveillance (paragraph 38).

(iii) ***On content of surveillance in areas outside the Fund's traditional areas of expertise.*** Investment climate issues, institutional reforms, and social issues receive substantial attention in Fund surveillance. In addition to greater selectivity of coverage and wider use of outside expertise, coverage of the first two of these issues would benefit from greater attention to past and current implementation of policy recommendations (paragraphs 43 and 46). Implementation of the 1997 guidance note on governance has been broadly satisfactory (paragraph 50).

(iv) ***On freshness of perspective.*** The quality of surveillance in program countries has risen since 2002, with progress being most pronounced on taking stock of the economic policy strategy to date. Promotion of the use of alternative scenarios in Article IV consultation would help make further advances in discussions of the economic outlook (paragraph 22). Further progress can also be expected from EPAs; a further review of surveillance in program countries should wait until substantial experience has been gained with EPAs (paragraph 55).

(v) ***On policy dialogue.*** Various steps could be taken to raise the quality of the policy dialogue between the Fund and member authorities, including preparation of more cross-country studies, more frequent contacts, and provision of policy statements by member countries (paragraph 58).

(vi) ***On surveillance in currency unions.*** The review recommends to seek formalization of surveillance activities with currency unions (other than the euro area) in consultation with relevant national and regional authorities (paragraph 62).

(vii) ***On communication.*** Various steps could be considered to strengthen communication of the Fund's policy messages, including a general reflection on interaction with various audiences, enhanced contact with local think tanks, and encouragement to members to make greater use of the "right of reply" provided for in transparency policies (paragraph 66).

(viii) ***On signaling.*** The Fund has been faced with a recurrent demand for delivery of a clear signal of the strength of a member's macroeconomic policies. The design of an acceptable signaling mechanism involves many delicate issues. There is scope for providing clearer and sharper signals in the context of surveillance than has been done so far (paragraph 71). Executive Directors will have the opportunity to discuss signaling issues in a number of forthcoming meetings (paragraph 72).

(ix) ***On assessing overall effectiveness of surveillance.*** The review points to the importance and the complexity of assessing the effectiveness of surveillance. To make further progress on this front, several steps could be considered, including setting monitorable strategic objectives in reviews of surveillance, promoting identification of priorities and enhancing discussions of effectiveness in individual Article IV consultations (paragraph 75).

(x) ***On use of staff resources.*** The review presents information on use of staff resources on surveillance and tentative estimates of the costs of the review's recommendations. It argues that these costs cannot be met without additional resources devoted to surveillance activities (paragraph 77).

(xi) ***On overall priorities.*** This review is centered on one ultimate objective, namely making surveillance more effective across the whole membership. Given the limits on resources, there is a need to define priorities among objectives and thus implementation of specific recommendations, reflecting as well that effectiveness of Fund surveillance depends on evenhanded implementation. The Fund's total surveillance effort should be evaluated against these priorities at the time of the next review of surveillance. As a balanced approach across the membership, staff recommends, *inter alia*, to give immediate Fund-wide priorities to sharpening the focus of consultations, enhancing financial sector surveillance, and deepening the coverage of regional and global spillovers in bilateral surveillance. These would be monitorable objectives for the next review of surveillance. In addition, given the IMFC's call for further progress on improving debt sustainability and reducing balance sheet vulnerabilities as well as further work on surveillance in low-income countries, the next

review of surveillance could be an opportunity to take stock of the situation in these areas (paragraph 77).

(xii) ***On the review of the 1977 Surveillance Decision.*** This review suggests that the 1977 Surveillance Decision, as amended, continues to provide an appropriate legal framework under which to seek further improvements in implementation of Fund surveillance.

### **The 1977 Surveillance Decision, as Amended**

1. The Executive Board has discussed the implementation of Article IV of the proposed Second Amendment of the Articles of Agreement and has approved the attached document entitled "Surveillance Over Exchange Rate Policies". The Fund shall act in accordance with this document when the Second Amendment becomes effective. In the period before that date the Fund shall continue to conduct consultations in accordance with present procedures and decisions.
2. The Executive Board shall review the document entitled "Surveillance Over Exchange Rate Policies" at intervals of two years and at such other times as consideration of it is placed on the agenda of the Executive Board.

*Decision No. 5392-(77/63)  
April 29, 1977, as amended by  
Decision No. 8564-(87/59), April 1, 1987,  
Decision No. 8856-(88/64), April 22, 1988,  
and Decision No. 10950-(95/37), April 10, 1995*

### **Surveillance over Exchange Rate Policies**

#### ***General Principles***

Article IV, Section 3(a) provides that "The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article." Article IV, Section 3(b) provides that in order to fulfill its functions under 3(a), "The Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies." Article IV, Section 3(b) also provides that "The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purpose of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members." In addition, Article IV, Section 3(b) requires that "each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies."

The principles and procedures set out below, which apply to all members whatever their exchange arrangements and whatever their balance of payments position, are adopted by the Fund in order to perform its functions under Section 3(b). They are not necessarily

comprehensive and are subject to reconsideration in the light of experience. They do not deal directly with the Fund's responsibilities referred to in Section 3(a), although it is recognized that there is a close relationship between domestic and international economic policies. This relationship is emphasized in article IV which includes the following provision:

“Recognizing...that a principal objective [of the international monetary system] is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates.”

***Principles of Guidance of Members' Exchange Rate Policies***

- A. 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.
- B. 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 value of its currency.
- C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

***Principles of Fund Surveillance over Exchange Rate Policies***

- 1. The surveillance of exchange rate policies shall be adapted to the needs of international adjustment as they develop. The functioning of the international adjustment process shall be kept under review by the Executive Board and Interim Committee and the assessment of its operation shall be taken into account in the implementation of the principles set forth below.
- 2. In its surveillance of the observance by members of the principles set forth above, the Fund shall consider the following developments as among those which might indicate the need for discussion with a member.
  - (i) protracted large-scale intervention in one direction in the exchange market;
  - (ii) an unsustainable level of official or quasi-official borrowing, or excessive and prolonged short-term or quasi-official lending, for balance of payments purposes.

- (iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, or restrictions on, or incentives for, current transactions or payments, or  
  
(b) the introduction or substantial modification for balance of payments purposes or restrictions on, or incentives for, the inflow or outflow of capital;
- (iv) the pursuit, for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows;
- (v) behavior of exchange rate that appears to be unrelated to underlying economic and financial policies that provide abnormal encouragement or discouragement to capital flows; and
- (vi) unsustainable flows of private capital.<sup>20</sup>

3. The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the developments in the member's balance of payments, including the size and sustainability of capital flows, against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. The appraisal shall take into account the extent to which the policies of the member, including its exchange rate policies, serve the objectives of the continuing development of the orderly underlying conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment.

#### *Procedures for Surveillance*

I. Each member shall notify the Fund in appropriate detail within thirty days after Second Amendment becomes effective of the exchange arrangements it intends to apply in fulfillment of its obligations under Article IV, Section I. Each member shall also notify the Fund promptly of any changes in its exchange arrangements.

II. Members shall consult with the Fund regularly under Article IV. In principle, the consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV, and shall take place annually. They shall include consideration of the

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<sup>20</sup> This paragraph, as well the following paragraph, were amended on April 10, 1995 by Decision No. 10950-(95/37), available at [www.imf.org](http://www.imf.org).



observance by members of the principles set forth above as well as of a member's obligations under Article IV, Section 1. Not later than three months after the termination of discussions between the member and the staff, the Executive Board shall reach conclusions and thereby complete the consultation under Article IV.<sup>21</sup>

III. Board developments in exchange rates will be reviewed periodically by the Executive Board, inter alia in discussions of the international adjustment process within the framework of the *World Economic Outlook*. The Fund will continue to conduct special consultations in preparing for these discussions.

IV. The Managing Director shall maintain close contact with members in connection with their exchange arrangements and exchange policies, and will be prepared to discuss on the initiative of a member important changes that it contemplates in its exchange arrangements or its exchange rate policies.

V. If, in the interval between Article IV consultations, the Managing Director, taking into account any views that may have been expressed by other members, considers that a member's exchange rate policies may not be in accord with the exchange rate principles, he shall raise the matter informally and confidentially with the member, and shall conclude promptly whether there is a question of observance of the principles. If he concludes that there is such a question, he shall initiate and conduct on a confidential basis a discussion with the member under Article IV, Section 3(b). As soon as possible after the completion of such a discussion, and in any event not later than four months after its initiation, the Managing Director shall report to the Executive Board on the results of the discussion. If, however, the Managing Director is satisfied that the principles are being observed, he shall informally advise all Executive Directors, and the staff shall report on the discussion in the context of the next Article IV consultation; but the Managing Director shall not place the matter on the agenda of the Executive Board unless the member requests that this procedure be followed.

VI. The Executive Board shall review the general implementation of the Fund's surveillance over members' exchange rate policies at intervals of two years and at such other times as consideration of it is placed on the agenda of the Executive Board.<sup>22</sup>

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<sup>21</sup> This paragraph was amended on April 1, 1987 by Decision No. 8564-(87/59), available at [www.imf.org](http://www.imf.org).

<sup>22</sup> This paragraph was amended on April 22, 1988 by Decision No. 8856-(88/64), available at [www.imf.org](http://www.imf.org).

INTERNATIONAL MONETARY FUND

**Biennial Review of the Implementation of the Fund's Surveillance and of the 1977  
Surveillance Decision—Modalities of Surveillance**

Prepared by the Policy Development and Review Department

In consultation with International Capital Markets, Research and other Departments

Approved by Mark Allen

July 2, 2004

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## I. INTRODUCTION

1. **This paper discusses the modalities of surveillance and surveillance-related activities.**<sup>1</sup> It provides a complementary view to its companion paper on the coverage and contents of surveillance by focusing on the procedures under which surveillance has been conducted since the last review and their contribution to the overall effectiveness of surveillance. Chapter II takes a broad perspective and tries to identify, on the basis of outreach surveys and interviews, areas where these modalities could be improved to make surveillance more effective in meeting its goals. Chapters III and IV look more closely at the modalities used in two specific sets of circumstances: the surveillance of countries whose conditions justify more intensive procedures, and regional surveillance. Chapter V discusses the amount and distribution of the resources assigned to surveillance, and the potential implications in that area of the recommendations included in this review.

## II. MODALITIES TO ENHANCE THE EFFECTIVENESS OF SURVEILLANCE<sup>2</sup>

### A. Introduction

2. **At the conclusion of the 2002 biennial review of surveillance, and in subsequent Board meetings, Directors agreed that one of the key aspects of the reflection on Fund's surveillance should be on ways to increase its impact.**<sup>3</sup> They noted that this impact depends, in particular, upon the delivery of high-quality policy advice that is both analytically rigorous and relevant to a country's social and economic realities, the maintenance of a close and open policy dialogue, the delivery of candid policy messages in a broadly transparent framework, and the continued flexibility of surveillance modalities. Directors generally found the current surveillance framework sound, but noted that its implementation should be better calibrated to members' realities and needs.

3. **In its April 2004 Communiqué, the IMFC considered that “effective and evenhanded surveillance remains an essential element of the international community's efforts to enhance crisis prevention, promote financial stability and foster high and**

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<sup>1</sup> As explained later in this paper, the exercise of surveillance is often accompanied by certain complementary activities that support and inform surveillance but do not involve the same obligations for member countries. For conciseness in presentation, and without legal implications, the term “surveillance” is used throughout this paper to refer to both surveillance and surveillance-related activities.

<sup>2</sup> The main author of this section is Natalia Tamirisa. Christian Mumssen also provided input.

<sup>3</sup> *Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision*, (PIN/02/44, 4/18/2002), available at [www.imf.org](http://www.imf.org); *Enhancing the Effectiveness of Surveillance—Operational Responses, the Agenda Ahead, and Next Steps*, (PIN/03/50, 4/10/2003), available at [www.imf.org](http://www.imf.org); *Strengthening Surveillance—Further Considerations*, (PIN/03/116, 9/10/2003), available at [www.imf.org](http://www.imf.org).

**sustainable growth.**<sup>4</sup> It looked forward to this review to “propose ways to enhance its focus, quality, persuasiveness, impact and overall effectiveness.”

4. **This chapter discusses the effectiveness of Fund surveillance and reflects on ways to enhance it through changes in its modalities.** It starts with a review of the coverage and modalities of surveillance and a discussion of methodological issues. It then draws on the findings of the outreach-based assessment selected for this review (as a complement to the in-house assessment on the content and modalities of surveillance) and suggests measures to improve the outcome.

### **B. Background: Purposes and Organization of Surveillance**

5. **As is required under the Articles, the Fund conducts surveillance to oversee members’ compliance with the obligations specified under Article IV, Section 1.** Regarding those obligations that relate directly to exchange rate policies, the Board adopted general principles in 1977 that continue to provide guidance to members on the performance of these obligations.<sup>5</sup> With respect to those obligations relating to the performance of domestic economic and financial policies, which are very general in nature, Fund surveillance has evolved over the years, reflecting changes in the international financial system. Members are required to provide the Fund with such information that the Fund considers necessary to enable it to conduct its surveillance activities.<sup>6</sup>

6. **The Fund exercises its surveillance mandate through Article IV consultations (which in principle take place annually), Board discussions of global developments, and maintenance of close contacts with members.** The Fund may also make use of special and supplemental consultations. In practice, these procedures have rarely been used. Article IV consultations, which culminate in Board discussions, involve multiple steps and outputs (shown in the left part of Figure 1). These include the compilation of economic and financial data, the production of analytical studies, the policy dialogue with the authorities, communications with non-officials, and written reports.<sup>7</sup> The Executive Board also conducts

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<sup>4</sup> Communiqué of the International Monetary and Financial Committee of the Board of Governors of the IMF, April 24, 2004, available at [www.imf.org](http://www.imf.org).

<sup>5</sup> *Surveillance over Exchange Rate Policies*, DEC No. 5392-(77/63), 29/4/1977, as amended, available at [www.imf.org](http://www.imf.org).

<sup>6</sup> The obligations of Fund membership constitute the unique element that distinguishes the economic policy advice provided by the Fund from that of other entities, either public or private. See Appendix I for a more detailed discussion of the legal basis for surveillance under Article IV.

<sup>7</sup> Article IV consultations also serve other purposes than surveillance. Article IV consultations comprehend regular consultations under Articles VIII and XIV. On occasion, they are used as a vehicle for dialogue with members on international economic issues, which is conducted on a voluntary basis consistent with the Fund’s purposes (Article I, *alinea* (i)).

multilateral surveillance, mainly reflected in the *World Economic Outlook* (WEO) and the *Global Financial Stability Report* (GFSR).

7. **In the context of regular Article IV consultations, discussions may include matters that do not directly relate to the performance of members' obligations under Article IV, Section 1.** These discussions, however, are voluntary in two senses. First, the Fund is not required to discuss these matters. Second, the Fund cannot require the member to provide information about these for the purposes of surveillance.

8. **The exercise of the Fund's surveillance mandate in Article IV consultations and formal Board discussions of global developments is informed and supported by many complementary activities.** These activities, which rely on members' voluntary cooperation, include staff visits; participation in the Financial Sector Assessment Program (FSAP), which results in Financial System Stability Assessment reports (FSSA); participation in the standards and codes initiative, which results in Reports on Observance of Standards and Codes (ROSC); informal Board meetings on country matters, World Economic and Market Developments sessions, the quarterly vulnerability assessment exercise, publication of Article IV consultation documents; and outreach activities, such as conferences and seminars. While participation in these activities (for example, the FSAP) is voluntary, many of the issues discussed (for example, financial sector issues) do fall within the scope of surveillance and would be a legitimate subject of discussion in the Article IV context.

### C. Assessing Effectiveness in Surveillance: Methodological Issues

9. **Assessing the effectiveness of Fund surveillance has long been recognized as a challenging task** because of its many aspects and the complex relations between them.<sup>8</sup>

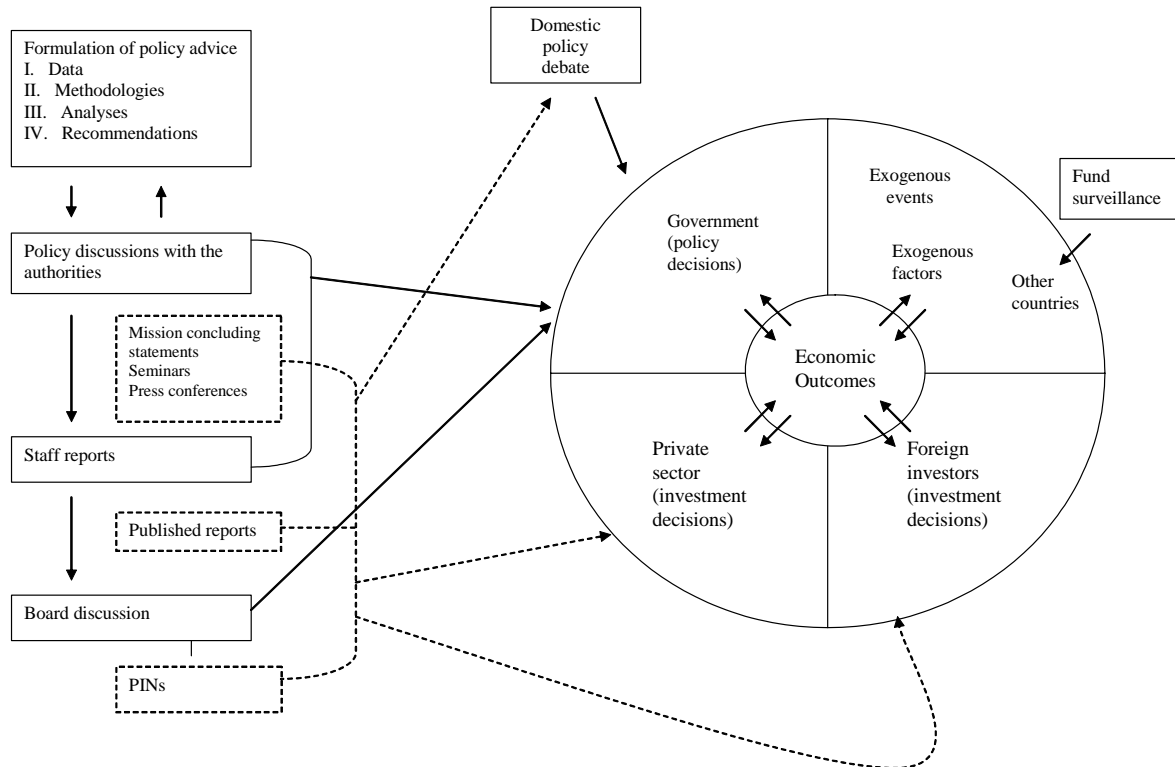
10. **Because surveillance and surveillance-related activities may involve different formats, time frames, and participants, their relationship with the final economic objectives is complex.**

- *The quality of the Fund's outputs is a key determinant of their effectiveness.* Quality in surveillance has many aspects. First, it may be associated with the accuracy, analytical rigor, and comprehensiveness of the staff's economic analysis. Second, it may depend on the staff's ability to focus on the policy issues that are most relevant in a given context, and to recommend policy options that take into account political constraints to the extent appropriate. Third, it may encompass the frankness of the policy dialogue and the persuasiveness with which the policy message is delivered to the authorities.

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<sup>8</sup> See, in particular, *External Evaluation of Fund Surveillance*, available at [www.imf.org](http://www.imf.org), and *Enhancing the Effectiveness of Surveillance—Operational Responses, the Agenda Ahead, and Next Steps*, available at [www.imf.org](http://www.imf.org).

Figure 1. The Fund's Bilateral Surveillance Process



- National, and in some cases regional, authorities are responsible for formulating and implementing policies.* Although Fund membership entails the obligation to engage in policy discussions for surveillance, the policy advice provided by staff and the Board is only one of many factors that influence the formulation of policy decisions (right part of Figure 1). The relative importance of Fund advice may vary over time and across countries. It may compete with advice from other local and international sources. Political factors may facilitate or hamper the adoption of certain decisions. Market participants and local interest groups may put pressures in defense of, or opposition to, certain policies.<sup>9</sup> In this context, it is usually extremely difficult to establish clear causality between a given piece of policy advice from the Fund and eventual policy decisions.

<sup>9</sup> Also, the Fund's advice is not formulated in a vacuum. Since the Fund contributes to, and draws input from, the broader policy debate, there is also a constant intellectual exchange between the Fund's policy advice itself and the advice expressed in national and international circles.

- *The links between the actual decisions of member governments and observed economic outcomes are also difficult to ascertain, because of the influence of exogenous or external factors on outcomes, the time needed to observe the effect of certain decisions, the quality of implementation, and the fact that the impact of a given policy may differ from that initially envisaged.*

11. **With the broadening of the purview of surveillance-related activities and their transformation into a more public process, the chain of reactions to Fund policy advice has become even more intricate and difficult to trace.** First, new outputs and new modalities (press conferences, seminars, etc.) have emerged. Second, these outputs are now transmitted to a wider audience through various channels and—either explicitly or implicitly—have different intermediate objectives. For instance, through the publication of its reports with the consent of its members, the Fund provides information to help markets assess and reach sound investment decisions. It also tries to build support for policy decisions that would enhance financial stability and economic growth. These overlapping webs of outputs and impacts (shown in dotted lines in Figure 1) make it even more difficult to map in a comprehensive and accurate manner the links between Fund surveillance and economic outcomes.

12. **Notwithstanding the framework established over the years to assess surveillance and other major activities, further progress is warranted, and the Fund has yet to develop a unified methodology to assess the effectiveness of all its activities, including surveillance.** The Fund has a demonstrated record of undertaking assessments of its activities, with performance subject to both internal (staff, management, and the Executive Board) and increasingly external scrutiny (Box 1). Nonetheless, assessing performance remains a challenging exercise for activities where outcomes depend upon a complex chain of events, and effectiveness is related to different, complementary aspects of quality. A number of approaches have been developed, mostly in advanced economies, to assess public sector performance. In the Fund, there has been a first attempt at combining some of these approaches and setting up, in the context of the budget exercise, an illustrative framework aimed at capturing the complexity of the Fund's activities, including surveillance. However, the construction of a comprehensive methodology for assessing the effectiveness of surveillance—that would be compatible, for budget purposes, with treatment of other Fund outputs—remains a challenge that is beyond the scope of this review.



### **Box 1. Assessment Methodologies**

**The Fund has a demonstrated record of undertaking assessment of its activities.** Its primary outputs are subject to systematic Executive Board review, country and policy papers are subject to extensive inter-departmental review, and task forces are regularly created to assess positions taken on difficult country cases and policy issues. The Office of Internal Audit (OIA) also conducts reviews of specific issues, as well as of the organization and management of departments. Nonetheless, the Fund has yet to develop an institution-wide framework for assessing the multiple dimensions of performance for the broad array of its key outputs, including surveillance.

**For this review, staff has paid particular attention to the evolving methodology being developed for assessing the effectiveness of complex Fund activities such as surveillance.**

- **Self-assessment** is the method that is most frequently adopted to assess effectiveness, both in the Fund and in other international organizations. Self-assessment generally relies on the detailed analysis by staff of a combination of ad hoc indicators with a view to reaching broad conclusions on the effectiveness of current procedures and identifying ways to improve their impact. Its main benefit is that it integrates quantitative and qualitative elements flexibly at a relatively low cost. Its conclusions also tend to benefit from close knowledge of the workings of an institution, facilitating the implementation of follow-up measures. However, because of its inherent lack of objectivity, a self-assessment is less likely to raise highly sensitive issues. Its methodological framework is also rarely explicit, limiting its credibility.
- **Frameworks based on a system of performance indicators** are used in a number of countries to assess the effectiveness of public institutions in meeting certain policy objectives and motivating improvements in outcomes. A range of quantity, quality, timeliness, and cost indicators are generally assessed together, in an attempt to shape a comprehensive, strategic assessment framework. Quantity and timeliness indicators are widely used because they can be readily defined, computed and monitored in a systematic manner. However, they have three important and well-recognized limitations. First, they focus on a few specific criteria at the expense of others (for example, short-term inflation rather than long-term growth). Second, they give more weight to quantifiable results than to qualitative ones (for example, a particular policy action over the strengthening of the policy-making framework). Thus, they must be supplemented by measures of quality that are inherently more difficult to capture and translate into indicators. And third—and most critically—they imply bold or unrealistic assumptions on causality in circumstances in which many factors are at play (including, for instance, changes in external conditions, or the degree of political consensus). The use of performance indicators for organizational management purposes raise other issues—for example, they may distort organizational incentives and encourage suboptimal behavior. In the Fund, work is advancing on the definition of a framework of performance indicators to support the budget process.
- **“User-satisfaction surveys”** are often used to provide a cross-check on other forms of assessments. They may be conducted by external consultants or in house. Their advantage lies in providing a relatively easy way to receive feedback and in raising the credibility of the process. However, there are no clear views on the weight to give them in an assessment. User surveys may be subjective and not fully reliable, as users’ perceptions may be affected by expectations more than actual performance. The individual views gathered through them may also reflect new or additional demands that may differ from the original purpose of the activity being assessed. Notwithstanding these limitations, surveys have been increasingly used in the context of the review of certain Fund policies, including, for example, the 2000 transparency review and the 2003 review of standards and codes.
- **External assessments through peer reviews** have increasingly been used to assess the effectiveness of activities with important qualitative dimensions, because they have the advantage of combining a good degree of internal acceptance with higher objectivity and credibility. However, peer reviews are expensive and cannot be relied upon for regular assessments. In addition, their scope and methodology may not be consistent over time, making it difficult to track progress. The Fund has used peer reviews to assess the effectiveness of a number of its activities. A peer review of surveillance was conducted in the aftermath of the Mexican crisis, and an external assessment in 1999. The procedure has been formalized with the creation of the Independent Evaluation Office (IEO).

13. **However, in an attempt to respond to the Board’s call for further progress on assessing effectiveness in surveillance, staff, for this review, complemented the in-house assessment traditionally used in the context of the biennial review of surveillance with several insights compatible with the evolving Fund-wide methodology:**

- It assessed surveillance outputs against different concepts of quality and tried to identify the various stages of the results chain underlying the process of surveillance;
- It gathered external views through outreach activities aimed at combining different perspectives on the effectiveness of surveillance;
- It attempted to define monitorable objectives that would orient the follow-up to this review and provide a benchmark for the next.

14. **Outreach activities included interviews, surveys and workshops with country authorities (including Executive Directors), market participants, think tanks and other non-governmental players, and the media** (Box 2). In addition, the views of mission chiefs were gathered through a web-based survey. Most interviews were conducted by staff, except for the survey of country authorities, which was undertaken by an external consultant, in an attempt to elicit more open responses by protecting confidentiality. Inputs on the modalities of surveillance were also drawn from the internal review of Article IV staff reports and Executive Directors’ BUFFs undertaken for the companion paper on the contents of surveillance.

15. **Owing to budget and time constraints, the geographical scope of the outreach was narrower** than that in the external evaluation of Fund surveillance conducted in 1999 or the studies conducted by the IEO. However, efforts were made to ensure, as far as possible, a balanced representation of the Fund’s diverse membership. The focus was on the conduct of surveillance over the past two years and the effect of the new modalities introduced during that period; however, in a number of cases references were made to experiences in earlier years.

16. **The discussions held in the course of the surveys and interviews covered the whole process of surveillance.** Questions were not limited to specific stages or outputs (the companion paper focuses on the contents of staff reports), or areas previously considered important by the Executive Board or the IMFC. This broader approach allowed interviewees to raise the issues that they deemed most important in surveillance and related activities, and clarify the benchmark against which they made their assessment.<sup>10</sup>

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<sup>10</sup> The surveys and interviews were based on specific questionnaires designed to elicit judgments on the quality of surveillance outputs and on their observed impact. Most of the questions were deliberately open-ended. The questionnaires were used in a flexible manner to leave scope for those interviewed to structure the discussion around the issues that they deemed most relevant.

## **Box 2. Outreach on Modalities and Effectiveness of Surveillance**

Staff organized a series of outreach activities to gather the views of country authorities (including Executive Directors), market participants, think tanks and academia, and the media on the modalities and effectiveness of Fund surveillance. In addition, staff conducted a web-based survey of Fund mission chiefs on the topics in question. The main findings of outreach activities are presented in Appendices II and III.

### **Country Authorities**

An external consultant interviewed senior officials from 29 countries during April—May 2004. Sixteen countries were surveyed through interviews with officials from ministries of finance and central banks, and 13 others through interviews with Executive Directors at the Fund. According to the WEO classification, 12 countries belong to the group of advanced economies, and 17 to the group of emerging market and developing countries. Three had programs supported by Fund arrangements at the time of the survey. Ten were from Europe, seven from Asia and the Pacific, five from the Middle East and Central Asia, four from the Western Hemisphere, and three from Africa. Three quarters of these countries have consented to the publication of their Article IV reports.

### **Market Participants**

Staff conducted informal workshops with senior representatives of major financial institutions and rating agencies in April 2004 in London, Tokyo, and New York. In addition, the effectiveness of Fund surveillance was discussed at the eighth meeting of the Capital Markets Consultative Group, held in Paris on April 7, 2004.

### **Think-Tanks and Academia**

Staff held informal workshops with selected representatives of academia, think tanks, and research agencies in Paris and Tokyo in April 2004. Many participants in the Tokyo meeting were closely associated with governments. A discussion on the effectiveness of surveillance also took place during a high-level seminar on the political economy issues facing the Andean region, held at the Fund Headquarters on April 27, 2004.

### **Media**

Staff interviewed a few prominent journalists reporting frequently on Fund activities from different regions of the world. These interviews were conducted by telephone in April—May 2004.

### **Mission Chiefs**

Staff conducted a web-based survey of mission chiefs in April 2004. The survey covered staff who had led Article IV missions during January 2003—March 2004. The response rate was 43 percent, or 60 Article IV consultations: 25 percent referred to advanced countries, 20 percent to transition economies, and the rest to developing countries.

17. **However, this review does not aim at presenting a fully comprehensive picture of effectiveness.** A number of elements were left outside the scope of this review; they may warrant separate consideration or be addressed in subsequent reviews.

- This review did not examine, for instance, whether the advice proffered in the context of surveillance was right. Although the appropriateness of the advice is clearly an important determinant of its effectiveness, and the Fund's advice has been found, with hindsight, to have had shortcomings in some cases, staff thinks that this question is better addressed on a case-by-case basis.<sup>11</sup>
- Neither did this review try to assess the specific value of the summings up of Board discussions in surveillance, or more generally the role of the Executive Board.
- Reflecting time and budget constraints, outreach concentrated on some audiences of Fund surveillance (the authorities, market participants, think tanks, and the media) and did not include discussions with other important players, such as legislators, labor unions, and international non-governmental organizations.

18. **The material gathered for this review through the outreach activities was valuable and varied, reflecting the diversity of country circumstances and opinions.**<sup>12</sup> Discussions generally clustered around four broad topics: the analytical quality of Fund advice, the quality of the policy dialogue, the effectiveness of the Fund in disseminating surveillance outputs, and assessments of the overall impact of surveillance. The following sections discuss each of these issues in turn, starting in each case with a summary of the results of the outreach interviews and surveys, followed by staff's reflection on their implications and, when appropriate, suggestions for potential changes that could further increase the effectiveness of Fund surveillance.

#### **D. Analytical Quality and Focus of the Fund's Policy Advice**

##### **Views of outreach participants**

19. **Most of those interviewed thought that the Fund generally delivers high quality output.** However, views differed on details, confirming that quality is a multidimensional concept.

- Some criticized the Fund's policy advice for relying too heavily on academic, mostly theoretical, knowledge, without drawing sufficiently on practical experiences.

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<sup>11</sup> A number of papers have attempted to respond to this question in specific cases. See, for example, *Lessons from the Crisis in Argentina* and *Independent Evaluation Office—Evaluation of Fiscal Adjustment in IMF-Supported Programs*, available at [www.imf.org](http://www.imf.org).

<sup>12</sup> The detailed findings of the outreach activities and the internal review are described in Appendices II and III, respectively.

- Others noted that Fund advice fails to take into account existing political constraints, or is so optimistic about the ability of the government to overcome them that it does not consider second-best policy choices that would be consistent both with the maintenance of macroeconomic stability and country-specific political realities.
- Yet others valued the role of the Fund in raising the bar and pushing forward the policy agenda. (“Economics is the art of what is desirable, and politics is the art of what is feasible. These two should not be confused,” as one official put it.)

**20. The general view was that recent initiatives had contributed to enhance the quality of the staff’s analysis.**

- Efforts to improve the assessment of vulnerabilities were generally well-received. Market participants praised related methodological and analytical work, but felt that the objectivity of resulting risk assessments was constrained politically. They generally saw scope for the Fund to issue sharper warning signals in the face of emerging risks through the use of less nuanced language in staff reports.
- The broadening of the coverage of surveillance in recent years, to include structural and institutional issues, was largely welcome. However, some officials, from advanced, emerging, and developing countries alike, expressed doubts as to whether staff had the necessary specialized expertise to provide sound advice in these areas.
- Many authorities, including from advanced economies, indicated that they had benefited considerably from participating in the FSAP. The exercise provided a cross-check on their own work and helped define the policy agenda in the financial sector area.
- The increasing use of cross-country studies to support policy recommendations was widely appreciated, particularly when it provided examples of implementation of unpopular tax or structural issues. It was felt that there was scope for expanding such work further.
- Efforts to generate more reliable, standardized data in key areas such as external debt were greatly valued, and there was a demand for better data and analysis of public debt.
- Views on multilateral surveillance outputs were mixed. Non-official participants mostly appreciated the WEO and GFSR for their analysis of global trends and thematic issues, but found them somewhat lengthy and insufficiently timely. They placed less value on the WEO projections, because they undertook their own forecasting exercises. In contrast, a number of authorities underscored that they relied on the WEO for their forecasts and therefore needed to be assured of their quality.

**21. On the content of surveillance, those interviewed perceived three weaknesses:**

- Many identified gaps in the coverage of recent reports, most notably in the analysis of international and regional linkages. Also, officials from a number of emerging economies emphasized that the Fund did not take sufficiently into account the increasing importance and changing nature of regional trade and financial links.
- Officials from low-income developing countries felt that the Fund's policy advice focused excessively on stability issues at the expense of growth issues. They also found that some of staff's policy recommendations in the structural and institutional policy area imposed unjustifiably high short-term costs on their countries.
- In the eyes of many interviewed officials, surveillance in program countries remained overshadowed by program issues. This view was confirmed by market participants, who found it difficult to differentiate surveillance documents in program countries from program documents. Authorities from low-income countries thought that surveillance discussions could offer them more room to define their own policy choices in the context of the broad macroeconomic guidelines provided by staff—including, for example, the allocation of public spending to specific programs against broad medium-term expenditure targets, or the calibration of structural and institutional reforms to country-specific conditions.

These observations are broadly consistent with the findings of the companion paper on the content of Fund surveillance, where recommendations are presented to address these issues.

22. **Two procedural aspects were mentioned frequently and may deserve special attention:** the focus of individual consultations, and the treatment of formal requirements to the content of Article IV reports.

#### **Sharpening the focus of consultations**

23. **The definition of the appropriate focus of individual consultations was approached by interviewees from different angles.**

- Some officials, mostly from advanced economies, found that the analysis provided by the Fund in the context of surveillance did not enrich or inform their policy-making capacities. They recommended focusing discussions on areas where the Fund can add value to them, such as the analysis of international spillovers and cross-country policy experiences, or on issues that are at the top of the member's policy agenda, and thus of great interest for the authorities and the public in general. There were suggestions to let national authorities determine, or at least influence more closely, the agenda of a given consultation, or to reduce the frequency of consultations to instances where staff can provide substantive input to the authorities on a given policy issue.
- At the same time, these officials also recognized that surveillance can provide early warnings of emerging problems and background information that can help incoming

governments in formulating their policies. They thought of surveillance as a regular, independent “health check.”

- Interviewed officials from a broad spectrum of countries expressed keen interest in consultations with other members, as a way to obtain a clearer view on developments in other countries that may have an impact on their own economy, and learn about other countries’ experiences in dealing with certain policy challenges.
- Yet others valued the role of surveillance as an opportunity to identify and assess risks in an evenhanded manner across countries. They appreciated the fact that surveillance could increase awareness of certain issues by raising their profile, even if it brings little or no new element to the discussion.

24. **In staff’s view, the idea of greater selectivity in coverage must be set against the international dimension of Fund surveillance** that has to balance the interests of the member concerned with those of the membership as a whole. Surveillance may provide analytical material and data to inform national policy choices, but this is not its only role. Even if a particular consultation might on occasion bring no new information or views to a member, the staff’s analysis could benefit the membership at large—for example, by discussing issues of systemic importance, or by disseminating knowledge about the member’s experience and drawing lessons that can be of use for other countries.

25. **In addition, surveillance aims at the formulation of an international opinion on the soundness of a member’s policies and its consistency with international financial stability.** This dimension acquires particular relevance for systemic economies.

26. **Broad principles have been defined to guide the coverage of individual consultations in a way that is consistent with these objectives.**<sup>13</sup> Surveillance should focus on the set of topics that are at the apex of the Fund’s hierarchy of concerns—external sustainability, vulnerability to balance of payments and currency crises, sustainable growth and policies to achieve it, and, for systemically important countries, conditions and policies affecting the global or regional economic outlook. These issues should be supplemented by other topics that have a clear impact on macroeconomic conditions. The internal review of staff reports found them to be generally well-focused in relation to these principles (See Section II.B of the companion paper).

27. **There may be scope to sharpen further the focus of individual Article IV consultations, while still meeting these broader objectives.**

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<sup>13</sup> *Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977 Surveillance Decision* (PIN/02/44, 4/18/2002), available at [www.imf.org](http://www.imf.org). The issue is also discussed in the companion paper on the content of surveillance.

- For example, without relinquishing the responsibility to raise whatever subject it deems necessary, even if unpopular, staff may be encouraged to liaise more closely with the authorities in deciding on the coverage of the consultation. This would generalize what is already a regular practice in a number of countries. Discussions would aim at identifying issues of mutual interest and better prioritizing the topics covered in consultations in the face of limited resources. Some topics could be selected in a multi-year context to allow sufficient lead time to pursue or tap into analytical research in the Fund or elsewhere, or dovetail with domestic research programs. Intended topics and modalities could be included in a forward-looking, priority-based work agenda that would be shared with the Board (possibly through a dedicated space on the Fund's intranet).
- The role of internal pre-brief meetings could also be strengthened. The survey of mission chiefs showed that pre-brief meetings are now organized for most consultations. However, their role varies greatly across countries and departments.<sup>14</sup> They could be used more systematically to define the strategic focus of a given consultation, its operational objectives and priorities, the topics to be discussed (in light of the broad, Fund-wide guidelines given by the Board), and the specific modalities of the consultation. To maximize their impact, these meetings should systematically include staff from other departments, and be organized early enough in the Article IV cycle.

### **Streamlining formal requirements**

28. **Many interviewed officials thought that the growing number of formal requirements tends to undermine the effectiveness of surveillance.** They regretted the tendency to attach every emerging concern to the Article IV process, without taking into account its relevance in the broad context of surveillance, thus overburdening the exercise and undermining its legitimacy. Consultations were sometimes criticized on the grounds that they attempt to cover a large number of issues (including, for example, AML/CFT or corporate governance), even if these topics were not very relevant in a particular case.

29. **The number of formal Article IV requirements has indeed grown significantly in recent years, especially in areas that are not central to the Fund's expertise.** In addition to 14 guidance notes on format requirements and 3 on jurisdictional issues, there are currently 21 operational guidance notes that deal with the coverage of specific issues in Article IV consultations (Appendix IV). Of the contents-related guidance notes, about one-third address macroeconomic and financial sector issues. The remainder offer guidelines on areas that may be of macroeconomic relevance in some countries but not in others.

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<sup>14</sup> Pre-brief meetings were organized in three-quarters of the responses to the mission-chief survey. In about half of the cases, they were attended by staff from one or more functional departments.



30. **Staff see benefits in streamlining the formal requirements that apply to issues beyond the macroeconomic and financial areas.** As mentioned above, Article IV policy discussions are expected to cover issues that are relevant for macroeconomic stability, even if they are not part of the Fund’s core expertise. Notes on such issues could provide useful guidance for teams that have identified them as a key vulnerability. However, the coverage of such issues should not be treated as a formal requirement for all Article IV consultations, irrespective of country circumstances. There has been a tendency to use formal requirements as “security devices,” to ensure that staff looks at all cases of a particular issue, or gives prominence to certain sensitive topics. In some cases, this has crowded out more critical topics in discussions with the authorities and in staff reports. To minimize this risk, staff suggests that a number of guidance notes be cancelled or modified to reflect better the need for selectivity in coverage of individual Article IV consultations.

31. **Specific information that is of interest to the Board could also be provided periodically outside the context of Article IV staff reports.** This information could be posted in a designated space on the intranet, and updated and referenced as appropriate in staff reports. Potential candidates for such treatment could include, for example, members’ views on, and use of, collective action clauses; and follow-up information on the implementation of the OECD Anti-Foreign Bribery Convention, which are now required to be included in Article IV staff reports.

32. **A mechanism could be established to keep Article IV requirements and guidance notes under periodic review.** For example, policy papers could be required to explicitly review relevant guidance notes and propose whether to let them expire, reclassify them as background information, update them, or reaffirm them in their current form.

**Summary of Recommendations to Enhance the Focus  
of the Fund’s Policy Advice**

- Closer liaison with the authorities on the coverage of individual consultations
- Preparation of a multi-year country-specific work agenda and its dissemination to the Board
- Systematic use of early pre-brief meetings for interdepartmental discussion of the topics and modalities of individual consultations
- Reclassification of guidance notes on the content of Article IV consultations
- Provision of information on selected issues to the Board outside of Article IV reports

**E. Quality of the Policy Dialogue with National Authorities**

**Views of outreach participants**

33. **Most interviewed officials rated the quality of the policy dialogue positively, although they mentioned that it had at times been strained.** Most felt that there is scope to calibrate policy messages better to country-specific institutional and political circumstances without diluting their economic content. Against this background, three specific issues came to the forefront in the discussions:

- Officials from many regions, but particularly from Asia, felt that *greater efforts are needed to ensure that surveillance is conducted as a collaborative and mutually beneficial exchange*, rather than what they perceived as a mere auditing exercise. Many officials praised staff for their increased efforts to understand local experiences and engage in a more balanced dialogue over recent years. Yet, some regretted what they perceived as a lingering tendency to dismiss the authorities' views and overlook their concerns. Some thought that the surveillance agenda was determined by the Fund's largest shareholders, casting doubt, in their view, on the legitimacy of surveillance and the credibility of the Fund. In this context, public expression of the Fund's concern about the policies of the largest members was seen as a healthy development.
- Many officials recommended that *contacts between Fund staff and the authorities be better timed, better paced, and better targeted*. Surveillance was viewed as more relevant and effective when missions were timed to coincide with local budget cycles. The benefits of more frequent exchanges were also widely recognized. Some officials thought that country teams should assume a more pro-active role in identifying key decision-making officials and institutions in a given country, instead of relying on their traditional contacts with technocrats in the central bank and the treasury. Some recommended complementing the mission concluding statement with a one-page summary of the key findings of the consultation specifically aimed at ministers and senior officials. In some cases, the ability to engage in a constructive policy dialogue may require greater participation of senior staff or Fund Management in policy discussions. Increasing contacts between Management and higher-level officials was seen as particularly important in deepening the policy discussion in systemically important members.
- Officials from emerging market and developing economies argued forcefully that *the high turnover of staff on country teams hinders the establishment of rapport between the parties*. While recognizing that staff rotation is needed to bring in a fresh, cross-country expertise to policy discussions, most officials recommended greater continuity in country assignments, with less frequent and better planned staff mobility to allow for the appropriate transmission of country-specific knowledge.

### **Enhancing the quality of the policy dialogue**

34. **The internal review confirms the perception that, although the dialogue with the authorities is generally of good quality, there is scope for improvement.** Four-fifths of

Article IV reports reviewed by staff conveyed the impression of a genuine policy dialogue, where both staff and the authorities were candid and open during discussions. The review of Executive Directors' BUFFs and the survey of mission chiefs were consistent with this assessment (Appendix III). In the remaining cases, discussions appeared constrained, at least on some issues.

35. **Difficulties in the policy dialogue may be a result of different factors.** They might reflect an institutional incentive structure that rewards staff for maintaining a good relationship with country authorities over writing candid reports. Country authorities might be reluctant to discuss certain issues openly with staff because of concerns about publication.<sup>15</sup> At the same time, strains in discussions might also reflect candor in the discussion of difficult policy choices that should not be avoided.

36. **Even against this background, certain steps could be taken to raise the quality of the policy dialogue with the authorities.** Staff would suggest the following measures:

- First, staff could prepare more cross-country comparative studies—an area where the Fund has a recognized comparative advantage—to inform its policy advice. Staff should also be encouraged to draw from the country-specific perspectives of national authorities and distill them into their analysis and advice, while preserving the integrity and independence of its analysis. Drawing on practical policy experiences would also help reduce the academic slant that some authorities perceive in the Fund's policy advice. Good cases of cross-country studies could be disseminated more systematically among staff (for example, by posting them on a designated place on the intranet) to enhance information sharing and the dissemination of good practices.
- Second, although country teams already seem to maintain regular contacts with their local counterparts outside the context of the traditional Article IV consultations, there may be scope to intensify such contacts, for instance through more frequent short staff visits, the exchange of technical policy notes, and participation in conferences and seminars. These contacts would allow for a closer coordination of the work agenda and create opportunities for more informal discussion of important policy issues, giving a more continuous character to surveillance. This course of action is clearly conditional on the willingness of the authorities to engage in policy discussions between consultations. The benefits of increased contacts would also need to be weighed against available resources, and potential trade-offs between more intensive interaction and more in-depth analytical work.

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<sup>15</sup> The same concerns about publication may induce staff to communicate sensitive matters to the Board through alternative channels such as informal country matters sessions or WEMD.

- Third, to strengthen the engagement of country authorities in Article IV consultations, the authorities could be encouraged to prepare a written statement on their main macroeconomic, financial, and structural policies and how they have evolved in light of previous recommendations, and share this statement with staff in advance of the mission. A standard request could be sent to the authorities before the mission.<sup>16</sup> This would be done on a voluntary basis and take into account members' internal capacity and resources.
- Fourth, to ensure that key policy messages effectively catch the attention of senior decision makers (for example, cabinet ministers), mission teams may consider preparing a one-page note to highlight the key findings and priority recommendations of the consultation. The note would complement the mission's concluding statement.

### **Managing staff turnover**

37. **Data suggest that the turnover of staff assigned to country work is relatively high.** Over the past five years, about 60 percent of teams for non-program countries changed with each mission (Figure 2).<sup>17</sup> Mission chiefs changed, on average, after two Article IV missions to the same country. There has been considerable variation across country groups. Turnover has tended to be lower, and the mission size larger, for large industrial economies and emerging markets, reflecting in part the complex nature and systemic importance of these economies. This has occurred largely at the expense of small members, which received small mission teams and experienced higher turnover. In one third of small country missions, turnover has reached 100 percent—i.e., the authorities would see a whole new team, including a new mission chief, at each consultation.<sup>18</sup> Many such countries were on the 24-month consultation cycle, where preserving staff continuity is particularly challenging.

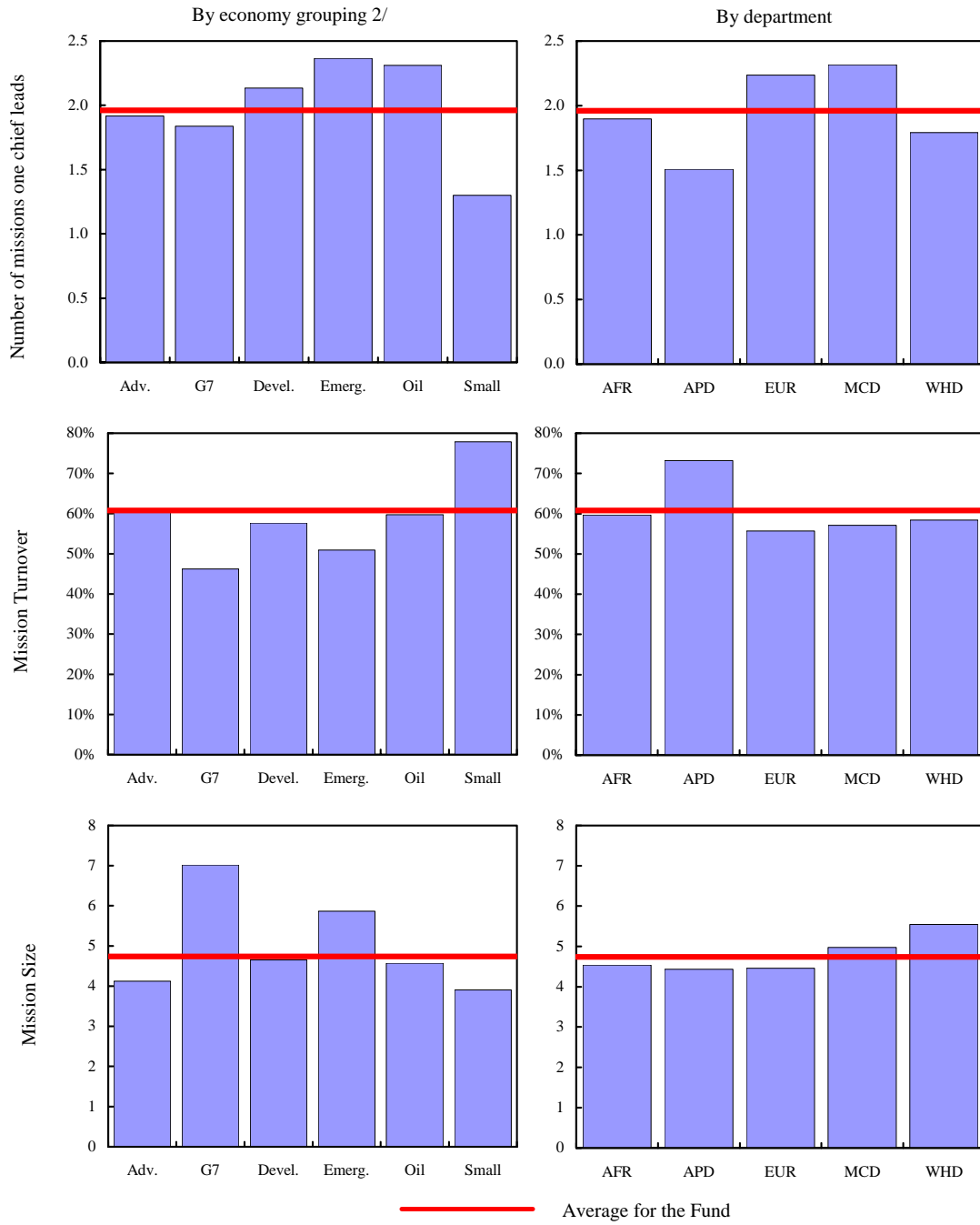
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<sup>16</sup> In cases where staff send questionnaires to the authorities in advance of the mission's arrival, the questionnaire could invite the authorities to prepare a policy statement.

<sup>17</sup> Based on TIMS data from FY 1998 to FY 2004. Turnover is calculated as the average of the percentage of new staff on each mission.

<sup>18</sup> Recent examples include Aruba, Cyprus, Myanmar, San Marino, and many Pacific Island economies.

Figure 2. Average Staff Turnover and Mission Size in Surveillance-Only Countries 1/  
(FY 1998 - FY 2004)



Source: TIMS data and staff estimates.

1/ Includes economies not involved in an arrangement with the Fund as of November 2003.

2/ See Appendix Table 1 of the companion contents paper for country groupings.

38. **Mechanisms for staff rotation and mobility across country teams may have to be reviewed** to achieve greater continuity in the policy dialogue, enhance mutual trust, and maintain internal country-specific knowledge and institutional memory. However, a balance needs to be struck between these objectives and bringing in fresh perspectives to country work by sharing cross-country experiences within the institution.

**Summary of Recommendations to Enhance the Quality  
of the Policy Dialogue with the Authorities**

- More systematic use of cross-country comparative studies to disseminate national experiences and inform policy advice
- Intensified contacts with the authorities outside the context of formal Article IV consultations
- Invitation to the authorities to provide a written policy statement
- Generation of one-page concluding notes for high-level counterparts
- Consideration of scope to reduce staff rotation

**F. Effectiveness in Communication**

**Views of outreach participants**

39. **While recognizing that the analytical quality of the Fund’s advice is the first and main determinant of its effectiveness, interviews suggested that two distinct, albeit related, aspects of communication also have an impact:** the general dissemination of surveillance output to the public at large, including through direct contacts with non-government representatives; and the publication of country documents under the Fund’s transparency policy.

40. **Most interviewees remarked that active dissemination efforts have raised the visibility of surveillance in recent years.** The Fund’s transparency policy and innovations in mission modalities, including more systematic outreach activities and more frequent contacts with the local press, were generally credited for this outcome. The fact that these innovations have been tailored to the member’s specific circumstances was widely appreciated.

41. **Yet, in spite of these increased communication efforts, public understanding of the role of surveillance remains limited; and the related policy messages reach only few people, even in countries that publish Fund documents.** Interviewed officials stressed that in most cases, only a narrow group of officials working directly with the Fund has some understanding of Fund surveillance. Among non-officials interviewed, a significant number showed little familiarity with Fund surveillance documents. Others complained of information overload, suggesting that the Fund should focus on disseminating better rather than more. Market participants thought that the coded language of the Fund and the obscure

format of staff reports complicated communication efforts and raised risks of misinterpretation of the Fund's policy messages. In this context, they emphasized the benefits of maintaining or enhancing the Fund's local presence; many saw resident representatives as a key source of information, and there were regrets that posts in some emerging market countries, especially in Europe, had been closed.

42. **Views on the desirability of outreach activities were mixed.** All interviewed officials supported outreach, if it is aimed at gathering information about a country's special situation or building public support for the authorities' reform agenda. Many pointed out, however, that effective outreach requires enhanced communication skills and a keen awareness of local sensitivities. They stressed that outreach should be closely coordinated with the authorities to prevent the Fund from being drawn into local disputes. Some officials, as well as journalists, adopted a more liberal attitude and called for more extensive interactions between staff and society, to stimulate domestic policy debates and to gather public support for policy changes.

#### **Better dissemination of the findings of Article IV consultations**

43. **The intensification of dissemination efforts was corroborated by both the mission chief survey and the internal review of staff reports.** About half of the mission chiefs surveyed reported having experimented with changes in the format and procedures of discussions, including through increased outreach, presentations, and contacts with the press. Increased outreach to the civil society and staff presentations were the most frequent change reported. Meetings of missions with the private sector have become the norm, and those with parliamentarians, labor unions, non-governmental organizations, and academia were also typical. The internal review of staff reports showed that their format had been enhanced to strengthen their presentation and readability. In some cases, intensified dissemination efforts resulted in a visible increase in the media coverage of Fund recommendations (Box 3).

44. **Notwithstanding their higher frequency, the impact of dissemination efforts generally appears to have been weakened by a number of factors:**

- The increasing diversity of products and interlocutors. Although surveillance is now associated with more complex webs of relations (between staff and the authorities, markets, and civil society), little attention has been paid to the parallel development of an integrated communication strategy and related staff training.
- The limited global outreach activities undertaken by the Fund to explain the general objectives and process of surveillance.
- The uneven format of Fund surveillance modalities and outputs. Although, as mentioned earlier, recent years have seen a significant degree of innovation in the specific modalities of Fund surveillance, the exchange of experiences among area departments to identify which approaches work in which circumstances has been limited.

**Box 3. Increased Media Coverage of Surveillance Documents:  
Recent Examples from Germany and the United States <sup>1/</sup>**

Media coverage of bilateral surveillance in a given country typically focuses on what the press sees as IMF forecasts and the Fund's main policy messages; outside the country itself, coverage is usually confined to the financial news wires. In the advanced economies, where the IMF is only one among many voices speaking on the economic outlook, media interest is likely to rise when the Fund's policy message touches on an issue that is topical or which—in the view of the media—is controversial. Recent media attention in Germany and the U.S. to the Fund's views illustrate this point:

- On November 3, 2003, the Executive Board discussed the Article IV consultation with Germany. A PIN and the staff report were published on November 6, and—as has become customary for recent Article IV consultations with Germany—staff held a conference call with reporters. The staff report's discussion of restructuring in the banking sector attracted considerable attention in the German print media, including in the non-financial press. Coverage focused on what journalists saw as a call from the IMF to the German government to reform the three-pillar banking system to make it more efficient and resilient to crises. In contrast, other themes discussed in the Article IV received much scantier attention. The press highlighted criticism of the report from parts of the banking sector, in particular the savings banks, as well as support for its views from the commercial banks. The willingness of prominent figures in the German financial sector to take public positions on these issues clearly added to the interest of the report in the eyes of the media.
- The Occasional Paper “U.S. Fiscal Policies and Priorities for Long-Run Sustainability,” published in January 2004, attracted wide coverage from the U.S. media, which typically pays little attention to Fund statements on U.S.-related issues. In this case, the prominence given to the paper was prompted by its clear message that the emergence of large fiscal deficits—together with signs that they would be sustained at substantial levels unless corrective action was taken—raised longer term and multilateral concerns. This view was consistent with the U.S. Article IV staff report, which was published several months earlier without attracting much attention. Potential reasons behind the stronger impact of the OP may include the topicality of the discussion, the prominence given to the paper by *The New York Times* and the sharp rebuttal of the views expressed in the paper by a spokesman for the authorities. Reflecting the systemic importance of the U.S. economy, the OP was extensively reported internationally.

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<sup>1/</sup> The main author of this box is David Hawley.



45. **Certain steps could be considered to strengthen communication in surveillance:**

- There seems to be a general need to reflect in more detail on the issues raised by the interaction with various audiences in surveillance. It would be useful to assess, for example, what form of outreach is most useful given a country's specific circumstances and who can best deliver such outreach (for example, the mission, the resident representative, EXR, or the authorities). The role of the Board's summings up in the Fund's dissemination strategy could also be considered, together with potential changes to existing communication vehicles (especially the PINs). These themes could be taken up in the forthcoming review of the external communication strategy of the Fund.
- Second, there may be benefits in developing a more proactive outreach program. It would be useful to reach out to various audiences (including within governments) to explain the broad purposes and modalities of surveillance and disseminate the key findings of individual surveillance rounds. At the bilateral level, staff could also be encouraged to experiment more with innovative approaches to enhance two-way contacts with local think tanks. For instance, a local research institution could be used as a platform for hearing local views, presenting conclusions of the work related to the consultation, and discussing desirable avenues for further research. Brief synopses of these discussions could be alluded to in staff reports. Participation of surveillance staff in local (including regional) conferences could be supported more broadly.
- Third, the dissemination of best practices within the institution should be actively pursued. With more widespread publication, there are institutional reasons to improve the presentation of staff reports. Further experimentation with the formats and styles of staff reports could be encouraged. The broader diffusion of innovations in consultation formats would also make the Fund's message more incisive and persuasive, and ensure its dissemination to a broader audience. Procedures could be introduced to facilitate the process, although the focus should be on the dissemination of best practices, rather than issuing Fund-wide rules, in order to preserve flexibility and creativity going forward.<sup>19</sup>

**Candor and transparency**

46. **On the publication of Fund documents**, the majority of interviewed officials thought that publication should remain subsidiary to the Fund's role as a provider of frank, high-quality policy advice:

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<sup>19</sup> One option could be the preparation of internal web-based notes illustrating best practices in certain areas, along the lines of a recent FAD note on presenting fiscal policy in staff reports.

- Officials from countries supporting publication observed that the practice is now quite widespread and that initial fears of adverse market impact have not been realized. They said that publication had been mostly aimed at increasing investor confidence, and to a lesser extent at fostering the domestic debate and increasing accountability. Market participants saw publication as “additional comfort,” although not a critical factor behind their investment decisions. They also noted that staff was now more accountable for the views expressed.
- Yet, some officials stressed that the risks potentially associated with publication should not be discounted. Although no evidence was presented that publication and the broader involvement of the Fund with the markets and the public undermine the candor of dialogue with the authorities, a number of those interviewed, especially from the Middle East and Asia, felt that the issue was not settled. In their views, the dissemination of Fund policy advice should be left for the authorities to decide, without pressing them to consent to publication of staff reports. Some officials also repeated the criticisms made during Board discussions on transparency, namely that the correction and deletion policy does not allow the removal of politically sensitive information.
- Many market participants thought that the content of published Fund assessments is already excessively influenced by political pressures.

47. **In staff’s view, ensuring the candor of policy discussions is a key objective of the Fund.** The surveys and interviews did not provide any clear evidence that the transparency policy has had a negative impact on candor so far, and a simple regression analysis does not show any significant statistical correlation between the degree of openness of the policy dialogue (as assessed in the internal review of staff reports) and whether the staff report was eventually published or not. However, concerns about publication may add a further layer of complexity to the discussion and presentation of already sensitive issues—including, for example, exchange rate issues.

48. **The authorities’ focus on the deletions and corrections policy to address concerns about market and political reactions raises important issues**—most of all, the danger of transmitting watered-down, potentially misleading messages to the public. It is striking how little use has been made of the authorities’ “right of reply” that allows them to post their views (including specific comments and technical clarifications) together with staff reports.<sup>20</sup> As a way to increase the authorities’ level of comfort with publication, staff could encourage them to make greater use of this right of reply.

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<sup>20</sup> Only 60 percent of country reports published over the period under review were published together with the presentation of the Executive Director at the Board. Only two reports were accompanied by a statement from the authorities commenting specifically on the views presented in the report.

**Summary of Recommendations  
to Enhance Communication in Surveillance**

- Definition of a comprehensive communication strategy for surveillance
- Development of a proactive outreach program in surveillance
- Two-way contacts with local think tanks
- Participation in, and organization of, national and regional conferences
- Dissemination of best practices and innovations with surveillance modalities and formats
- Preservation of candor in policy discussions
- Greater use of “right of reply” by the authorities

**G. Overall Impact of Surveillance**

**Views of outreach participants**

49. **Most of those interviewed considered that overall, Fund surveillance contributes positively to policy making.** However, they also recognized that the impact of surveillance is far from uniform across countries, and may occur at different places in the results chain.

- Many authorities believed that the *direct impact on policy actions* is not the most important contribution of surveillance. In addition to being hard to quantify, it is often obscured by political constraints and institutional weaknesses that hamper the capacity of the authorities to implement Fund advice.
- Most officials found that Article IV consultations help stimulate the *policy debate within the government*. They often bring about a broad macroeconomic policy perspective that fosters the dialogue between different government agencies and supports collaborative policy making. The information provided on the experience of other countries in addressing similar policy challenges was also highly valued. In general, the Fund’s contribution to the process of policy formulation was deemed as more important than its effect on policy action *per se*.
- Both officials and others interviewed thought that Fund advice helped stimulate the *broader domestic policy debate*.<sup>21</sup> Examples were given of how the Fund’s analysis

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<sup>21</sup> A number of Executive Directors have also acknowledged in their BUFFs the positive impact that surveillance had had on policy design in their country.

had raised the profile of specific policy issues (for example, budget or pension reform) and broadened the domestic consensus for reforms. The role of resident representative offices (in coordination with the authorities) was particularly valued in this regard. Some officials underscored that they appreciated the role of the Fund in pushing for policy reforms that are politically unpopular, acknowledging that the Fund is bound to be used sometimes as a “scapegoat” for domestic political purposes.

- Market participants found Fund assessments to be a useful, albeit not crucial, input to their *investment decisions*. They tended to value most the dissemination of high-quality and standardized data by the Fund, noting that through this channel the Fund contributes to enhanced policy-making. Consequently, they argued that the impact of Fund surveillance appears to be inversely related to the availability of other sources of information and analysis. For this reason, assessments of smaller emerging markets and low-income countries in Africa were particularly valued.

### **Assessing effectiveness of the context of individual consultations**

50. **The finding that the effect of surveillance has varied in form, time and intensity across countries seems broadly consistent with staff perceptions.** To compare the survey conclusions with in house views, staff looked at five very different country experiences (Box 4). The aim was limited to gathering insights on the possible impacts of surveillance over a 10 to 15-year period. Staff did not try to undertake an extensive study of all potential interactions or to reach definite conclusions. This brief review suggests that surveillance does make a mark, although in ways that are quite varied and difficult to measure and compare in time and across countries.

51. **In this context, it is not surprising that efforts to stimulate a regular staff reflection on the effectiveness of surveillance have yet to bear fruit.** Following the 2002 biennial review of surveillance, a requirement was introduced that staff reports include a brief assessment of the authorities’ response to the key policy challenges identified in previous consultations. The objective was to encourage staff to reflect on the effectiveness of past surveillance, as a base to enhance its impact in the future. The implementation of this requirement has not been particularly satisfactory. A review of its treatment in recent staff reports shows that in many cases the reporting was cursory, partial, and pro-forma. It did not clarify to what extent the authorities’ actions had been influenced by Fund policy advice, or if this advice has had any benefits other than its impact on policy decisions.

**Box 4. Diversity of Effective Surveillance: Some Country Examples Over Recent Years**<sup>1/</sup>

**Ethiopia**

**Disentangling the impact of Fund surveillance from that of Fund-supported programs is difficult in the case of Ethiopia.** Following a major shift in policy orientation from a centrally planned economy to a market-based one, the country has had a long program engagement with the Fund (a SAF in 1992, an ESAF during 1996-1999, and a PRGF in 2001, due to expire in mid-2004). Over the years, both program and surveillance discussions have had some influence on policymaking. Surveillance appears to have had its greater impact during periods where the program was off-track, maybe because it contributed to a better appreciation of the risks of delays in policy implementation.

**Important policy reforms have been implemented in the last 15 years, but in many areas progress has been uneven and slower than originally expected.** The official and market exchange rates were unified by 1996, and all foreign exchange transactions were moved to the interbank market in 2001. A few current account exchange restrictions still remain in place, however. Monetary management has improved, and interest rates have been liberalized. Progress has been made to improve bank supervision, but the authorities have remained reluctant to allow foreign participation in the banking sector. In the fiscal area, the government has taken steps to direct expenditures away from defense spending toward poverty alleviation. While agreeing with the Fund on the need for fiscal consolidation, on a number of occasions the authorities were not able to meet agreed targets. Many of the most immediate and distortionary policies of the centrally-planned past have been overhauled, but the authorities have remained suspicious of greater market orientation in key areas such as land, enterprise ownership, agriculture and financial sector.

**Germany**

**The fact that the Fund is one among many institutions providing economic policy assessments for Germany makes it especially difficult to isolate the contribution of Fund advice to the authorities' policy actions.** Many of the issues raised in the context of Fund surveillance have been emphasized by other institutions as well, both domestic (such as the *Sachverständigenrat*, the government's council of economic experts; and the German economic research institute, *DIW*) and international (the OECD and the European Commission). These institutions tend to play a more active and visible role than the Fund in the domestic policy debate.

**Yet over time the Fund appears to have made a mark on the policy debate in Germany.** By joining the voices of other policy institutions in favor of labor market reforms, the Fund appears to have helped the authorities overcome political obstacles and create a momentum for policy action. The government's "Agenda 2010"—a set of measures to reduce entitlements for the jobless and restrict the growth in non-wage costs—builds upon a series of partial steps implemented in recent years, in line with the Fund's advice. Following Germany's participation in the FSAP, the staff recommendation to break down regulatory barriers between private and public sector banks was widely cited in the German press. The authorities have expressed their intention to follow up on most of the FSAP recommendations.

**The Fund also appears to have contributed to policy analysis within the government.** The work on deflation threats initiated by staff last year apparently prompted the authorities to undertake their own study on the topic in preparation for the Article IV consultation. Although conclusions on underlying risks differed, debating the issue with staff helped the authorities deepen their understanding of the issue and formulate a potential policy response. The authorities also reportedly draw on the WEO in their world trade and financial market developments forecasts.

1/ The main author of this box is Natalia Tamirisa, with inputs from Ales Bulir, Ketil Hviding, Kalpana Kochhar, Yuri Sobolev, Nita Thacker, and Johannes Wiegand.

### India

**India's experiences illustrate the difficulties of evaluating the effectiveness of surveillance where there is agreement on diagnosis but differences on implementation.** Since the mid-1990s, policy discussions with India have focused on the need for rapid fiscal consolidation and second-generation structural reforms to sustain high growth—two areas where political constraints can loom large.

**The authorities recognized the desirability of rapid fiscal consolidation, but have favored a more gradual adjustment,** given political constraints and a favorable economic environment. They have been more sanguine than the Fund about their ability to reach the fiscal targets. When this proved difficult, commissions were established to reform the civil service and subsidy schemes, and to suggest ways to mobilize revenues, but implementation of the recommendations continues to be a challenge. Significant preparatory work went into the introduction of a state-level VAT, but political opposition resulted in the indefinite postponement of the measure. More than three years after its initial submission to Parliament, the Fiscal Responsibility and Budget Management Bill was enacted into law in 2003 but details of its implementation remain to be clearly articulated. The authorities have focused on taking some pressure off general government finances by restructuring domestic debt—in the Fund's view, a strategy fraught with risks in the absence of more fundamental measures to put public finances on a sustainable footing.

**On structural reforms, discussions have been dominated by the large unfinished agenda** in the areas of foreign trade, privatization, infrastructure, industrial and agricultural policies, and labor market reform—areas deemed crucial for growth by the Fund, but where the authorities preferred to take a more gradual approach for political reasons.

### Tunisia

**After exiting from an IMF-supported program in 1992, Tunisia has maintained a close and productive policy dialogue with the Fund in the context of surveillance.** There seems to be a sense of appreciation for Fund policy advice as contributing to the authorities' success in achieving high economic growth and financial stability. The authorities have consented to publication of country reports, which helped reinforce investors' positive views on the economy. The Fund's policy advice also seems to have been a useful input into the internal policy debate.

**Over the years, the authorities have demonstrated ownership of reforms.** They have persisted in pushing forward with reforms in a gradual, yet steady, manner. Among other things, they have prepared a long-term roadmap and taken steps to liberalize the capital account and redesign the monetary policy framework, paving the way for a move toward a floating regime. In 2002, Tunisia participated in the FSAP, and the authorities are implementing key FSAP recommendations in close cooperation with Bank and Fund staff. Other initiatives highlighted during Article IV consultations—trade liberalization, fiscal consolidation, banking system restructuring, and labor market and civil service reforms—have proceeded at a slower speed.

### United States

**The U.S. economy is extensively monitored and analyzed, making it difficult for the Fund to add new information to the debate.** There is a broad range of views on different policy issues, including recently on fiscal policy. The Fund's analysis and advice is discussed with the authorities in the context of the consultation and then disseminated to the general public. Some reports—including a recent occasional paper on the long-term sustainability of fiscal policies—have received significant media coverage, contributing to an already active policy debate.

**Over the past 15 years, Fund advice consistently sought to strengthen the momentum for long-term fiscal sustainability, taking into account the global implications of macroeconomic imbalances in the U.S.** (The Fund has been supportive of the conduct of the monetary policy, applauding the Federal Reserve for its flexibility and pragmatism.) In the early 1990s, the views of the authorities and those of the Fund on the need for fiscal restraint broadly coincided; the authorities were eventually successful in bringing down the deficit. More recently, there has been a somewhat greater dissonance between the authorities and the Fund's advice. The disagreement has largely focused on the realism of fiscal projections, with the authorities factoring in relatively large supply-side effects of tax reductions, and Fund staff using more traditional estimates.

**Discussions also have covered trade policy and official development assistance (ODA).** The Fund has expressed concerns about the use of anti-dumping and countervailing duties and agricultural subsidies, and has repeatedly called for an increase in the fiscal resources dedicated to ODA. In the authorities' view, the use of trade instruments is in compliance with the WTO rules and ODA is supplemented by other initiatives to help poor countries.

## The way forward

52. **Staff recommends that more time be given to gain experience with the requirement to reflect on the effectiveness of individual surveillance exercises.** Country teams could be further encouraged to identify the main factors hampering the effectiveness of surveillance, drawing when appropriate on feedback from the authorities. The focus of this reflection could be broadened to include not only the impact of surveillance on policy decisions, but more broadly its contribution to the policy debate, the process of policy design, and the dissemination of data and information. The results of this assessment could be discussed with the authorities in the field and used as an input (including in pre-brief meetings) to shape the focus of subsequent consultations. Over time, such efforts to assess the effectiveness of individual surveillance exercises should help identify the main obstacles encountered in practice. Transparent reporting of these assessments to the Board—and to outside audiences, if Article IV reports are published—should help increase the accountability of the Fund.

53. **Executive Directors could also be encouraged to present more detailed views on the effectiveness of surveillance** on individual countries at the time of the Article IV consultation. Executive Directors could comment in particular on staff's choice of topics, and on the authorities' response to previous staff recommendations. Such a practice would help generate more systematic information on factors that boost (or limit) the effectiveness of surveillance in different circumstances, contributing over time to increase its traction and staff accountability.

54. **Assessments of effectiveness would also be improved if staff identified more explicitly, in the preparation of an individual consultation, its specific priorities and related modalities.** This reflection could take place in pre-brief or other early inter-departmental meetings so as to draw input from experience in other countries while maintaining consistency with broad institutional priorities.

55. **At a broader level, it would be important to ensure that each biennial review of surveillance concludes with the identification of a set of strategic, monitorable objectives for the period ahead.** These objectives will allow for continuous monitoring of performance and provide a clear starting point for the next review.

56. **Staff would also pursue its work on the development of the methodological framework to assess the effectiveness of surveillance.** This work would be informed by the procedures put in place to assess the effectiveness of individual Article IV consultations, and would be coordinated with other ongoing work, including that on the definition of performance indicators being developed in the context of the budget exercise.

**Summary of Recommendations  
to Strengthen Assessments of Effectiveness in Surveillance**

- Improve the reflection on the effectiveness of individual consultations through regular reporting in staff reports
- Encourage Executive Directors to present their views on the effectiveness of individual consultations
- Encourage the explicit identification of the priorities and modalities of individual consultations
- Conclude each Biennial Review of Surveillance by identifying strategic, monitorable objectives for the period ahead
- Continue to develop the methodological framework to assess effectiveness of surveillance

**H. Conclusions**

**57. Beyond the many nuances, three general conclusions appeared to be shared broadly by those interviewed for this review:**

- The recognition that changes in the coverage and modalities of surveillance introduced in recent years have enhanced its effectiveness, although with different intensity across the membership.
- The perception that there is still scope to give surveillance more “traction.” There were differences across countries and audiences on the most appropriate approaches and relative priorities to reach this result. Overall, most of those interviewed expressed a preference for calibrating ongoing initiatives to different country circumstances and needs, before considering structural changes or radical redesign.
- The desire to maintain flexibility in modalities, allowing surveillance to adapt rapidly to changing circumstances, and missions to innovate within the framework defined by the Articles of Agreement, the 1977 Surveillance Decision, and Board guidance on the conduct of surveillance.

**58. The recommendations proposed by staff in the context of this review are in line with these conclusions.** They do not look for radical changes to the present *modus operandi* but rather attempt to build on recent initiatives to enhance their impact while maintaining flexibility to adapt to varying country situations.



### III. MODALITIES FOR MORE INTENSIVE SURVEILLANCE<sup>22</sup>

59. **As mentioned earlier, there is significant flexibility in the procedures of Fund surveillance.** The 1977 Surveillance Decision specifies that members shall consult with the Fund regularly under Article IV. In principle, consultations shall take place annually and be concluded with a discussion at the Executive Board. In addition, staff shall maintain close contact with members in connection with their exchange policies, and be prepared to discuss on the initiative of the member important changes that it contemplates in its exchange rate policies.<sup>23</sup>

60. **In practice, a variety of modalities has been developed, in addition to annual Article IV consultations, to provide for more frequent or intensive contacts between the Fund and member countries outside a program relationship.** Although they do not fall under members' obligations under Article IV, these modalities are commonly referred as more frequent or intensive surveillance.<sup>24</sup> This section reviews the experience of member countries with these procedures since the last review,<sup>25</sup> briefly summarizes issues in the design of more structured mechanisms, and suggests possible options for further exploration.

#### A. Experience with More Intensive Surveillance

61. **Over the period under review, 40 member countries have experienced one or more forms of closer surveillance.** Modalities have ranged from more frequent informal contacts in the context of traditional Article IV consultations to more formal relations bearing some similarities in format to a program engagement (Table 1). Some (but not all) have involved formal or informal reporting to the Board. Also, the degree of publicity given to their output has varied greatly.

62. **Traditional Article IV consultations have often included more frequent contact with the authorities.** Some 65 percent of mission chiefs responding to the survey for this review indicated that they undertake regular staff visits to member countries between consultation cycles (Appendix III). Excluding program countries, over half of the countries in the sample received staff visits.<sup>26</sup> Staff visits have generally been focused on providing

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<sup>22</sup> The main author of this section is Piyabha Kongsamut.

<sup>23</sup> Surveillance over Exchange Rate Policies, DEC No. 5392-(77/63), 29/4/1997, as amended, available at [www.imf.org](http://www.imf.org).

<sup>24</sup> For drafting convenience, and without legal implications, the term "intensive surveillance" or "closer surveillance" is used in the remainder of this section to refer to more frequent or closer contacts with member countries outside the context of a program relationship.

<sup>25</sup> Except when otherwise specified, data refers to the period from January 2003 to March 2004.

<sup>26</sup> A similar proportion (52 percent) of the entire surveillance-only membership received staff visits during that period.

advice at an important stage of a country's policy design cycle, or on specific policy or reform initiatives. They were also used to keep abreast of recent economic developments and macroeconomic policy issues and lay the ground for the full Article IV consultation mission later in the year. In most cases, staff visits did not generate formal reports to the Board. During the review period, seven percent of staff visits to non program countries were followed by the publication of a mission concluding statement or staff statement.

Table 1. Surveillance and Related Involvement  
(January 2003-March 2004)

	<i>Number of countries</i>	<i>Number of published reports</i>
Article IV consultations	135	78
of which: program countries	29	26
Post program monitoring	2	--
Staff-monitored programs	6	5
Countries discussed in informal country matters sessions	19	---
Staff visits	59	4
Reports on interim staff visits	1	---
Assessment letters	14	---

**63. A number of other ad hoc modalities have been used for more intensive surveillance:**

- For internal purposes, staff has developed analytical tools and procedures to assess the economic conditions of its members in a regular, systematic manner. The analysis of systemically important economies, and countries deemed particularly vulnerable, has been subject to frequent updates and follow up.
- WEMD and informal country matters sessions have been used to keep the Board abreast of developments in particular countries or groups of countries. Since January 2003, 50 country cases have been discussed in 12 sessions; 19 countries were surveillance-only cases. Many countries were discussed more than once. The main objective of these sessions was to update the Board on recent economic and sometimes political developments, and when relevant share staff conclusions on vulnerabilities. The proceedings of these sessions were not made public.
- In a few countries, with the consent of members and usually at their request, contact between Fund staff and the authorities has been more frequent and extensive. In most cases, this situation originated because of perceptions of significant near-term risks. Economic conditions were monitored more closely, and policy advice has tended to be more elaborate. These cases have generally received little publicity, and there has

been no reporting of the staff conclusions and recommendations to the Board beyond the WEMD and informal country matters sessions.

- Following the endorsement by the Board of a request from official creditors, mid-year staff reports on Lebanon are to be circulated to the Board. The first such interim report was circulated in 2003, but was not published.<sup>27</sup>

64. **Two formal procedures have been used for more intensive contacts between staff and the authorities.**<sup>28</sup>

- Post program monitoring (PPM) has been a vehicle for more frequent contact with countries that are just exiting from a Fund program. It provides for regular reporting to the Board on the progress toward external viability of countries with substantial Fund credit outstanding (usually over 100 percent of quota at the expiration of the arrangement). Although the basis for the PPM is in Article V, in practice it closely resembles a second, more focused Article IV consultation each year. PPM has been conducted for six countries since its establishment in 2000 (two countries during the period under review). Publication of PPM staff reports has been voluntary, as is the case for Article IV staff reports.<sup>29</sup> In practice, no stand-alone PPM report has been published.<sup>30</sup>
- Staff Monitored Programs (SMPs) are closer to the program mode of operation. They entail regular (often six-monthly) staff visits to assess policy implementation and outcomes against a set of policy intentions backed by a detailed quantitative program. Since 2003, all SMPs should be for the purpose of allowing members to establish a track record of sound policy implementation in advance of a request for a Fund arrangement.<sup>31</sup> The policies included in an SMP generally do not meet the standards required for a Fund arrangement, and they are not formally endorsed by the Board. Publication of the staff reports and other documentation is voluntary but helps in building commitment and credibility. During the period covered by this review, six SMPs have been in place (one was a signaling SMP). The reports for five of these SMPs were published.

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<sup>27</sup> *Lebanon—Report on Interim Staff Visit.*

<sup>28</sup> Another formal procedure, the supplemental consultation, exists, but it has been used only rarely.

<sup>29</sup> Publication of PPM and Article IV staff reports became voluntary, but presumed in July 2004.

<sup>30</sup> Two combined Article IV/PPM reports have been published (out of a total of seven issued).

<sup>31</sup> Prior to 2003, members could also enter into a SMP for the purposes of signaling; this instrument has been discontinued due to Board concerns that it could be misinterpreted as carrying the Fund's seal of approval. See *Signaling Assessments of Members' Policies* (PIN/03/12, 2/13/2003), available at [www.imf.org](http://www.imf.org).

65. **Assessment letters have been prepared in response to ad hoc requests for a formal policy assessment.**<sup>32</sup> They typically contain a brief history of the Fund's relationship with the member country and a clear but nuanced assessment of the quality of macroeconomic and related structural policies, and may be prepared for any Fund member. Such letters are targeted to a specific audience (mostly donors and creditors) and circulated to the Executive Board. Fourteen letters have been prepared for twelve countries since the adoption of the policy (2 for program countries, 5 for near-program, and 5 for surveillance-only cases).

#### **B. Issues in the Design of Structured Modalities for Intensive Surveillance**

66. **The demand for more intensive surveillance has occurred in a variety of circumstances, and may have originated from the member, from its creditors, or from the Fund itself.**

- Some members have asked for more intensive surveillance when exposed to a high degree of vulnerability, or faced with broad policy challenges. This included, but was not limited to, members exiting from an arrangement. Staff may also have intensified its monitoring of countries that were considered vulnerable because of concerns over a potential crisis and its spillover to other members.
- Some members have requested closer contacts with the Fund in order to stress their commitment to policy reform, increase credibility, or to help sustain the momentum of reform.
- Donors and private creditors have asked for a signal from the Fund on the quality of policies of certain members as a condition for new or continued financing.
- The Fund has maintained more intensive involvement with members exiting from an arrangement, or wishing to enter into one, in order to safeguard Fund resources.

67. **These circumstances reflect a recurring demand for two outputs that go beyond the traditional modalities of surveillance:** (i) policy monitoring that is more frequent and intensive than is normally the case in an annual consultation; and (ii) the delivery of a stronger, more frequent, and more focused policy signal. The Fund provides similar services in the context of a program relationship. However, the need may also occur in members whose economic or political situation does not justify a program arrangement (either because they have limited actual or potential financing needs, or because of they cannot or do not wish to commit to the conditionality of a formal arrangement).

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<sup>32</sup> The policy on assessment letters was formalized in 2003. See *Signaling Assessments of Members' Policies* (PIN/03/12, 2/13/03), available at [www.imf.org](http://www.imf.org).

68. **This demand is not new, and the Fund has repeatedly attempted to address it over the past decades** (Box 5). The flexibility built into surveillance procedures has allowed the institution to respond relatively well to demands for more frequent monitoring. But efforts to establish a signaling mechanism outside a program context have generally been unsuccessful.<sup>33</sup> Procedures that were established were rarely used, and the signaling SMP was discontinued. New proposals did not find sufficient support from the Board. On the donor/creditor side, funds have often been conditioned—explicitly or implicitly—on the existence of a program involving Fund financial support, contributing to the increased use of precautionary arrangements for signaling purposes. Over the past ten years, the proportion of arrangements in the GRA that were precautionary on approval has increased from 14 percent to 60 percent of all arrangements approved.<sup>34</sup>

69. **Greater transparency may have raised the potential for signaling in the context of surveillance.** With increasing numbers of Fund reports and statements in the public domain, more avenues for signaling have been opened. However, in outreach surveys undertaken for this review, market participants found that published surveillance documents do not convey a clear signal of the Fund’s view on the strength of a member’s policies. Moreover, the nuanced nature of the Fund’s assessment is open to misinterpretation.<sup>35</sup> Conversely, issuing a clearer signal in a high-risk and volatile environment may end up precipitating the very crisis that it was attempting to prevent.

70. **Previous discussions at the Board indicate that the design of an acceptable signaling mechanism must balance a number of delicate issues.** The main ones are summarized below:

- *Incentive-compatibility issues.* As observed with signaling SMPs, countries will continue to receive the benefits of signaling even if they cannot stay the course of reform after the signal has been issued. A successful signaling mechanism would require an element of monitoring, to keep the signal accurate and credible, and to assure the Board that adequate follow-up of the implementation phase is in place.<sup>36</sup> This may include the possibility of issuing “negative” signals in the event that

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<sup>33</sup> For recent attempts see, for example, *Signaling Assessments of Members’ Policies* (PIN/03/12, 2/13/03), available at [www.imf.org](http://www.imf.org); *Completion of the Review of Contingent Credit Lines and Consideration of Some Possible Alternatives* (PIN/03/146, 12/19/2003), available at [www.imf.org](http://www.imf.org); and *The Fund’s Role in Low-Income Member Countries—Considerations on Instruments and Financing*, (PIN/04/40, 4/15/2004), available at [www.imf.org](http://www.imf.org).

<sup>34</sup> On the basis of five-year averages calculated for 1998-2003, 1993-98, and 1988-93.

<sup>35</sup> Interpretation issues were also raised in *The Fund’s Transparency Policy—Issues and Next Steps*, available at [www.imf.org](http://www.imf.org), where presumed publication would increase the need to ensure high-quality staff reports to reduce the likelihood of misinterpretation.

<sup>36</sup> *Signaling Assessments of Members’ Policies*, available at [www.imf.org](http://www.imf.org) and *Signaling Assessments of Members’ Policies* (PIN/03/12, 2/13/2003), available at [www.imf.org](http://www.imf.org).

implementation slips. For the Fund, it may be difficult to keep a surveillance signal free from political pressures.

- *The definition of a standard against which to assess country performance.* Such a standard would be desirable to ensure clarity and uniformity of treatment. However, the standard of upper tranche conditionality has never been adopted as a standard for signaling under surveillance because of concerns that such an approach would put the Fund in a position of acting like a rating agency. In addition, it would be difficult to differentiate such a signal from that associated with precautionary arrangements.<sup>37</sup>
- *Signal clarity.* The signal given needs to be sufficiently clear not to lend itself to misinterpretation. Clarity should also imply symmetry: clear assessments could be either positive or negative. However, increased clarity from the Fund should not absolve market participants from the need to make their own decisions. Besides possible confusion and misinterpretation arising from a differing standard for countries under surveillance and those with Fund financial arrangements, the role of the Board and the staff under such a mechanism would also need to be clarified.
- *Ensuring country ownership.* A high degree of ownership of the reform program would be critical for a surveillance signal to be credible and to enhance commitment. Even more than in the case of Fund conditionality, it would be important to ensure that the promise of a signal is not used to induce countries to commit to policies that they would be reluctant to implement.<sup>38</sup>
- *Acceptability to the donor community.* The donor community has generally preferred the strongest signal a member can provide through the existence of a financial arrangement with the Fund. In light of recent indications, however, more consultations are warranted to determine whether and under what circumstances a signal under surveillance would be sufficient to assure donors that their assistance is being provided in an appropriate macroeconomic policy environment.

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<sup>37</sup> *Summing Up by the Chairman on Precautionary Arrangements, Enhanced Surveillance, and Program Monitoring; and Need as a Condition for the Use of Fund Resources.*

<sup>38</sup> *Enhancing the Effectiveness of Surveillance—Operational Responses, the Agenda Ahead, and Next Steps* (PIN/03/50, 4/10/2003), available at [www.imf.org](http://www.imf.org).

**Box 5. Existing and Proposed Procedures for More Intensive Surveillance**

Name	Date	Purpose	Key Features	Issues raised	Current status	Experience
Supplemental consultations	Adopted in 1979	To make surveillance procedures on exchange rates more even-handed and not dependent on the type of exchange arrangement being maintained.	The MD calls for a supplemental consultation with a member after consulting informally with Executive Directors.	Stigma issues.	Currently unused.	Two (1982, 1987)
Enhanced surveillance	Adopted in 1985; applicability broadened in 1993	To assist members with a good record of adjustment in addressing their debt problems with commercial creditors in the context of multi-year rescheduling arrangements.	(i) entry criteria (strong track record, no financing need); (ii) a quantified macroeconomic program prepared by the authorities in consultation with Fund staff describing major objectives and supporting policies; (iii) semi-annual consultations to assess progress in implementation; (iv) the release of staff reports by the member to relevant creditors; (v) the use of the mechanism, but not the program, is endorsed by the Board.	Concern that it would interfere with the normal functioning of markets and undermine the candor of the policy dialogue. Difficulty in defining exit procedures.	Fell into disuse after 1994.	Six (1985-1993)
Fund monitored programs	Adopted in 1989	To help members resolve their arrears to the Fund; developed into the "rights accumulation programs" (RAP) for members with larger and more protracted arrears to the Fund.	Authorities develop policy program consistent with conditionality in the upper credit tranches; implementation progress monitored on quarterly targets without commitment of Fund resources.	With regard to the FMPs, Directors thought that it might be difficult to maintain the standards of endorsement in the absence of the commitment of Fund resources.	No FMPs in use, but the RAP is still available to members with protracted arrears to the Fund.	Three FMPs (1989-1990); Two RAPs.
Staff-monitored programs (SMPs)						
Track-record SMPs	Discussed in 1998	To allow the authorities to demonstrate their commitment to strong policies and pave the way for eventual entry into a Fund program, while also sending donors and creditors a positive signal on the direction of policies.	All SMPs involve agreement between the staff and the authorities on a reform program, including a macroeconomic framework and other reform, along with regular staff assessments of program implementation. The Board is usually informed of such arrangements through informal country matters sessions or usual Article IV consultations.	Concerns about possible misinterpretation as implying a formal endorsement of a country's policies by the Board.	Currently in use	57 track-record SMPs (of which two currently in place)
Signaling SMPs	Discussed in 1998	To provide markets or donors with positive signal of the authorities' reform program.	See above. Signaling SMPs did not have as rigorous reporting requirements for assessment of policy implementation as track record SMPs.	Concerns that signaling SMPs could be misinterpreted as carrying the Fund's seal of approval. In addition, concerns arose of inadequate follow-up on implementation.	Discontinued	15 signaling SMPs
Post-program monitoring	Adopted in 2000	To provide early warning of policies which could call into question a member's continued progress toward external viability and imperil repayment of outstanding Fund resources.	Applies to countries with over 100 percent of quota at the expiration of the arrangement. Management recommends to the Board initiation and termination of PPM; the threshold of 100 percent of quota is a guiding criterion. Originally applied only to countries with outstanding GRA resources, it is being extended to PRGF credit. Staff reports to the Board generally twice a year under PPM; once in combination with the Article IV consultation.	No major issues raised.	Currently in use.	Six, of which two are current
Enhanced Monitoring Procedure	Proposed in 2003	To provide for regular assessments between Article IV consultations.	To be initiated by the member. The authorities' policy program would be presented; staff would assess the adequacy of the program against staff's identified key policy challenges, and assess the implementation of the policy program.	Notwithstanding some support for this instrument, the majority of Directors thought that existing surveillance and precautionary arrangements were adequate to serve as signaling devices.	Proposal was not adopted.	None.
Enhanced Monitoring Policy	Proposed in 2003 for all, in 2004 for low-income members	To provide close Fund monitoring without formal performance criteria, and limited contingent financing in case of need.	Program design and monitoring would closely mirror that of PRGF and GRA arrangements, though with no/few structural targets and without immediate commitment of resources. Contingent financing feature to provide a safety net.	Concerns that the EMP would be too close to a Fund program; its contingent financing feature raises moral hazard concerns; and its acceptability to the donor community is unclear.	Proposal was not adopted.	None.

71. **Further work is needed to explore possible signaling mechanisms.** In the meantime, there may be scope to use more extensively the flexibility offered by surveillance to provide more frequent and pointed assessments:

- More frequent Article IV consultations could be conducted, at the request of the authorities, to present their economic policy framework, flag problems and needs, and allow for more frequent (e.g., six-monthly) assessments of a country performance.<sup>39</sup> A number of countries have expressed interest in more frequent Fund assessments.
- Greater quantification of policy frameworks could be used as a means to generate more pointed surveillance assessments. Such frameworks would be fully home-grown, and could be complemented by a detailed policy agenda. Country-generated quantitative references would provide a more precise context for assessing policy objectives and performance, and could allow for the delivery of a more informative and effective signal under surveillance, particularly since such assessments can now be published.
- Each of these options may be associated with different degrees of formality and publicity (e.g., circulation of a staff report, discussion at the Board, preparation of the Summing Up, and publication).

72. Directors will have the opportunity to explore options for signaling in a number of forthcoming meetings, including the discussion on precautionary arrangements and on the design of a signaling mechanism for low-income countries.

**Summary of Recommendations  
on Modalities for More Intensive Surveillance**

- Continue discussions on possible signaling mechanisms in other contexts in the months ahead
- Consider ad hoc use of more frequent consultations and of quantitative frameworks

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<sup>39</sup> *The Fund's Role in Low-Income Member Countries—Considerations on Instruments and Financing* (PIN/04/40, 4/15/2004), available at [www.imf.org](http://www.imf.org).



#### IV. MODALITIES OF REGIONAL SURVEILLANCE<sup>40</sup>

73. **This chapter reviews modalities of the Fund’s regional surveillance activities, and explores options to enhance their contribution to bilateral surveillance.** The regional surveillance activities of the Fund can be grouped under two broad categories: those related to the conduct of surveillance with members of currency unions, and those more broadly aimed at following and analyzing regional economic conditions. Activities in the first group are much more formalized than those in the second, although both constitute important inputs to Fund surveillance.

##### A. Surveillance of Currency Unions

74. **For members of currency unions, firm surveillance requires that discussions be held with representatives of relevant regional institutions,** since these countries have devolved responsibilities over monetary and exchange rate policies—two central areas of Fund surveillance—to regional institutions. Until the establishment of the euro area, this need had been addressed in an ad hoc manner.

##### Surveillance of the euro area

75. **The move to the third and last stage of the European Economic and Monetary Union (EMU) in the late 1990s triggered consideration by the Board of the modalities of surveillance with future members of the euro area.**<sup>41</sup> Directors agreed that this development required strengthening the framework for regional surveillance. They debated the need for formalization: some argued that the inclusion of discussions with regional institutions as a direct part of the Article IV process with each individual member would explicitly recognize the obligations of members of the euro area to consult with the Fund in this context and give the Fund clarity with which to pursue its mandate; some saw advantages—at least for an initial period—in a less formal approach where discussions with regional institutions would continue to provide an important input to surveillance without being directly part of the Article IV process.<sup>42</sup>

76. **In the event, in November 1998, new, formal procedures were adopted for surveillance of the euro area, making discussions with its regional institutions an integral part of Fund’s Article IV surveillance over its members.** Some of these

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<sup>40</sup> The main author of this section is Jesmin Rahman.

<sup>41</sup> *European Economic and Monetary Union and the Fund--Institutional Aspects; European Economic and Monetary Union and the IMF—Main Legal Issues Relating to Rights and Obligations of EMU Members of the Fund; EMU and Fund Surveillance; Surveillance over the Monetary and Exchange Rate Policies of the Members of the Euro Area; and European Central Bank-Observer Status.*

<sup>42</sup> See *Concluding Remarks by the Acting Chairman Operational and Legal Aspects of EMU for the Fund.*

procedures reflected the systemic importance of the euro area. Their key elements, as subsequently amended in 2002, were as follows:

- Annual Article IV consultations with individual members were maintained.
- Twice-yearly staff discussions would be held with regional institutions responsible for common policies that fall within the mandate of the Fund. Although held separately from the discussion with individual countries, these discussions are considered an integral part of the Article IV process with each euro-area member.
- An annual staff report would be prepared on the monetary and exchange rate policies of euro-area countries. The report would be discussed at the Board, and titled “The Monetary and Exchange Rate Policies of Euro-Area Countries in the Context of the Article IV Consultations with these Countries.”
- A report on the follow-up set of discussions would be sent to the Board for information. At the request of euro-area authorities, this was replaced in November 2002 by a WEMD-like session where staff makes an informal oral presentation supplemented by charts and tables. This change brought the modalities for the euro area closer to those applied to large countries, which have one staff report and an interim visit.<sup>43</sup>
- A summing up would be prepared at the conclusion of the Board’s annual discussion. This summing up would be cross-referenced in the summings up for the Article IV consultations with individual euro-area countries given at the conclusion of the Article IV process for each country.
- To the extent possible, there would be a clustering of individual Article IV discussions to allow for a broader assessment of EMU-wide developments and ensure timely input to the bilateral consultations.
- The ECB would receive observer status at selected IMF Board meetings.
- Public Information Notices (PINs) could be issued with the members’ consent following the conclusion of the Board discussion of the regional report, mirroring the procedure for individual Article IV consultations.

**77. Attention was given to the appropriate focus of discussions with regional and national authorities.**

- The coverage of discussions with euro-area regional institutions was expected to include monetary and exchange rate policies as well as common policies in structural

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<sup>43</sup> *Surveillance over Euro Area Policies.*

and other areas that are relevant to Fund surveillance, such as trade and competition policies. An assessment of the fiscal position of the euro area as a whole was also seen a necessary input for assessing the coherence of macroeconomic policies. In practice, regional surveillance consultations with the euro area have typically included a main report covering recent developments, monetary policy and inflation, aspects of fiscal policy such as operations of Stability and Growth Pact, structural policies with regional relevance and trade policy. In addition to the main report, selected issues papers have been prepared to inform policy discussions in the areas covered by common policies—e.g., specific aspects of monetary policy, exchange rate pass-through, trade policies, and business cycles.

- At the same time, the scope of Article IV consultations with individual Fund members was narrowed to focus on fiscal, financial, and structural policies. In that context, discussions on monetary policy have centered on the impact of the policy stance of the European Central Bank (ECB) on the national economy, as well as issues relevant to the implementation of monetary policy operations through the national central bank.

78. **These arrangements have worked reasonably well in practice.** Bilateral consultations with the main economies of the euro area have been grouped in time around either the discussion of the main regional report or the WEMD-like follow up session, allowing for more productive discussions.<sup>44</sup> All annual reports have been published, together with a PIN.

### **Surveillance of other currency unions**

79. **Modalities of regional surveillance over the other three existing currency unions have not yet been discussed in depth at the Board.** During the Board meeting on the 2000 biennial review of Fund's surveillance, a few Directors called for the adoption of more systematic arrangements for discussions with regional institutions of currency unions beyond the euro area, but these did not materialize.<sup>45</sup>

80. **Nonetheless, since 1998, the practice of policy discussions with the West African Economic and Monetary Union (WAEMU), the Central African Economic and Monetary Community (CEMAC) and the Eastern Caribbean Currency Union (ECCU) has moved towards greater formalization.**<sup>46</sup>

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<sup>44</sup> As reported in Appendix II, country authorities generally appreciated the clustering of individual consultations around regional discussions.

<sup>45</sup> *Summing Up by the Acting Chairman—Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision.*

<sup>46</sup> Staff has also provided advice to the GCC in its process towards the establishment of a currency union.

- For the WAEMU, annual staff reports have been prepared and discussed at the Board starting in 1998, with concluding remarks by the acting chair at the end of the Board discussions. A PIN was issued for the first time following the 2000 Board discussion and in 2003. The authorities also consented to the publication of the 2003 staff report.<sup>47</sup>
- In the same vein, for the CEMAC, annual reports have been discussed by the Board since 1999, and the conclusions of the discussion have been summarized in chairman's concluding remarks. A PIN on the regional consultation was issued following the 2002 and 2003 Board discussions.<sup>48</sup> The reports have not been published.
- For the six members of the ECCU that are members of the Fund, a regional dimension was gradually introduced to surveillance starting in 1999.<sup>49</sup> After the circulation of two—mostly descriptive—papers on recent economic developments and institutional arrangements as background for the 1999 Article IV consultations with individual ECCU member countries, a more policy-oriented regional paper was circulated to the Board in 2001, also as background information to individual Article IV consultations.<sup>50</sup> The Fund conducted a regional consultation with ECCU institutions for the first time in 2002, along the line of its consultations with WAEMU

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<sup>47</sup> *West African Economic and Monetary Union—Recent Developments and Regional Policy Issues* (PIN/00/51, 7/24/00), available at [www.imf.org](http://www.imf.org); *West African Economic and Monetary Union—Recent Economic Developments and Regional Policy Issues in 2000*, available at [www.imf.org](http://www.imf.org); *West African Economic and Monetary Union—Recent Economic Developments and Regional Policy Issues*, available at [www.imf.org](http://www.imf.org); *West African Economic and Monetary Union (WAEMU)—Recent Economic Developments and Regional Policy Issues* (PIN/03/31,3/12/03), available at [www.imf.org](http://www.imf.org).

<sup>48</sup> *Central African Economic and Monetary Community—Recent Developments and Main Regional Policy Issues; Concluding Remarks by the Acting Chairman—Central African Economic and Monetary Community (CEMAC)—Recent Developments and Main Regional Policy Issues; Central African Economic and Monetary Community—Recent Developments and Regional Policy Issues in 2000*, available at [www.imf.org](http://www.imf.org); *Concluding Remarks by the Acting Chairman—Central African Economic and Monetary Community (CEMAC)—Recent Developments and Main Regional Policy Issues; Central African Economic and Monetary Community—Recent Developments and Regional Policy Issues*, available at [www.imf.org](http://www.imf.org); *Central African Economic and Monetary Community (CEMAC)—Recent Developments and Regional Policy Issues* (PIN/02/96, 9/3/02), available at [www.imf.org](http://www.imf.org); *Central African Economic and Monetary Community—Recent Developments and Regional Policy Issue*, available at [www.imf.org](http://www.imf.org); *Central African Economic and Monetary Community (CEMAC)—Recent Developments and Regional Policy Issues* (PIN/03/141, 12/4/03), available at [www.imf.org](http://www.imf.org).

<sup>49</sup> The Fund had already been engaged with these countries on a regional basis before 1999, through staff visits to the ECCB. The Fund had also assisted the ECCB on regional projects, such as the regional government securities project, the OECS statistics project, and the ECCB country programming exercise.

<sup>50</sup> *The Eastern Caribbean Currency Union—Recent Developments and Policy Issues* and *The Eastern Caribbean Central Bank—Institutional Arrangements and Issues in a Currency Union*.

and CEMAC institutions, and a PIN was issued following the Board meeting.<sup>51</sup> In an effort to cluster Article IV consultation around discussions with regional authorities, the regional staff report was discussed together with Article IV staff reports on Grenada, St. Lucia, and St. Vincent and Grenadines. Directors appreciated the grouping of regional surveillance discussion with the Article IV consultations of three of the ECCU members, and saw benefits to an interim update of regional developments.<sup>52</sup> An interim visit was conducted later in the year to provide an update on regional issues to the Executive Board.<sup>53</sup>

81. **The coverage of regional discussions with these currency unions is broadly comparable to that of the euro area.** It includes a discussion of monetary and exchange rate policies, their instruments and effectiveness, as well as competitiveness, progress in macroeconomic convergence, common trade policy, banking supervision, and other structural issues. Policy discussions are increasingly backed up by background research, and a selected issues paper was included in the documentation for the 2003 consultation with ECCU institutions.

82. **Nonetheless, the absence of a formal regional consultation process weakens the ability of the Fund to exercise surveillance over these currency unions in areas that are central to its responsibility.** In particular, the vulnerabilities faced by a particular member of a currency union cannot be assessed independently of the policies of the currency union itself. In the context of a currency union, the integration of bilateral and regional policy discussions is a key requirement for effective crisis prevention and efficient crisis resolution.

83. **Further formalization of surveillance over existing currency unions, toward modalities closer to those followed for the euro area, would be advisable.** The establishment of a clear framework for policy discussions with regional institutions, and the explicit recognition that these discussions form part of the Article IV consultation with each member, would strengthen the conduct of surveillance over their monetary and exchange rate policies, trade policies, and financial sector regulation and supervision. It would also ensure uniformity of treatment across the membership. The clustering of individual consultations around discussions with regional authorities would also help enhance their effectiveness.

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<sup>51</sup> *Eastern Caribbean Currency Union—Staff Report Following Discussions with Regional Institutions*, available at [www.imf.org](http://www.imf.org); *Eastern Caribbean Currency Union—Selected Issues*, available at [www.imf.org](http://www.imf.org); *Eastern Caribbean Currency Union (ECCU)—Following Discussions with Regional Institutions (PIN/03/40, 3/28/03)*, available at [www.imf.org](http://www.imf.org); *Eastern Caribbean Currency Union—Report for the 2004 Regional Surveillance*; *Eastern Caribbean Currency Union—Selected Issues*; and *Eastern Caribbean Currency Union—The Acting Chair’s Summing Up—Report for the 2004 Regional Surveillance*.

<sup>52</sup> *Eastern Caribbean Currency Union (ECCU)—Following Discussions with Regional Institutions (PIN/03/40, 3/28/2003)*, available at [www.imf.org](http://www.imf.org).

<sup>53</sup> *Eastern Caribbean Currency Union—Update on Regional Developments*.

84. **The modalities for more formalized consultations with the WAEMU, the CEMAC and the ECCU would need to be determined in consultation with the relevant national and regional authorities, and approved by the Executive Board.** The following five elements would need to be clarified: (i) the frequency of Article IV consultations with individual countries that are members of currency unions; (ii) the frequency, status, and timing of discussions with regional institutions; (iii) the nature of the reporting to the Board and of Board discussions; (iv) the outcome of Board discussions (e.g., summing up), and (v) the regional institutions' representation at the Board. On some of these elements, modalities may differ from those applied in the euro area, given the characteristics of the countries involved.

## **B. Other Regional Surveillance**

85. **Beyond monitoring developments in currency unions, the staff conducts a broad range of regional surveillance activities.** These activities—which encompass the production of regular regional outlook and other notes, the maintenance of a dialogue with various regional fora, and the development of research on regional issues—have developed from various origins, and most are conducted informally. The results feed into Fund's bilateral surveillance through information sharing, strengthened policy analysis, and enhanced policy outreach.

86. **A survey of Fund's regional surveillance activities outside the scope of currency unions shows significant diversity in intensity across regions.** In most cases, the frequency and quality of the policy dialogue seem largely related to the scope and strength of regional institutions, and the importance of regional initiatives in the agenda of individual countries. Thus, regional surveillance activities take place with higher frequency in Africa, Asia and Europe than in the Middle East and the Western Hemisphere.

87. **The themes of regional policy analysis also seem to respond largely to regional demands, contributing to the significant variety of themes across departments.** For example, policy discussions in Africa have mostly aimed at facilitating the dialogue and cooperation among a plethora of overlapping regional groupings, and stressed the need for a strong degree of economic convergence and political support prior to extending regional commitments.<sup>54</sup> In the Middle East, analysis has concentrated on tax and trade reform (including the removal of obstacles to intraregional trade), and annual discussions with the GCC. In Europe, it has focused on exchange rate and fiscal sustainability issues and on the preparation for EU accession and euro adoption. Regional research has also frequently analyzed the impact on a region of a particular event (such as the implications of China's

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<sup>54</sup> In recent years, two such prospective currency unions have emerged: the West African Monetary Zone consisting of Nigeria, Ghana, Guinea, The Gambia, and Sierra Leone; and the East African Currency Union consisting of Uganda, Tanzania and Kenya.

accession to the WTO, or the impact of the conflict in Kosovo), or issues that are relevant for specific sub-groups (for example, Central America, the Pacific Islands).

88. **Efforts to disseminate the output of regional surveillance have increased in recent years.** All departments produce regional outlook notes, albeit with varying frequency, and disseminate them to the rest of the staff and informally to country authorities. All have issued working papers and occasional papers on regional issues, and an increasing number of regional seminars have been organized to disseminate the proceedings of this research locally.

89. **Outreach activities confirmed the large interest of country authorities for more detailed regional policy analysis.** A number of interviewed officials, particularly from the Middle East, asked for more in-depth analysis of the growing weight and changing nature of regional trade and financial links. This is consistent with the results reported in the companion paper (Section III.A), that found that the coverage of regional trade issues was not always at par with the changes brought about by regional trade agreements, and that region-specific spillover risks and transmission mechanisms were not always analyzed in sufficient depth.

90. **A number of options could be considered to enhance the articulation of regional surveillance and bilateral surveillance outputs.** Staff could assess in a more systematic manner the vulnerability of individual countries to regional shocks, building on the framework now used to assess their vulnerability to global shocks. In some cases, the timing of Article IV discussions of neighboring countries could be coordinated, as in the case of currency unions, to facilitate consideration of the regional impact of certain policies. To promote information sharing and foster further analysis along regional lines, departments could be encouraged to organize annual regional or sub-regional conferences where regional trends and inter-linkages would be discussed, and disseminate the proceeds of ongoing regional analysis to the Board . Another proposal would be to hold regular (perhaps annual) meetings on regional economic and market developments, led by the relevant area department, where key issues, including exchange rate arrangements in the region, would be discussed.

**Summary of Recommendations  
On Modalities of Regional Surveillance**

- Formalization of surveillance over the ECCU, WAEMU and CEMAC
- More systematic assessment of vulnerabilities to regional shocks
- Synchronization of Article IV consultations in neighboring countries
- Organization of regional and sub-regional conferences
- Dissemination of regional surveillance outputs to the Board

## V. USE OF STAFF RESOURCES IN SURVEILLANCE<sup>55</sup>

91. **This section examines the level and share of staff resources dedicated by the Fund to its surveillance activities.**<sup>56</sup> It looks at recent changes in the distribution of these resources across different types of activities and country groups, and attempts to assess the implications in terms of resource use of the recommendations advanced by staff in the context of this review.

### A. Use of Staff Resources in Surveillance: Recent Trends

92. **The amount of staff resources dedicated to surveillance grew markedly in FY2001-2003,** reaching 510 staff years, or 2.8 staff years per member, in FY 2003 (Table 2).<sup>57</sup> This represents an increase of 25 percent over the average of 410 staff years, or 2.2 staff years per member, registered in FY1998-2000. However, the pace of growth slowed to an annual rate of 5 percent in FY 2003, well below the rate of the two previous years. Preliminary indicators suggest a still lower rate of growth in FY 2004.

93. **The increase in the use of resources for surveillance was concentrated on two categories:** the work on the FSAP and ROSCs, and multilateral surveillance (Figure 3). Activities related to the FSAP and ROSCs accounted for 100 staff years in FY2003, or 20 percent of total surveillance work. Multilateral surveillance absorbed close to 90 staff years (17 percent of the resources dedicated to surveillance), up from 70 staff years in FY1998.

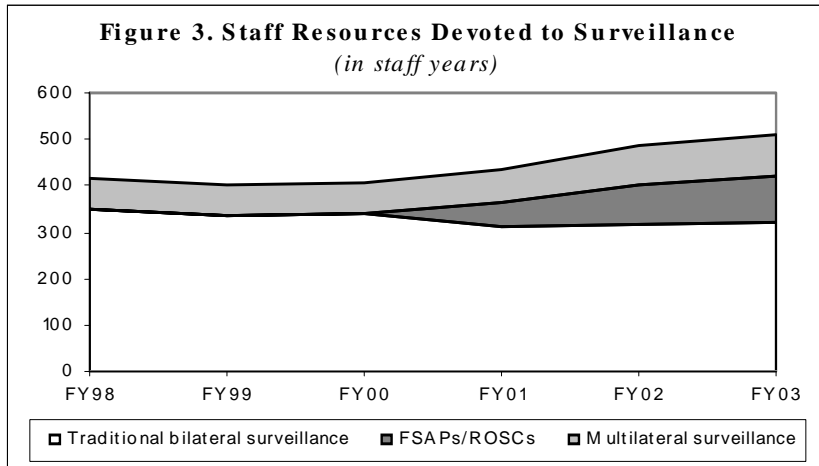
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<sup>55</sup> The main author of this section is Piyabha Kongsamut. Eddy Chi provided research assistance.

<sup>56</sup> The data was constructed on the basis of information drawn from the Fund's Budget Reporting System (BRS). Although BRS data has recognized limitations in terms of accuracy and reliability (the criteria for allocating data across activities is not always uniform), it remains the most complete source of information on staff activities. For this review, surveillance was taken to include the preparation and conduction of annual Article IV consultations and staff visits; country-specific background, review and support work; work on FSAP and ROSCs; and multilateral surveillance work. It does not include non-country-specific policy development and research, although this work may be relevant for surveillance. Overhead costs are also excluded.

<sup>57</sup> Excluding overhead. With overhead, the staff resources assigned to surveillance in FY2003 come to 638 staff years, or 24 percent of the Fund's total staff resources.





94. **In contrast, the amount of staff resources dedicated to more traditional bilateral surveillance activities has declined over that period, to around 315-320 staff years, or 1.8 staff years per member. Annual Article IV consultations (including those combined with an UFR discussion, and associated review and support work) accounted for about 70 percent of total, with 225 staff years (roughly 1.3 staff years per member).<sup>58</sup> In FY2003, the amount of resources assigned to regular bilateral surveillance activities (excluding FSAP and ROSCs) was broadly similar to that dedicated to program work (320 staff years) or technical assistance (325 staff years).**

<sup>58</sup> Excluding background research work and staff visits.

**Table 2. Personnel Resources Devoted to Surveillance and Related Activities 1/**

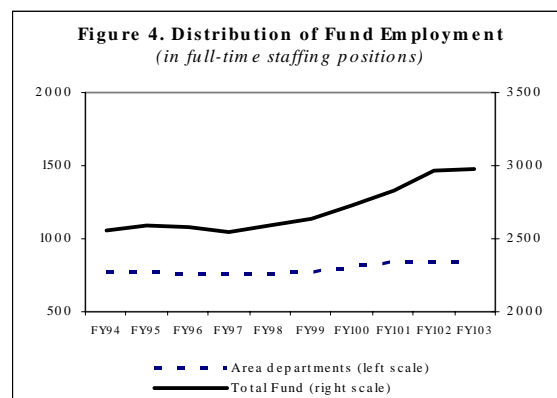
	FY1998	FY1999	FY2000	FY2001	FY2002	FY2003	FY2004 (Q1-Q3)
	(in staff years, unless otherwise indicated)						
<b>Total surveillance</b>	<b>416</b>	<b>403</b>	<b>409</b>	<b>435</b>	<b>485</b>	<b>510</b>	<b>360</b>
<i>(change, in percent)</i>		-3.1	1.3	6.6	11.5	5.1	...
<b>Bilateral surveillance 2/</b>	<b>348</b>	<b>335</b>	<b>340</b>	<b>364</b>	<b>402</b>	<b>422</b>	<b>301</b>
<i>(change, in percent)</i>		-3.9	1.4	7.1	10.7	4.8	...
Country desk surveillance work	348	335	340	314	315	322	237
Article IV consultations/combined with UFR	240	229	244	215	224	225	163
Other desk work	109	105	96	99	92	97	74
FSAPs/ROSCs	...	...	...	49	87	100	64
<b>Multilateral surveillance</b>	<b>68</b>	<b>68</b>	<b>69</b>	<b>72</b>	<b>83</b>	<b>88</b>	<b>59</b>
<i>(change, in percent)</i>		0.9	1.0	4.2	15.4	6.3	...
WEO	13	14	13	14	25	22	17
Other multilateral surveillance	25	32	33	36	39	48	31
Support work	30	23	23	22	19	18	11
<b>Memorandum items</b>							
Program and related work	256	277	297	315	338	319	241
Technical assistance	334	346	331	318	316	324	227
	(in percent of total)						
Bilateral surveillance	83.7	83.1	83.1	83.5	82.9	82.7	83.6
Article IV consultations	57.6	56.9	59.6	49.4	46.1	44.2	45.3
FSAP/ROSCs	...	...	...	11.3	17.9	19.6	17.8
Other	26.1	26.2	23.5	22.7	18.9	19.0	20.5
Multilateral surveillance	16.3	16.9	16.9	16.5	17.1	17.3	16.4
	(in staff years per country)						
Total surveillance	2.3	2.2	2.2	2.4	2.7	2.8	...
Bilateral surveillance	1.9	1.8	1.9	2.0	2.2	2.3	...
Bilateral surveillance excl. FSAP/ROSC	...	...	...	1.7	1.7	1.8	...

Sources: Departmental estimates from the Budget Reporting System (BRS), and staff estimates.

1/ The categories are aggregations of BRS staff time spent on surveillance, UFR, and technical assistance and training; they exclude BRS codes 4 to 8, i.e., time spent on administrative activities, supervision and training, and leave. They differ in a number of ways from concepts used in the Fund's administrative budget. For example, they do not include travel and other non-staff administrative expenditures nor the costs of support and service departments. Also, they do not include the time of all staff, including externally-financed staff.

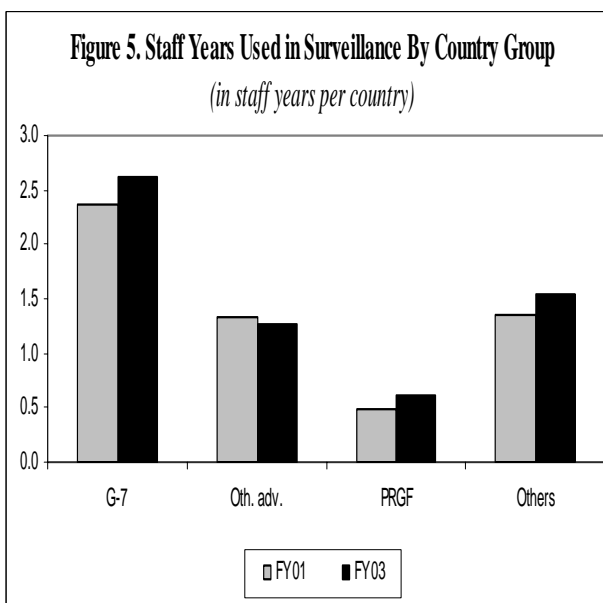
2/ Review and support work has been apportioned among the shown subcategories.

95. **The increasing share of specialized activities and technical work such as FSAPs and standard assessments and the decline in the share of more traditional country work are reflected in the smaller share of staff allocated to area departments:** it has fallen from 34 percent of full-time Fund staffing in 1994 to 30 percent in 2003. The quantity of staff assigned to area departments has remained stable since FY2001, at about 840 staff positions, at the same time as staff reports have become increasingly complex (Figure 4).



96. **In addition to the FSAP and ROSCs, a number of recent initiatives have increased demands on staff time and compete with more traditional surveillance activities.** For example, ex post assessments have involved resource needs of around 0.2 to 0.3 staff years per assessment.<sup>59</sup> Preparation of a selected issues paper containing balance sheet analysis is estimated to require between 0.25 to 0.5 staff years.<sup>60</sup> Certain new requirements, such as debt sustainability analyses (DSAs), appear to have had high start-up costs, but subsequent updates have required much less staff time. These accumulated demands have stretched surveillance resources to the point where, in the views of area departments, there is no scope left to undertake additional tasks without reducing the quality of output.

97. **Fund-wide averages mask significant differences in resource use across country groups** (Figure 5). Because of the complexity of their economies and their systemic importance, bilateral surveillance with the G-7 economies (excluding FSAPs and ROSCs) has been the most resource intensive with 2.6 staff years per country in FY2003, or double the Fund-wide average of 1.3 staff year. They also have fielded the largest missions (an average of 7 members, compared with an average of 4.7 members for surveillance missions Fund-wide). At the other extreme, surveillance over low-income (or PRGF-eligible) countries has



<sup>59</sup> Based on a survey of seven EPA team leaders.

<sup>60</sup> *Integrating the Balance Sheet Approach into Fund Operations*, available at [www.imf.org](http://www.imf.org).

used the smallest relative amount of staff resources (0.7 staff year per member).<sup>61</sup> Compared to FY2001, this pattern of resource allocation across country groups was largely unchanged.

## **B. Resource Implications of the Present Review**

98. **Staff estimates that implementing all the recommendations of this review would entail significant resource costs.** Preliminary calculations point to additional requirements of about 27-32 staff years (including overhead)—an increase of 5-6 percent in the resources now dedicated to surveillance and related activities (Table 3). After incorporating related travel costs, this amounts to about US\$10-11 million (Table 4).<sup>62</sup>

99. **The single largest need identified is for work on the financial sector.** There is now a large discrepancy in treatment between countries that have participated in the FSAP and those that have not, and more broadly between those where the country team has included staff with technical expertise and those where it did not. Ensuring a minimum level of coverage and quality across countries would require more qualified resources to be devoted toward regular financial sector surveillance; preliminary estimates by area departments suggest 8-10 staff years would be needed to meet that goal (with some uncertainties on the distribution of work between area and functional departments).

100. **Resource requirements to enhance quality and focus in other areas vary significantly:**

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<sup>61</sup> This number does not include the hours assigned to program work that provide input for the preparation of Article IV consultations.

<sup>62</sup> These estimates are provided only as tentative indications of resource costs. They are “net” resource requirements, that is, over and above resources currently devoted to these tasks. They have been developed, in consultation with OBP, on the basis of rough Fund-wide averages of work requirements and broad assumptions on the number of countries to which each recommendation would apply on an annual basis. The exception is the estimate for financial sector surveillance, which was developed by area departments on a country-by-country basis. Notwithstanding this approach, the figures are preliminary and subject to uncertainty regarding the distribution of tasks between area and functional departments and the time needed for training and to gain experience with financial sector surveillance.

**Table 3. Estimated Resource Requirements of the Proposals  
Included in This Review 1/  
(in staff years, including overhead)**

	Total
<b>Focus of analysis</b>	<b>2-3</b>
Greater selectivity in the coverage of individual consultations	2-3
Provision of information to the Board through different channels	--
<b>Quality of analysis</b>	<b>18-20</b>
Global and regional spillovers	3-4
Exchange rate analysis	2-3
Financial sector analysis 2/	8-10
Vulnerability assessments	0.3-0.7
Growth in low-income countries	1-2
Strengthened focus on other issues	1-2
Freshness of perspective	--
<b>Policy dialogue</b>	<b>1-2</b>
Closer dialogue in bilateral surveillance	1-2
Surveillance in currency unions	--
<b>Communication and signaling</b>	<b>5-6</b>
Communication	5-6
Signaling	--
<b>Assessing effectiveness</b>	<b>1-2</b>
<b>Grand total</b>	<b>27-32</b>
<b>Potential sources of savings identified in the review</b>	
Streamlined formal requirements	-0.6
More focused treatment of trade policy	-0.3

Source: Staff estimates.

1/ The estimates are subject to a significant degree of uncertainty and have been provided for illustrative purposes only.

2/ Based on preliminary estimates provided by area departments, which have been calculated on a country-by-country basis. However, the figure still contains a degree of uncertainty related to the distribution of tasks between area and functional departments, as well as time needed for training and to gain experience with the requirements of financial sector surveillance.

**Table 4. Total Estimated Resource Requirements**

<b>Staff resources</b>	
In staff years <sup>1/</sup>	27 -32
In millions of US dollars <sup>1/</sup>	5 - 6
<b>Travel costs</b>	
In millions of US dollars	5
<b>Total cost</b>	
In millions of US dollars	10 - 11
<sup>1/</sup> Including overhead.	

- Staff estimates that to increase the selectivity in the coverage of individual consultations across the membership would roughly call for an additional 2-3 staff years. These additional resources would be needed to select appropriate topics and disseminate the outcome to the Board. A greater involvement of functional departments in the process would be particularly advisable, in order to foster the sharing of cross-country experiences and ensure that individual consultations remain consistent with the Fund's strategic priorities. Even with increased selectivity, the scope for savings in this area is limited by the need for staff to continue to have a minimum degree of familiarity with all macro relevant issues to be able to assess their importance in a given country setting.
- Strengthening the analysis of global and regional spillovers would also carry significant resource costs. For example, staff estimates that the preparation and discussion of alternative scenarios to assess the vulnerability to global and regional shocks of selected emerging market and advanced economies would absorb about 3-4 staff years.
- The recommendation to improve the analysis of exchange rate issues is also resource-intensive, but the topic may not be relevant for all countries. As a proxy, staff estimated the cost of calculating and analyzing competitiveness indicators in all emerging markets and half of developing countries. This would require an additional 2-3 staff years.
- The cost of integrating the analysis of vulnerabilities and balance sheet positions would be relatively limited initially (staff estimates it at about 0.3-0.7 staff years) because data limitations restrict their application to a rather narrow group of countries in the near term.

- As a first step to improve the treatment of growth issues in low-income countries, staff could systematically analyze the potential impact of external shocks and policies to respond to them. This would be complemented by broader analytical work on the linkages between macroeconomic policies and growth, and ways to better integrate macroeconomic policy considerations in PRSPs. In all, these tasks would entail additional resource costs of about 1-2 staff years.
- Efforts to strengthen the focus on issues that are not central to the Fund's expertise, such as institutions, governance, and social issues would be limited to cases where these issues are macro relevant and would in each case require a smaller, but not insignificant, amount of additional resources.

**101. Enhancing the policy dialogue with the authorities and communication with society at large would entail significant staff and travel costs.**

- To enhance the quality of the policy dialogue, staff could be encouraged to prepare cross-country comparative studies and informal policy notes to be shared with local counterparts. Staff estimates that undertaking such activities on a regular basis across the membership would use an additional 1-2 staff years.
- The organization of joint conferences with local think tanks, the development of an active outreach program, and the dissemination within the institution of best practices in communication would also absorb a sizeable share of resources (staff estimate them at roughly 5-6 staff years).
- Although technology facilitates the maintenance of frequent contacts at relatively low cost, the surveys indicate that both the authorities and non-governmental groups value face-to-face contacts and the organization of conferences and other public events in the field. Even under rather conservative assumptions, such activities would involve sizeable travel costs (Table 5). For instance, staff estimates that undertaking an additional staff visit in 40 countries (one third of surveillance countries) would imply an increase of about US\$1.3 million in travel expenses. The organization of regular conferences at the regional and national level to inform and disseminate the results of Article IV consultations would require an estimated additional US\$3.6 million.<sup>63</sup> In all, travel expenses would increase by close to US\$5 million—a 5 percent increase in the overall travel budget of the Fund. In terms of staff resources, these activities would also carry non-negligible opportunity costs.

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<sup>63</sup> Under the assumption that each area department organizes a large, international conference every year; and a smaller country-based seminar in the context of every other Article IV consultation.

**Table 5. Estimated Additional Travel Expenses**  
(in millions of US dollars)

Staff visits	1.3
Regional conferences	0.7
National seminars	2.9
<b>Total</b>	<b>4.9</b>

102. **The review did identify a few potential sources of savings.** The streamlining of formal requirements, for example, would free time for higher-priority activities. The more focused treatment of certain issues (including, for example, trade) may also save some resources. However, as mentioned above, these savings are likely to be limited by the need to ensure that no potential source of vulnerability is overlooked.

103. **There may be other sources of potential offsets, though these are difficult to quantify and are unlikely to be large enough to meet estimated needs.** For example, the continual upgrading of the Fund's technological infrastructure could contribute to some efficiency gains. Staff finds it difficult to identify areas where other savings could be generated under current business plans, particularly after the large redeployment included in the FY2005 budget and the Fund's added responsibilities in AML/CFT. In the past, area departments have often been obliged to use surveillance work as a buffer (through, for example, reduced travel or smaller missions) in the face of unexpected program demands.

104. **Thus, while the recommendations in the report may be highly desirable to improve the quality and effectiveness of Fund surveillance, there seems to be little scope for implementing them fully without devoting additional resources to surveillance.** The Board will have the opportunity to discuss the Fund's upcoming work agenda and strategic priorities in the fall, to lay the ground for the FY2006 budget and beyond. Such a discussion would allow Directors to reflect upon the Fund's global priorities and set the scope, speed and pace of implementing the proposals from the current review. Refined resource cost estimates would be presented to the Board as background for a potential reallocation of resources across surveillance activities as well as between surveillance activities and other areas of work.<sup>64</sup>

105. **In the meantime, and within the scope for redeployment of current resources, a clear, Fund-wide priority could be given to three specific recommendations:**

<sup>64</sup> As mentioned earlier, the bulk of surveillance now falls under the responsibility of area departments. This is fully consistent with the country-based nature of Article IV consultations. However, this review suggests that an increasing part of regular surveillance work requires technical expertise that is now located in functional departments.



- *Enhancing financial sector surveillance.* Staff considers that advances in this area are both urgent and unavoidable, because this is a central responsibility of the Fund, a key channel for crises and contagion, and a field where large weaknesses have been identified for several consecutive years.
- *Sharpening the focus of consultations.* In addition to its own direct benefits, this would generate the greatest number of positive offshoots, as it would enhance the quality of both the advice and the dialogue, and its resonance for society at large. Over time, it should promote efficiency and accountability.
- *Strengthening the analysis of global and regional spillovers,* both from the perspective of the countries where the shocks originate, and that of the countries that absorb them. In addition to enhancing the effectiveness of surveillance, this would also strengthen ongoing analytical work on the design of policies to address external vulnerabilities.

106. **As for the other recommendations, priorities could be defined on the basis of the specific circumstances of a given country or region.** For example, cross-country studies and the dissemination of their findings may be useful in economies where a difficult policy debate is ongoing on certain issues. Outreach to explain the role of surveillance may be advisable in countries exiting from a long period of program engagement. More frequent informal contacts could be warranted in certain countries. In practice, staff would be expected to carefully define its priorities and explain the rationale of its choices in the staff report. Staff could also be encouraged to clearly identify situations where the scarcity of resources prevented giving appropriate attention to aspects otherwise deemed important (be it through the in-depth analysis of an issue, the conduct of an additional mission, or the dissemination of the findings of the consultation to key sectors of society); and the potential risks entailed by this situation.

### THE LEGAL BASIS FOR SURVEILLANCE UNDER ARTICLE IV<sup>65</sup>

The purpose of surveillance under Article IV is to enable the Fund (i) to oversee the international monetary system to ensure its effective operation, and (ii) to oversee members' compliance with the obligations specified under Article IV, Section 1 of the Fund's Articles.

Article IV, Section 1 requires members to "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." Moreover, Article IV, Section 1 sets out four specific obligations for members. Each member is required to:

- (i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;
- (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;
- (iii) 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; and
- (iv) follow exchange policies compatible with the undertakings of Article IV, Section 1.

With respect to these four specific obligations, several points should be noted. First, while the first two obligations (i.e., Article IV, Section 1(i) and (ii)) address a member's economic and financial policies, the latter two obligations focus specifically on the member's "exchange" and "exchange rate" policies. (Exchange policies would include not only exchange rate policies but also a member's policies on exchange controls). Second, while the obligations set forth in (i) and (ii) are "best efforts" obligations, those contained in (iii) and (iv) are "achievement" obligations and, therefore, are more demanding. Third, a member's obligations relating to its economic and financial policies do not include an obligation to conduct these policies in a manner that does not impair another member's economic and financial policies. In this respect, a distinction may be made between the economic and financial policies referred to in (i) and (ii) of Article IV, Section 1 and the exchange and exchange rate policies referred to in (iii) and (iv) of Article IV, Section 1 where a duty not to manipulate exchange rates in order to gain a competitive advantage is clearly established.

Article IV, Section 3 requires the Fund to engage in surveillance to ensure members' compliance with the above obligations. It does so at two levels. At a general level, Article

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<sup>65</sup> The main author of this appendix is Ross Leckow.

IV, Section 3(a) requires the Fund to “oversee the compliance of each member with all of the obligations specified in Article IV, Section 1.” At a more specific level, Article IV, Section 3(b) requires the Fund to exercise “firm surveillance” over the “exchange rate policies” of members (i.e., their compliance with the latter two obligations specified in Article IV, Section 1). In that context, Article IV, Section 3(b) also requires the Fund to adopt principles for the guidance of all members with respect to those policies. Article IV, Section 3(b) establishes a requirement that these principles “respect the domestic social and political policies of members”. Moreover, in applying these principles, the Fund must “pay due regard to the circumstances of members.”

As a means of implementing its “firm surveillance” obligations under Article IV, Section 3(b), the Fund adopted the Surveillance Decision in 1977. As is clear from the decision (and consistent with the above analysis), the principles and procedures set forth in the decision deal only with members’ obligations with respect to exchange rate policies. It does not directly address those obligations relating to the overall conduct of economic and financial policies, which were referred to as domestic policies (the decision “recognize[s] that there is a close relationship between domestic and international economic policies”).<sup>66</sup> Under the procedures set forth in the 1977 Surveillance Decision, an Article IV consultation would focus on the extent to which members were in compliance with the principles set forth in the Decision.

The surveillance process has evolved considerably since 1977. Drawing on its general oversight responsibilities under Article IV, Section 3(a), the Fund, in an Article IV consultation, now focuses more on an assessment of a member’s performance of its obligations under Article IV, Section 1(i) and (ii) – i.e., its economic and financial policies. While the Fund has not articulated specific principles to provide guidance to members regarding the conduct of their economic and financial policies, it has attempted to delineate the overall scope of the Fund’s surveillance. Specifically, in the 2000 Biennial Surveillance Review, it distinguished between “core” and “non-core” issues. The Board identified as the core issues of surveillance exchange rate policies and their consistency with macroeconomic policies, financial sector issues, the balance of payments and capital account flows and stocks, and related cross-country themes; these issues would be covered in all Article IV consultations.<sup>67</sup> Other “non-core issues” would only be discussed when they have a direct and sizeable influence on macroeconomic developments. The 2002 Biennial Surveillance Review built upon this approach by recognizing that surveillance is no longer limited to

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<sup>66</sup> See: Joseph Gold, *Developments in the International Monetary System, the International Monetary Fund, and International Monetary Law since 1971*, in 174 *Recueil des Cours*, 111, 218 (1982): “Subparagraphs (i) and (ii) refer to policies that are primarily domestic, and here the language is hortatory (“endeavour to direct,” “seek to promote”).”

<sup>67</sup> *Summing Up by the Acting Chairman, Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977 Surveillance Decision.*

fiscal, monetary and exchange rate policies but now includes a broader review encompassing external vulnerability assessments, external debt sustainability analyses, financial sector vulnerabilities, and structural and institutional policies that have an impact on macroeconomic conditions.<sup>68</sup>

In addition to surveillance over members' compliance with the obligations specified in Article IV, Section 1, the Fund engages in multilateral surveillance. The legal basis for multilateral surveillance is the requirement set out in Article IV, Section 3 (a) that the Fund "oversee the international monetary system in order to ensure its effective operation." The Fund's principal mechanisms for multilateral surveillance are the regular Board discussion of two staff reports – the *World Economic Outlook* and the *Global Financial Stability Report*.

Surveillance is mandatory both for the Fund and for members. The Fund is required to exercise surveillance under Article IV, Section 3 and members are required to cooperate for this purpose. Members are required to discuss with the Fund those issues that fall within the scope of surveillance under Article IV and to provide the Fund with any information which it may require for this purpose.

Beyond its oversight of a member's compliance with the obligations specified under Article IV, Section 1, the Fund, within the context of an Article IV consultation, often addresses issues that fall outside the scope of surveillance entirely.<sup>69</sup> The legal basis for such discussions is Article I(i) of the Fund's Articles under which the Fund, as one of its purposes, is "to promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems." Moreover, Article XII, Section 8 permits the Fund, at any time, "to communicate its views informally to any member on any matter arising" under the Articles.<sup>70</sup> The issues that form the basis for such discussions are important for the Fund but are not issues which fall within the scope of members' obligations under Article IV. Stated differently, while they are discussed in the context of an Article IV consultation, they are not the subject of surveillance under Article IV.

The fact that such issues fall outside the scope of surveillance under Article IV has important legal consequences. Specifically, their inclusion in an Article IV consultation is purely voluntary – both for the member and the Fund. The Fund is not required to raise these issues,

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<sup>68</sup> *Summing Up by the Chairman, Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision.*

<sup>69</sup> For example, the Fund uses the occasion of an Article IV consultation to consult with members with respect to the retention of exchange restrictions under Articles VIII and XIV; these Article VIII and XIV consultations are "comprehended" by an Article IV consultation but they do not form part of the Article IV consultation. They are legally different and serve different purposes.

<sup>70</sup> *The Role of the Fund in Governance Issues – Guidance Note – Statement by the General Counsel.*

and members are not required under the Articles to discuss them with the Fund. Moreover, members are not required to provide the Fund with information related to these issues for the purposes of Article IV.

Activities of the Fund that fall outside of Article IV may still inform an Article IV consultation. For example, a Financial System Stability Assessment under the FSAP program is a technical service provided by the Fund to a member at its request under Article V, Section 2(b). However, the information obtained through the FSAP can be used for the purposes of informing discussions under an Article IV consultation.<sup>71</sup> Similarly, information obtained and discussions held in the context of Fund financial assistance in support of a member's program of economic reform may provide important background for the Fund's consultation discussions with the member.

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<sup>71</sup> Many of the issues that are discussed in a Financial System Stability Assessment do fall within the scope of surveillance under Article IV; in the absence of a Financial System Stability Assessment for a member, the issues that are normally discussed in such an assessment could be discussed by the Fund as part of surveillance.

## **SURVEYS AND INTERVIEWS OF OUTSIDE PARTICIPANTS ON THE EFFECTIVENESS OF FUND SURVEILLANCE**

**This appendix presents the findings of the different outreach activities conducted with outside participants for this review.**<sup>72</sup> Surveys and interviews of country authorities, market participants, think tanks, and media provided valuable inputs for staff's assessment of the effectiveness of surveillance and related activities. This appendix summarizes information collected without seeking to assess, clarify, interpret, or recast it in light of Fund staff's understanding of the purposes of surveillance. Interviews were conducted on a confidential basis, and, hence, no country or personal names are mentioned.

### **A. Interviews of Country Authorities by an External Consultant**

**Interviews were conducted with senior officials from 29 countries.**<sup>73</sup> According to WEO classification, 12 countries belong to the group of advanced economies, and 17 to the group of emerging market and developing countries. Three had programs supported by Fund arrangements at the time of the survey. Ten countries were from Europe, seven from East Asia and the Pacific, five from the Middle East and Central Asia, four from the Western Hemisphere, and three from Africa. Three quarters of the countries in the sample have consented to publication of Article IV staff reports.

**Interviews were based on two standard questionnaires.** A brief questionnaire was distributed to interviewees before the meetings, and a more detailed one was used by the interviewer to guide discussions. Both included open-ended questions on the main issues raised in recent Board discussions on the effectiveness of Fund surveillance: its usefulness, the quality of the policy dialogue, the impact of transparency and other changes in the modalities of surveillance, and ways to assess the effectiveness of Fund surveillance.

#### **Usefulness of Fund surveillance**

**Most of those interviewed found Fund surveillance to be a useful forum for the exchange of views on the economy.** Those from advanced countries compared surveillance to a regular check-up of their economic and financial health. In emerging market and developing countries, surveillance was viewed as providing assurances to markets that the

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<sup>72</sup> As is the case in the main report, the term "surveillance" is used in this Appendix to refer to surveillance and surveillance-related activities.

<sup>73</sup> Sixteen countries were surveyed through interviews with senior officials from the ministries of finance and central banks, and 13 others through interviews with Executive Directors at the Fund. Interviews were conducted during April–May 2004 by an external consultant, Dr. Pisit Leeahtam, a former Deputy Finance Minister for Thailand, and a former senior staff of the Bank of Thailand. No staff were present during the interviews.

government's economic management was sound. Surveillance also helped governments advance the policy debate and explain the rationale for reforms to the general public.

**Interviewed officials from emerging market and developing countries saw a number of benefits in surveillance.** They found that Fund assessments helped them gain domestic and international policy support and encouraged capital inflows. Some emerging market countries observed that Fund staff appraisals were an important input for investment and rating decisions. An official for a low-income country considered Fund endorsement of their policies a pre-requisite for access to other sources of official funding. Maintaining a frank and open dialogue with Fund missions was seen as important to ensure a satisfactory appraisal. Fund missions were considered helpful in providing additional information, technical know-how, and, especially in program countries, an impetus for policy actions. Missions also helped identify technical assistance needs.

**In advanced countries, the Fund was seen as providing an independent policy assessment which, over time, could help overcome political resistance to reforms.** The demand for Fund advice was lower than in emerging market and developing countries, because of the large number of alternative sources of analysis. Surveillance did not always bring additional information and staff's analytical contributions were considered at times repetitive. Nonetheless, by adding its voice to those of others, the Fund had helped increase public awareness of policy options in key structural areas such as pension and labor market reforms. Several countries also acknowledged the contributions that Fund staff made to budget formulation, especially when the timing of missions was aligned with national calendars. For example, the authorities from one country thought that staff's persistent advocacy of fiscal consolidation had helped build support for fiscal strengthening. Staff inputs to the discussion of the budget deficit ceiling in the EU were also appreciated. The authorities also benefited from other countries' experiences and best practices that staff brought to their attention. Many countries used the WEO forecasts in their own forecasting exercises and were aware that these forecasts were based on inputs from bilateral surveillance.

**The Financial Sector Assessment Program (FSAP) was highly valued.**<sup>74</sup> The opportunity to share experiences in financial policies was seen as unique to the Fund. The authorities from one country indicated that they initiated major legislative reforms as a follow up to the FSAP. In another country, although the initial reaction to FSAP participation had been negative, the authorities found that the exercise helped strengthen their internal assessment capacity and dispel market misperceptions.

**Most country authorities appreciated the use of examples of international good practices.** For example, one FSAP mission was credited for bringing to the attention of the authorities a successful experience with the restructuring of state banks in a country with

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<sup>74</sup> The FSAP is not part of surveillance obligations. Participation in the program is voluntary.

comparable background and a similar level of financial development. Staff was encouraged to disseminate positive experiences of structural reforms, particularly in health care and inflation targeting.

**Many interviewed officials credited the Fund for helping mobilize support for reforms within the government, the legislative branch, and the general public.** Staff occasionally helped bridge differences between the treasury and the central bank on sensitive policy issues. In some cases, staff analysis and outreach efforts, including through resident representative offices, helped raise the profile of specific policy issues and broadened the domestic consensus for reforms. In advanced countries, surveillance was credited for having at times encouraged important policy debates within the government. The dialogue with the Fund was considered useful even in cases where the authorities disagreed with staff. The authorities had to prepare extensively for discussions with staff, and these in-depth policy analyses left them better equipped to face contingencies.

**While considering the government to be the primary audience for Fund advice, a large number of interviewed officials supported Fund outreach to other groups in society.** The effectiveness of such outreach was by no means guaranteed: in one country, staff helped convince parliamentarians about the merits of reforms, but a similar attempt failed in another country. Some authorities cautioned that staff should be careful not to be drawn into internal political debates as this might jeopardize the credibility of the Fund.

**Systemically important countries recommended a greater focus on how their policies affect other economies and the world as a whole.** They found that this type of analysis made better use of Fund staff than the traditional country-bound perspective. A stronger focus on the identification of external risks was also advisable. Some authorities suggested unifying, or at least coordinating Article IV missions with those on the WEO and capital markets. Some recommended that Fund management participate more frequently in high-level policy discussions.

**Some authorities favored a more selective focus on issues pertinent to a given country.** They thought that the emphasis on equal treatment tends to undermine the effectiveness of surveillance, particularly given the expanded scope of Fund work. They recommended more selectivity in choosing topics for discussions and setting priorities for each individual consultation, rather than filling in an extensive check-list. Some countries thought that the strict adherence to the 12-month cycle could be relaxed in some cases, including smaller European countries where there were no major outstanding policy issues. Missions could be limited to times when staff had a specific message to deliver. The recent practice of synchronizing Article IV consultations for individual EU countries was viewed favorably.



## Quality of policy dialogue and advice

**While appreciating the quality of the Fund’s advice, many interviewed officials from emerging market and developing countries underscored that it would be more effective if it were conducted in a more collaborative manner.** One country compared the Fund to an auditor looking for errors rather than a constructive partner. Staff were blamed by a few authorities for adopting a preaching attitude without giving due consideration to local insights. For example, the authorities from one country could not agree with the Fund’s advice to break up a major state-owned bank and open up the banking system to foreign entry, because they saw the advice as favoring special interests. When this concern had not been acknowledged, policy discussions became frustrating and unproductive. Several interviewed officials thought that other international institutions left more space for national policy choices through retreats to define a joint strategy with the authorities without predetermined positions designed at headquarters, and peer-based approaches to policy assessments.

**Many of the officials surveyed thought that the quality of the policy dialogue had improved over the past few years.** Overall, staff had become more flexible and understanding. There was also a perception that the authorities were assuming greater initiative in shaping the policy agenda, although the Fund remained accountable for the quality of its own advice.

**Still, many interviewed authorities saw scope for a better calibration of Fund advice to the specific circumstances of individual countries.** In one case, the authorities praised staff for understanding the policy implications of the special administrative arrangements between the federal and state governments. But there were also cases where staff was criticized for failing to appreciate a country’s unique conditions. For example, the authorities from one country thought that Fund missions failed to appreciate fully the influence of workers’ remittances on the foreign exchange and asset markets. Some authorities, particularly those from low-income countries, felt that the Fund’s approach did not adequately take into account their developmental and growth needs. They perceived some of staff’s policy recommendations in the structural and institutional policy areas as unduly costly for their countries. Other authorities complained that Fund missions tried to micro-manage their banking systems instead of focusing solely on the systemic issues relating to the largest financial institutions.

**Many thought that staff advice would be more effective, if local political constraints were factored into the analysis.** Policy recommendations would be more convincing, if they relied more on second-best solutions that take into account country-specific limitations, rather than focusing on first-best reforms, as is too often the Fund’s practice. An example was given of a drastic reduction in bread price subsidies that led to protests and riots, delaying the adjustment process and prompting a stop-gap policy response that the authorities called a “second-worse” outcome. In another country, the approach had been more pragmatic and oil price increases had been accompanied by measures to mitigate the

negative impact on the most vulnerable groups. Some authorities thought that in cases of political stalemate, staff should help convince the public of the necessity of reforms, albeit in consultation with the government.

**A recent initiative to discuss the authorities' responses to previous Fund advice in staff reports was well-received.** It was seen as a way to focus attention on the effectiveness of surveillance and to increase the accountability of staff for previous policy advice. Staff reports should clearly explain the reasons why the authorities did or did not follow up on this advice, and the consequences, if any. This would encourage both staff and the authorities to take more careful public positions. It should enhance the role of the Fund as a learning and knowledge-based institution.

**Officials from the few program countries included in the sample saw surveillance in their countries as secondary to program activities.**<sup>75</sup> Article IV consultations were mixed together with program discussions. However, there was little support for having separate surveillance missions in addition to program missions, because of resource constraints and the possibility of confusion, if the two missions were to disagree. One official suggested that one or more program mission members be specifically assigned to take charge of surveillance issues during program missions. In countries with longer term program engagement, the effectiveness of both surveillance and program activities should be thoroughly evaluated.

**Frequent staff rotation was seen as eroding the effectiveness of Fund surveillance.** A large number of authorities complained quite bitterly about constant changes within country teams, which required them to train new staff, particularly fresh university graduates, in the specifics of Fund-required datasets. Transitions would be easier, if before taking up a new assignment, incoming staff accompanied outgoing staff on a mission.

### **Transparency and candor**

**The publication of country documents was generally seen by those interviewed for this survey as a positive development, provided that market sensitive information was excluded.** In emerging market and developing countries, transparency has helped in generating public and market support for a government's policy agenda. Concerns about the impact of publication on the candor of dialogue were not prominent.

**However, some of the emerging market and developing countries in the sample still do not publish Fund assessments, mainly for political reasons.** A view was held that when domestic political conditions are volatile, publishing a staff report could provoke a political backlash. In some cases, the economic and financial situation might be too fragile to

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<sup>75</sup> In all of these cases, the most recent Article IV consultation was combined with a program request or review.

withstand a sharp market reaction following the release of information on a country's vulnerabilities.

**Staff reports have to be objective and technically accurate to elicit trust.** They need to reflect the authorities' and staff's views objectively and in full. The Fund should not behave as a "cheer-leader," as one official put it; nor should it try to negotiate staff reports with the authorities, as some other institutions do.

**Despite the broadly positive views on publication, many of those interviewed thought that staff reports and PINs could be more effective at disseminating the Fund's policy message to the broader public.** Staff reports and PINs are published several months after the Article IV mission. Their technical and coded language makes them difficult to understand for non-economists. Mission concluding statements, in contrast, were seen as helping raise the profile of surveillance. In many cases, they are available immediately after the mission ends, and are sometimes accompanied by a press conference. It is important that they are translated into the local language quickly, to avoid any misunderstandings, as happened in a recent case. For this, the statement should be drafted in a clear and straightforward manner. Some authorities thought that the staff's press conference would be more objective if the national authorities did not participate in it.

#### **Assessing effectiveness of Fund surveillance**

**Overall, the authorities surveyed had positive views on the effectiveness of surveillance, but the degree of satisfaction varied across countries.** Most countries appreciated the various contributions the Fund makes through surveillance and related activities and emphasized the high quality of Fund work. They valued staff professionalism and their strong academic background. They emphasized, however, that staff advice tends to rely primarily on mainstream economic theories that need to be supplemented with greater practical knowledge.

**Most of those interviewed found it difficult to define what effectiveness means in surveillance, and even more to measure it.** The final impact of surveillance depends on a variety of factors, many of which are outside the Fund's control. It is easy for the authorities to claim credit for success, while placing the blame on the Fund for failures. Every erupting crisis will cast doubt on the effectiveness of Fund surveillance. The Fund will be held responsible and criticized for not having predicted or prevented the crisis.

**The incidence of crises per se was not considered as a good indicator of effectiveness.** The onset of a crisis does not necessarily mean that surveillance has been ineffective. By the same token, financial stability should not lead to the opposite conclusion. A key issue was seen to be whether Fund surveillance had raised awareness of risks and vulnerabilities and helped the authorities prepare contingency plans and take actions before problems loom large. Some officials thought that if the Fund had made a visible contribution to the internal policy debate in most countries, this was an indication of the effectiveness of Fund surveillance in its own right.

**Many authorities thought that surveillance was overburdened**, and flagged this as a factor limiting its effectiveness. Some compared the agenda for Article IV consultations to a Christmas tree, where new tasks are constantly added. The excessive demands placed on surveillance put a strain on the limited resources of the authorities and staff. Some authorities suggested greater reliance on other institutions, especially the World Bank, for matters outside the Fund's primary areas of competency.

### **B. Survey of Market Participants**

**Staff organized informal workshops with representatives of major financial institutions and rating agencies** to gather their views on the effectiveness of surveillance. Workshops were held in April 2004 in London, New York, and Tokyo.<sup>76</sup>

**Surveillance documents were found to have become more useful in recent years and their content more consistent across countries.** Their relevance was deemed higher in areas requiring "subjective" judgments, e.g., on the quality of regulations and institutions. Participants thought that staff reports were a useful source of country-specific information, and selected issues papers, of methodological ideas. They consulted multilateral surveillance documents for information on global trends.

**Participants expressed most appreciation for the data provided by the Fund.** They credited the Fund for its contribution to the increased availability of higher-quality, more timely, and standardized data for many countries. Participants considered transparency a positive, but not crucial, element behind investment decisions: publication was thought to provide an "additional comfort," and some thought it might gain in importance, when liquidity conditions tighten. Tokyo participants noted that the relatively weak publication record in the region limited the impact of Fund surveillance.

**By contrast, most participants found relatively little value-added in the staff's and the Board's policy advice.** They preferred to draw their own policy conclusions on the basis of the data provided. In their view, the Fund's ability to address the issues of main concern was severely constrained by political considerations and the degree of its own financial involvement. Participants found the drafting of Fund documents too nuanced and careful to allow them to draw clear conclusions. They also found it difficult to differentiate surveillance documents in program countries from program documents. Projections in staff reports and in the WEO were perceived to be systematically on the optimistic side.

**Participants found it difficult to attribute a specific and measurable impact to surveillance.** Some observed that the Fund sometimes plays a useful role in enhancing the quality of the public debate on policy issues, citing as examples the discussion of inflation targeting in Central and Eastern Europe, and the management of floating exchange rates. The

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<sup>76</sup> The issue was also discussed at the eighth meeting of the Capital Markets Consultative Group, held in Paris on April 7, 2004.

Fund often provides technical background to frame the discussion of policy choices, and helps raise investors' awareness of certain developments and issues.

**The relevance of surveillance outputs was found to vary greatly across countries.** The Fund was seen as a unique source of information on international reserves, balance of payments, and the fiscal position for countries with less developed or less reliable national data sources, and for global aggregate flows. The Fund has less of a comparative advantage in providing data on G7 countries, where many competing data sources exist. Fund analyses were perceived to be more relevant in smaller countries, where it is expensive for financial institutions to gather information and undertake research on their own, and there are few alternative sources of information. Although in most G7 countries, the Fund's policy message was well-relayed by the press, it was often not seen as distinctly different from that of other regional and international organizations.

**Opinions differed on how the impact of surveillance could be increased.** Some participants expressed a preference for more in-depth studies on topical issues, while others favored more comprehensive overviews of risks and vulnerabilities. The former, focused approach was preferred in cases where alternative sources of country analysis were widely available, or where market participants had a strong internal capacity to assess risks. Participants called for efforts to reduce publication lags and increase the frequency of data, especially for countries where there was a need for continuous monitoring. There were also demands for the Fund to provide clearer assessments of data quality and reliability. Although the availability of external debt data has improved markedly in recent years, in part owing to inter-agency collaboration, participants saw scope for improving the availability and comparability of domestic debt data.

**Participants felt that there was a need for the Fund to strengthen its communication strategy.** They found that interaction with the markets had much improved in recent years, but still thought that the current approach was not always consistent across countries and types of information. The Fund must strike a better balance between providing useful insights about risks and inside information that may cause excessive market volatility. Participants saw benefits in adopting a professional communication strategy to clarify expectations about what the Fund can and cannot communicate. It is important also to make staff more aware of the potential impact of their statements on the markets, while trying to avoid a reduction in the flow of information that might result from increased accountability and visibility. They also noted that Fund staff generally remains uncomfortable with public exposure and should be trained to deliver broad messages more clearly and effectively.

**Participants valued highly face-to-face contacts with Fund staff.** They appreciated the flexibility they had in setting the agenda for discussion in the context of these meetings, and a certain feeling of exclusivity of access. The messages conveyed orally by missions and resident representatives appeared more critical to them than Fund documents. Some participants saw scope to improve interaction with headquarters staff and GFSR missions, noting that at present meetings with the latter had little benefit for the market participants.

**The Fund needs to disseminate better rather than more.** Participants advised the Fund to differentiate its policy message better. In their view, the Fund’s website suffers from information overload, with excessive space given to what they perceived as “non-relevant” documents, such as statements at the Annual Meetings. Participants stressed the benefits of maintaining or enhancing the Fund’s local presence, including in smaller, non-program countries.

### **C. Survey of Non-Market Participants**

**Staff held informal workshops with selected representatives of academia, think tanks, and research agencies in Paris and Tokyo in April 2004.**<sup>77</sup> Many participants in the Tokyo meeting were or had been government officials so that their opinions were based in part on their direct interaction with Fund missions. Participants generally appreciated the present outreach exercise, which they saw as a welcome opportunity to give feedback. They hoped that the practice would be extended to the discussion of other Fund policies.

**Participants generally thought that the most valuable service provided by the Fund was the provision of cross-country data.** Fund data was most useful as a base for comparative analyses and long time series. In recent years, the Fund helped improve national data sources. The importance of the Fund as a data provider differed across countries. For OECD countries, the Fund was one source of information among many, with the OECD being the primary source. The Fund was more useful as a data source for other economies; in some cases it was the only source of reliable information.

**Participants consulted Article IV reports only occasionally.** They found that their content varied across countries, making it difficult to know what to look for in them. Some participants, especially those not associated with governments, showed little familiarity with PINs, FSSAs, and ROSCs, and more generally with the role of the Board in surveillance. One participant remarked, however, that because of the international policy debate at the Board, its assessment tended to be more balanced than the staff’s.

**The quality of surveillance outputs was found to have improved in recent years.** Those familiar with staff reports regarded them as more focused on key issues. The Fund’s efforts to sharpen its assessment of economic vulnerabilities were welcome, but the warning signals issued by the Fund in the face of emerging risks were often deemed weak and unclear.

**According to workshop participants, the analytical quality of Fund documents still suffered from certain biases and weaknesses:**

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<sup>77</sup> A discussion on the effectiveness of surveillance also took place during a high-level seminar on the political economy issues facing the Andean region, held at the Fund’s Headquarters on April 27, 2004.

- **Fund policy advice often relied too heavily on academic research** without taking sufficiently into account the complexities of a real economy. Staff should be more pragmatic and draw more on empirical research and practical experience.
- **Fund advice had sometimes been dogmatic and ideological**, pushing “market fundamentalism.” It did not draw lessons from regional experiences, nor did it take into account institutional weaknesses. Staff should aim to strike a better balance between the need for cross-country consistency and due flexibility in the face of diverse country circumstances. For instance, inflation targeting might not be the appropriate regime for countries with low monetization or widespread currency substitution.
- **Fund advice often failed to take into account political constraints** or was too optimistic about the ability of the government to overcome them. In many cases, Fund staff only paid attention to “first-best” policies without considering alternatives that might be more acceptable politically. Staff should aim to provide the best advice within the domain of feasibility.
- **Staff should assess the quality of its past policy advice more systematically.** Some participants questioned the soundness of some past policy recommendations, particularly during the Asian crisis. In their view, a regular analysis of the economic impact of Fund advice in countries that implemented it would help enhance the quality and effectiveness of surveillance.
- **Fund analyses had often not recognized the importance of global and regional linkages.** They seemed to rely on closed economy models that do not help identify contagion channels and risks. Forecasts suffered, in the views of some participants, from excessive optimism and were often too closely aligned with the views of the authorities. This bias was seen as particularly pronounced in the growth projections for program cases.
- **Fund advice was seen as being excessively influenced by its major shareholders.** To the extent that advice did not take into account concerns of other members, its credibility would be dented (a view held especially in Asia).
- **Views on multilateral surveillance were mixed.** Participants acknowledged that the Fund now provided more background data and more frequent updates on the global economy, but some found a consistent upward bias in its global forecasts. Fund studies on global market trends have not always highlighted risks appropriately, and the impact of global developments has rarely been integrated in the analysis of individual countries.
- **The “coded” language of Fund documents was striking.** Staff reports were so subtly nuanced that the degree of staff concern became unclear, running the risk that politicians, in particular, would not receive the correct message.

**Participants identified several channels through which surveillance affects countries.**

First and foremost, the Fund has helped improve data and, through this, enhanced policymaking. Fund assessments also have fed into the internal policy debates, strengthening technical arguments over short-term political considerations. Participants from Asia underscored that, since it takes time for the internal consensus to build up, including an explicit assessment of the effectiveness of past policy recommendations in staff reports may be counterproductive. The Fund also might bring a new perspective into the economic policy debate, or strengthen the debate around some issues, particularly in emerging market countries. Most participants thought that the Fund's direct impact on policy decisions was rare in surveillance cases, as a country's willingness to implement outside policy advice is closely linked to its degree of economic distress.

**To increase the impact of surveillance, participants made a number of suggestions:**

- **Country data** could be better standardized, and there should be an assessment of their quality (for example, margins of error). The Fund could provide such an assessment itself, or encourage countries to do so. It should be also clarified that so-called forecasts were only reasonable assumptions, given data imperfections.
- Staff should take a more proactive position in **national policy debates**. As an example, in one country, where capital controls and a stabilization fund were hot domestic issues, staff failed to present its position in a clear and timely manner, missing, in the view of a participant, the opportunity to influence the debate. Some participants believed that a more active local presence of the Fund was essential to increase the impact of surveillance.
- The Fund should engage more in **capacity building**. It helps countries establish monitoring and supervisory systems, but these are not always well-understood by local staff. More training of mid-level staff in local languages is needed.

**Those participants who had previously been in government positions offered the following recommendations:**

- They saw scope to further enhance the **policy dialogue** and increase the persuasiveness of Fund recommendations. While maintaining the frankness and directness expected of the institution, staff should seek to establish a relationship of mutual trust with the authorities. Staff should be trained to deal constructively and patiently with the inevitable tensions arising in policy discussions. Staff should not dismiss the authorities' intentions and concerns, pushing aggressively for rapid policy changes. Continuous dialogue, outside regular consultations, should be encouraged.
- The policy message should be delivered to **high-level decision makers** who could otherwise be unaware of the Fund's advice. This may require the participation of Management or senior staff in the concluding meetings. Management should also increase its degree of engagement with local authorities.



**Participants noted that the audience for Fund documents has remained relatively narrow.** After the Asian and Russian crises, a larger public has gained access to the arguments presented by the Fund in the debate and the possibility to undertake cross-country comparisons. However, Fund documents were still not well-known among policymakers, researchers, and the press. Their format and language made them difficult to understand. They could be easily misinterpreted, particularly by the local press.

**Efforts to increase transparency should be constructive and subsidiary to the provision of frank, open, and practical policy advice.** In Asia, there was a general concern that the broader involvement of the Fund with the markets and the public in general may undermine the candor of its dialogue with the authorities. Several participants underscored that although the Fund should not understate its concerns to the authorities, there might be valid reasons to maintain a guarded tone in communications with markets and the outside world.

**Most participants favored better tailoring the application of the transparency policy to country circumstances.** Some believed that staff missions were going overboard in their efforts to reach out to non-governmental groups. Participants from Asia thought that the Fund should not short-circuit the domestic political process, and that the degree of divulgence of received policy advice should be left for the authorities to decide on. Forcing dissemination of the Fund policy message in a country that was not ready for it could undermine the candor of discussions.

#### **D. Survey of Media**

**Staff interviewed a few prominent journalists from different regions in April—May 2004,** all reporting frequently on Fund activities.

**The journalists interviewed believed that Fund documents provided valuable information, although their use varies across countries.** In advanced economies, Fund documents are used as background information for the treatment of country events but are rarely treated as “news.” The British press has tended to report Fund assessments more frequently than the U.S. press, although coverage in the U.S. has increased over the last year. In emerging market and developing countries, the Fund has a higher profile and the media closely watches the results of Article IV consultations.

**On transparency, the journalists interviewed generally trusted staff reports and did not detect any obvious signs of deception or a lack of candor.** They observed that a multilateral institution such as the Fund is expected to transmit negotiated messages. They noted that publication will always be a challenge in some regions, particularly Asia, given a political culture discouraging public criticism of senior officials. They appreciated the Fund’s efforts to disseminate the findings of surveillance exercises and to reach out to the press, and remarked positively on the ease of access to information through the website.

**To improve the effectiveness of surveillance, the journalists recommended hiring more local staff and conducting consultations in a more cooperative manner.** More regional seminars and briefings would also be useful to improve the dissemination of Fund views.

### Modalities and Effectiveness of Surveillance: Results of Staff Survey and Review of Staff Reports

This appendix summarizes the results of different activities undertaken to gather staff’s views on recent changes on the modalities of surveillance and their relative effectiveness.

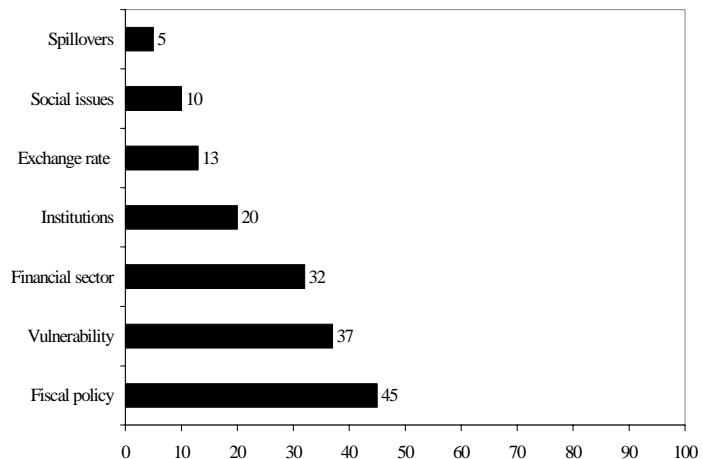
#### A. Survey of Mission Chiefs

**Staff conducted a web-based survey of mission chiefs in April 2004.** It was aimed at staff who had led Article IV missions between January 2003 and March 2004 and focused on questions about the modalities of consultations and their effectiveness. The response rate was 43 percent, or 60 Article IV consultations, covering a diverse set of countries. The majority of responses (60 percent) were for countries with access to international capital markets: 25 percent referred to advanced countries, 20 percent to transition economies, and the rest to developing countries.<sup>78</sup> About 78 percent of consultations were on a stand-alone basis (about half of these were for program countries); 78 percent of reports were published.<sup>79</sup>

**Innovations in content and modalities.** Most mission chiefs (80 percent) had tried to change the analytical coverage of consultations: by placing more emphasis on the medium-term fiscal policy analysis, vulnerabilities, financial sector and institutional issues (Figure 1).

Extending the coverage of exchange rate, social and distributional issues, and global and regional spillovers was less common. Changes to the format and procedures of Article IV discussions were less widespread than changes in the analytical coverage (only 52 percent of mission chiefs reported that they have introduced such changes). Increased outreach to civil society and staff presentations were a most frequent change (introduced by 60 percent of those who reported innovations in this area).

Figure 1. Changes in Analytical Coverage  
(in percent of Article IV consultations)



<sup>78</sup> Advanced and transition economies were overrepresented and developing countries underrepresented in the sample, compared to Fund membership.

<sup>79</sup> By department, 33 percent of responses came from EUR, 25 percent from AFR, 20 percent from MCD, 10 percent from APD and WHD. The response rate was the highest (63 percent) for AFR and MCD, 56 percent for EUR, and 22–24 percent for APD and WHD.

**Pre-brief meetings** were organized in most cases (76 percent), but only in half of the cases were they attended by staff from PDR or other functional departments. Almost all mission chiefs found pre-brief meetings useful, with most thinking that their primary role was to help define the content and coverage of the consultation (80 percent) and draw on different perspectives (67 percent). Only in 20 percent of cases did the meetings help introduce a broader or cross-country perspective.

**Cross-country analysis** was used in most consultations (63 percent). Mission chiefs learned about cross-country policy experiences through informal conversations with other mission chiefs (73 percent); their own previous country experiences, and staff reports for other countries (63 percent each); division chiefs' meetings, interdepartmental notes, and Board papers (52 percent each).

**Dialogue with the authorities.** About 56 percent of mission chiefs characterized the dialogue as fluid, open, and frank; 35 percent as mostly open, except for a few issues; and 9 percent felt that the dialogue was constrained (Figure 2). The degree of openness and candor of the policy dialogue did not depend systematically on whether the staff report was published or not. Contacts with the authorities were not limited to Article IV missions and included discussions during the Spring or Annual meetings (72 percent of cases), staff visits (63 percent), and written communication (40 percent).

Figure 2. Policy Dialogue  
(in percent of Article IV consultations)

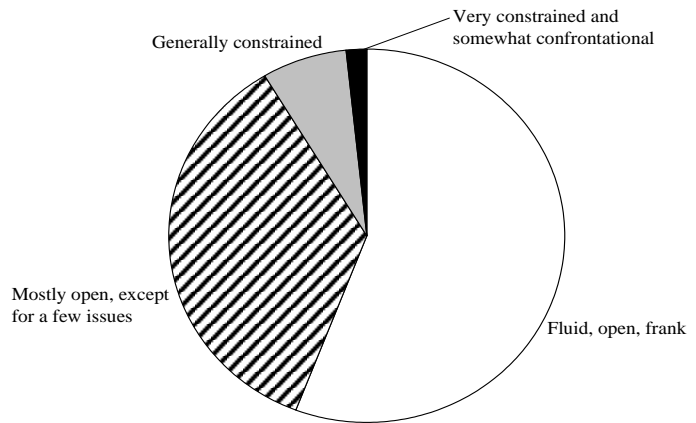
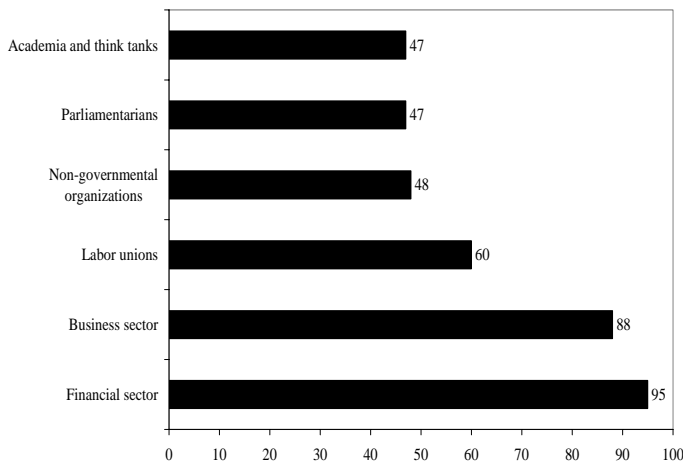


Figure 3. Outreach by Article IV Missions  
(in percent of Article IV consultations)



**Outreach.** Meetings of missions with the private sector have become standard, and those with parliamentarians, labor unions, NGOs, and academia were also quite common (45–60 percent) (Figure 3). Two thirds of respondents considered these meetings moderately useful (another third found them valuable). Other forms of outreach were less widespread: 40 percent of consultations included a seminar, 35 percent a press conference (often held together with the authorities), and less than 10 percent regular interviews with the press.

**Effectiveness of surveillance.** Most respondents (77 percent) believed that the main benefit of Article IV consultations was bringing a new, different perspective to the authorities’ policy discussions (Figure 4). More than half observed that surveillance influences policy actions, and 45 percent believed it disseminates methodological knowledge. Ten percent felt

Figure 4. Usefulness of Surveillance  
(in percent of Article IV consultations)

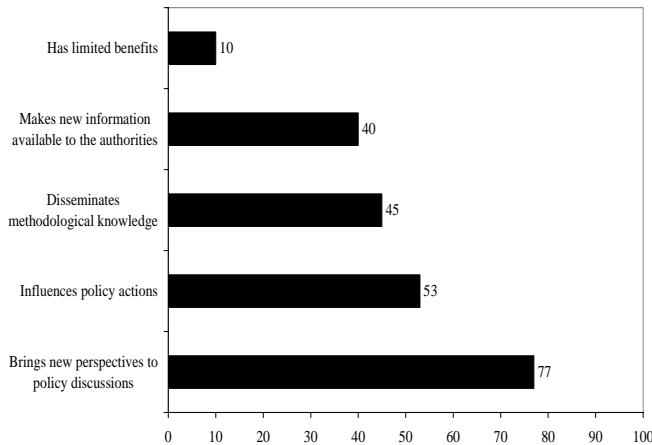
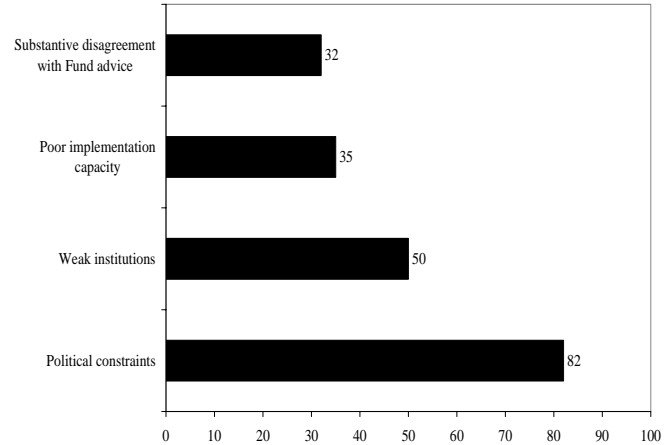


Figure 5. Constraints on Implementation of Fund Advice  
(in percent of Article IV consultations)



that surveillance has only limited benefits. In the views of respondents, the authorities' ability to implement Fund advice was constrained mainly by political factors (82 percent of cases), weak institutions (50 percent), poor implementation capacity (35 percent), and substantive disagreements with staff (32 percent) (Figure 5).

### B. Review of Staff Reports and Executive Directors’ BUFFs

**The analysis of surveillance modalities drew in part on the review of staff reports and Executive Directors’ BUFFs for 140 Article IV consultations completed during January 1, 2003—March 4, 2004.**<sup>80</sup> The detailed questionnaire prepared for this review included questions on the reporting of the authorities’ views, the nature of the dialogue between staff and the authorities, outreach to non-governmental actors, the reporting on the effectiveness of past surveillance, and the use of cross-country analysis.

#### Policy dialogue

**Most staff reports seemed to reflect a good-quality policy dialogue.** While staff reports generally refrained from characterizing the policy dialogue explicitly, they conveyed an impression that staff’s advice and the authorities’ response were candid and open in 89 percent and 79 percent of consultations, respectively. Candor and openness of the policy

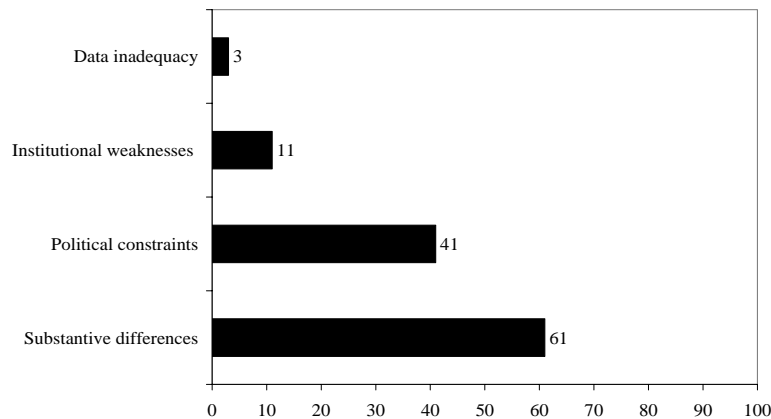
<sup>80</sup> For more details on the sample and methodology, see Section II of the paper on the Contents of Surveillance.

dialogue during an Article IV consultation did not appear to be statistically correlated to whether staff report would be published or not.<sup>81</sup>

**The review of Executive Directors’ BUFFs yielded similar conclusions:** more than a half of them described the dialogue as candid and open. These references also were not correlated with the publication status of the respective staff reports.

**In about one half of the reports, the authorities disagreed with staff on major policy issues.** Such disagreements arose mostly on fiscal (84 percent) and monetary and exchange rate policy issues (about 40 percent), followed by the financial sector and labor market policies (about 10 percent each) (Figure 6). In about two thirds of cases differences between the authorities and staff were substantive, concerning the appropriateness, timing, or sequencing of the proposed measures. In 41 percent of cases they reflected political constraints on policy implementation, and in 11 percent of cases institutional weaknesses. In about two thirds of cases where disagreements arose, it appeared that some of staff’s arguments convinced the authorities, and in 37 percent of cases, vice versa.

Figure 6. Reasons for Disagreements between Authorities and Staff  
(in percent of Article IV consultations where disagreements arose)

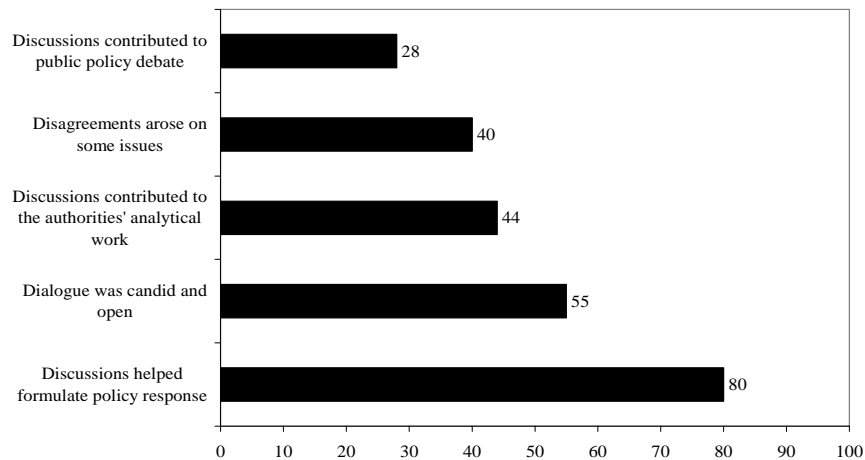


**Reporting of the authorities’ views was not uniform across staff reports.** In more than a half of the reports, the authorities’ views on major policy issues were presented in a balanced and clear manner, identifying their possible merits. However, in some cases reporting seemed more ambiguous than what appeared to be warranted under the circumstances (14 percent of cases where the authorities’ views were reported), dismissive of the authorities’ views (13 percent), or not critical enough (14 percent).

<sup>81</sup> A simple regression between the two did not show any significant correlation.

**Most BUFFs (80 percent) suggested that discussions with staff were useful**, because they helped the authorities identify an appropriate policy response (80 percent) and/or contributed to their analytical work (44 percent) and public debate (28 percent) (Figure 7). About 40 percent of BUFFs suggested that the authorities disagreed with staff on the need for or the timing of a policy action. Few BUFFs made specific suggestions on how to improve the effectiveness of surveillance.

Figure 7. Executive Directors' Views as Expressed in BUFFs  
(in percent)



**Staff reports did not explicitly discuss whether and how staff had tried to respond to the authorities' objections and concerns.** Political constraints were identified as the key obstacle to policy action in 21 percent of cases, followed by institutional weaknesses (at 6 percent). One fifth of staff reports left an impression that staff had tried to formulate second-best policies to take into account the authorities' constraints.

### Other issues

**Outreach activities were common during Article IV consultations, but their purpose and role were unclear from staff reports.** Although most missions met with non-governmental representatives, the views of these representatives appeared to have been mentioned in discussions with the authorities in less than 10 percent of reports. About 16 percent of staff reports identified the main themes of the domestic debate.

**Many Article IV consultations included cross-country comparative analyses.** Most (77 percent) of Article IV reports contained references to other countries. Of these, about one half compared policy experiences or economic performance across a set of countries, one third discussed developments in trading partner countries or members of a monetary union, and one fifth related to economic spillovers. About one half of cross-country references were extensive or significant.

**About one half of staff reports referred to or made use of the analysis done by other institutions or individuals.** Staff drew often on the analysis of the World Bank and other multilateral organizations (36 percent), and, to a much lesser extent, on the research done in academia (11 percent) and by think tanks (7 percent). Few reports cited studies prepared by bilateral donor organizations.

**Experiences with reporting on the effectiveness of surveillance were mixed.** Most reports (79 percent) did assess the authorities' response to the Fund's past advice and explained their actions, as required. However, many assessments appeared cursory, partial, and pro-forma. It was not clear to what extent the authorities' actions had been driven by Fund advice and whether surveillance had had any benefits for the country other than its impact on policy actions.



### Guidance Notes Pertaining to Article IV Consultations and Reports—A Synopsis

	Subject	Date	Proposed Action
<b>I. General</b>			
1	Operational Guidance Note Following the 2002 Biennial Review of Surveillance	September 2002	
<b>II. Coverage</b>			
2	Data provision	May 2002	To be revised following March 2004 review
3	Presentation of fiscal issues	April 2004	
4	Financial sector issues	June 1998	New guidance note under preparation
5	Debt sustainability analysis	September 2003	
6	Discussion of EWS model results	March 2002	
7	Capital account issues	December 1995	
8	Governance	July 1997	
9	Poverty issues in program and potential program countries	March 1991	
10	Social expenditure and social indicators	May 1997	To be reviewed or consolidated with guidance no.11
11	Implications of policies on income distribution	March 1996	To be reviewed or consolidated with guidance no.10
12	Environmental issues	February 1991	To be cancelled
13	Military expenditures	October 1994	To be cancelled
14	Size of public sector	October 1997	To be cancelled
15	Incorporation of FSSA assessments and recommendations	September 2003	

	<b>Subject</b>	<b>Date</b>	<b>Proposed Action</b>
16	Incorporation of ROSC findings and recommendations	February 2002	
17	Coverage of AML/CFT issues	January 2002	
18	Incorporation of outputs of technical cooperation action plans (TCAP) and technical consultations (TC)	October 1999 December 1999	
19	Assessment of the authorities' response to key policy challenges addressed in past consultations	September 2002	
20	Inclusion of thrust of Executive Directors' views in last Article IV consultation discussion	n/a	To be consolidated with guidance no. 19
21	Implementation of OECD anti-bribery convention	February 2001	Provision of the information contained in this appendix could be done through a different support, e.g. omnibus reports
22	Use of collective action clauses	July 2003	<i>idem</i>
<b>III. Format</b>			
23	Focused staff appraisals	December 1991	
24	Reference to the consultation cycle	April 1983	
25	Inclusion of an executive summary	May 1995	
26	Inclusion of a chart on real effective exchange rates	n/a	
27	Inclusion of a medium-term balance of payments	May 1984	
28	Inclusion of measures of reserve adequacy	April 1999	
29	Inclusion of a table of indicators of external and financial vulnerability	March 1998	
30	Inclusion of a table of financial and economic indicators	June 1980	
31	Inclusion of basic social data table	July 1998	To be reviewed in light of introduction of table on MDGs in selected countries
32	Inclusion of table on MDG for selected countries	June 2004	

	<b>Subject</b>	<b>Date</b>	<b>Proposed Action</b>
33	Fund relations appendix	August 2001	Provision of the information contained in this appendix could be made in a different way (e.g., through the intranet)
34	World Bank relations appendix	June 1980	<i>idem</i>
35	PIN—Background Section	September 1998	
36	Prohibition of exchange rate projections	July 1998	
<b>IV. Jurisdictional Issues</b>			
37	Information on Article VIII/XIV status and Article VIII restrictions	July 1978	
38	Incorporation of recommendation for approval or non-approval of exchange restrictions and proposed decisions	October 1987	
39	Strategy for encouraging acceptance of the obligations of Article VIII	April 1993	

Table 1. Indicators Related to Article IV Consultations, 1998-2003

	1998	1999	2000	2001	2002	2003
<b>Coverage and frequency</b>						
Consultations concluded by Board 1/	126	138	123	126	135	121
Membership coverage (in percent)	69	74	67	68	72	64
Average interval since last consultation (months)	15.3	16.7	17.9	17.6	16.6	17.5
<b>Missions</b>						
Number of consultation missions	160	167	165	170	166	139
Average size of missions 2/	4.6	4.8	4.4	4.2	4.3	4.9
<b>Reporting</b>						
Number of staff reports issued	132	136	118	128	135	118
Average length of staff reports (pages) 3/	19.6	20.0	19.8	20.6	20.7	20.7
Number of REDS issued 4/	86	89	84	77	82	78
Average length of REDs (pages) 5/	102	101	101	87	85	74
<b>Executive Board discussion</b>						
Total Board hours on consultations 6/	203	223	223	217	222	195
In percentage of total Board hours	36	35	29	32	35	33
Average Board hours per consultation	1.6	1.6	1.8	1.7	1.7	1.6
<b>Memorandum item:</b>						
Number of program countries 7/	60	58	67	72	54	60
Number of country items discussed by Board 8/	191	186	196	191	199	208

Sources: Office of Budget and Planning, and the Policy Development and Review and Secretary's Departments.

1/ Including consultations which were concluded on a lapse-of-time basis.

2/ Excluding assistants.

3/ Main text up to and including staff appraisal and excluding decisions, tables and graphs.

4/ Category includes REDs and background papers and excludes stand-alone statistical appendices.

5/ Includes text, tables, and charts.

6/ Including consultations combined with use of Fund resources and with overdue obligations reports.

7/ As of December of each year, excluding compensatory and contingency financing facility and arrangements under the systemic transformation facility.

8/ Including consultations, use of Fund resources, and reports on overdue obligations.

Table 2. Article IV Consultations -- Membership Coverage, 1998-2003

	1998	1999	2000	2001	2002	2003
	(Number of consultations)					
<b>Consultations concluded by Executive Board</b> 1/ 2/	<b>126</b>	<b>138</b>	<b>123</b>	<b>126</b>	<b>135</b>	<b>121</b>
Industrial countries	19	22	21	19	23	22
G-10	10	11	11	11	11	11
Non G-10	9	11	10	8	12	11
Emerging markets	16	16	28	28	30	27
Program countries	6	8	13	10	9	5
Non program	10	8	15	18	21	22
Developing countries	67	78	59	70	82	72
Program countries	23	27	28	27	32	20
Non program	44	51	31	43	50	52
Countries in transition 3/	24	22	15	9	...	...
Program countries 4/	12	11	8	7	...	...
Non program	12	11	7	2	...	...
	(In percent of the corresponding country group)					
Coverage	69	74	67	68	72	64
Industrial countries	79	92	84	76	92	88
G-10	91	100	100	100	100	100
Non G-10	69	85	71	57	86	79
Emerging markets	94	94	78	75	78	70
Program countries	86	80	65	56	75	45
Non program	100	100	88	94	80	81
Developing countries	60	68	57	66	66	57
Program countries	64	87	72	66	76	41
Non program	58	60	48	66	60	68
Countries in transition 3/	80	73	79	47	...	...
Program countries 4/	71	65	100	54	...	...
Non program	92	85	64	33	...	...
	(Number of consultations)					
Memorandum items:						
Staff reports issued	132	136	118	128	135	118
Consultation missions 5/	160	167	165	170	166	139
Total membership	182	182	183	183	184	184
Industrial countries	24	24	25	25	25	25
G-10	11	11	11	11	11	11
Other	13	13	14	14	14	14
Emerging markets	16	16	36	36	37	37
Program countries	7	10	20	18	12	11
Non program	9	6	16	18	25	26
Developing countries	112	112	103	103	122	122
Program countries	36	31	39	41	42	49
Non program	76	81	64	62	80	73
Countries in transition 3/	30	30	19	19	0	0
Program countries 4/	17	17	8	13	0	0
Non program	13	13	11	6	0	0

Source: Policy Development and Review Department.

1/ Includes consultations with Finland and Sweden in 2000 and Austria, Kuwait, Malta, and Singapore in 2001, which were concluded on a lapse-of-time basis without Executive Board discussion.

2/ Includes consultation discussions with Aruba and the Netherlands Antilles at the request of the Netherlands' authorities, with Hong Kong at the request of UK authorities, with Hong Kong SAR at the request of the People's Republic of China's authorities, and with Macau at the request of Portugal's authorities.

3/ From 2002, countries in transition are included in the groups or emerging markets or developing countries.

4/ Excludes arrangements under the systemic transformation facility.

5/ Includes multiple missions for individual consultations.

Table 3. Frequency of Article IV Consultations, 1998-2003

	Average interval since last consultation (In months)					
	1998	1999	2000	2001	2002	2003
<b>Consultations concluded by the Executive Board</b> <sup>1/</sup>						
All countries	15.3	16.7	17.9	17.6	16.6	17.5
of which: countries on 12-month cycle	14.7	15.8	17.4	16.6	15.8	16.8
Industrial countries	13.5	15.4	13.4	14.6	14.4	13.5
Of which: G-10	12.2	13.0	11.7	12.9	11.8	12.2
Non G-10	14.9	17.8	15.4	16.9	16.7	14.8
Emerging markets	14.1	14.4	15.9	14.9	15.4	16.1
Of which: program	13.9	15.9	17.0	15.7	18.8	23.4
Non program	14.2	12.8	15.0	14.5	13.9	14.4
Developing countries	16.4	17.9	20.9	19.8	17.6	19.2
Of which: program	15.8	16.2	19.3	18.8	16.8	18.0
Non program	16.6	18.8	22.4	20.4	18.2	19.6
Countries in transition	14.5	15.8	16.4	15.5	...	...
Of which: program <sup>2/</sup>	15.9	16.3	16.3	16.1	...	...
Non program	13.2	15.2	16.6	13.3	...	...
Countries without consultations <sup>3/</sup>						
Number of countries	57	48	60	60	51	66
Of which: program	19	12	18	28	13	35
Countries without a consultation for more than 24 months	10	11	11	11	9	7

Source: Policy Development and Review Department.

<sup>1/</sup> Includes consultation discussions with Aruba and the Netherlands Antilles at the request of the Netherlands authorities, with Hong Kong at the request of UK authorities, with Hong Kong SAR at the request of the People's Republic of China's authorities, and with Macau at the request of Portugal's authorities.

<sup>2/</sup> Excludes arrangements under the systemic transformation facility.

<sup>3/</sup> Member countries not concluding consultations with the Executive Board.

Table 4. Reasons for Delays and Further Delays  
in Completion of Article IV Consultations, 1998-2003  
(Number of cases)

	1998	1999	2000	2001	2002	2003
Change of government, change within government, or unstable political situation	15	20	25	25	13	18
Scheduling conflicts	3	20	17	13	7	6
Issuance of staff report delayed pending additional data or action by the authorities 1/	7	6	8	8	2	1
Desire to combine consultation with program request or review	32	35	56	50	63	11
Request of the authorities	11	15	6	9	15	7
Staff constraints	14	29	12	10	12	7
Ongoing policy discussions	4	9	3	2	2	3
To align timing of consultation with budget cycle or regional surveillance	...	...	...	...	4	1
<b>Total</b>	<b>86</b>	<b>134</b>	<b>127</b>	<b>117</b>	<b>118</b>	<b>54</b>
By region						
Africa	34	33	56	46	34	29
Asia	11	16	18	19	15	5
Europe	14	32	19	24	20	7
Middle East	5	12	12	6	13	4
Western Hemisphere	22	41	22	22	36	9
Total	86	134	127	117	118	54
Memorandum item:						
Number of countries involved in delays in completion of Article IV consultations 2/	54	87	76	69	72	39

Source: Policy Development and Review Department.

1/ Including the Staff's desire to incorporate inputs from the FSAP exercise in the Article IV staff report for one case in 2001.

2/ In some cases more than one delay notice was issued for a country – for example, on occasion the revised date for a delayed consultation proved unattainable, necessitating a further delay. Thus, the number of delays and further delays will exceed the number of countries in delay.

Table 5. Article IV Consultations -- Time Elapsed Between Termination of  
Discussions with the Staff and Board Consideration, 1998-2003 1/

	(Average number of days)					
	1998	1999	2000	2001	2002	2003
Industrial countries	87.6	90.8	82.6	83.9	90.8	88.7
G-7	77.0	85.2	81.7	73.9	95.0	87.1
Non G-7	92.5	93.3	83.0	89.8	89.0	89.4
G-10	82.5	90.4	82.2	78.3	90.8	83.8
Non G-10	93.3	91.0	83.0	91.8	90.8	93.5
Emerging markets 2/	81.7	52.0	75.2	77.2	80.8	83.9
Program	63.3	41.0	61.2	73.8	71.7	49.2
Non program	86.7	66.7	87.3	79.1	84.8	91.7
Developing countries	78.5	83.3	86.7	86.9	87.5	91.8
Program	70.0	69.2	78.8	75.1	78.9	88.6
Non program	83.8	90.1	93.9	94.3	93.6	93.2
Countries in transition 2/	79.2	60.3	88.1	80.6	...	...
Program	70.5	50.0	75.5	79.9	...	...
Non program	88.7	73.4	102.4	83.0	...	...
All countries	80.4	77.8	83.6	83.8	86.6	89.5
	(Percentage distribution)					
50 days or less	13	22	11	10	7	5
51-65 days	12	13	14	17	13	8
66-80 days	23	21	19	23	19	21
81-95 days	26	22	31	20	29	38
More than 95 days	26	22	26	31	32	28

Source: Policy Development and Review Department.

1/ Recorded as the year in which the consultation discussions with the staff are terminated.

2/ Excludes arrangements under the systemic transformation facility.



Table 6. Reasons for Request for Extension of the Three-Month Period  
for the Conclusion of Article IV Consultations, 1998-2003

(Number of cases) 1/

	1998	1999	2000	2001	2002	2003
Scheduling conflicts 2/	5	9	7	15	17	10
Desire to discuss jointly use of Fund resources and Article IV consultations	0	0	2	3	9	8
Additional information or discussion required, e.g., policy or institutional changes	0	0	5	4	5	3
Staff committed to other missions or other duties	1	2	6	2	2	1
Delays at the request of the authorities	0	1	1	1	3	1
To align consultation with budget cycle or regional surveillance	...	...	...	...	0	2
<b>Total</b>	<b>6</b>	<b>12</b>	<b>21</b>	<b>25</b>	<b>36</b>	<b>25</b>

Source: Policy Development and Review Department.

1/ Individual countries may have had more than one request for extension in a given year.

2/ Most on account of heavy Executive Board schedules, often around the time of the Interim Committee Spring meeting and Annual Meetings, but also including cases where the Executive Director elected by the member concerned was unable to be present.

Table 7. Average Length of Article IV Consultation Staff Reports, 1998-2003 1/

	(In number of pages)					
	1998	1999	2000	2001	2002	2003
<b>Article IV staff reports</b>						
Average length of main text 2/	19.6	20.0	19.8	20.6	20.7	20.7
Percentage distribution						
14 pages or less	9.1	10.3	12.7	7.8	9.6	5.1
15-19 pages	46.2	41.9	32.2	36.7	33.3	39.0
20-24 pages	31.8	33.1	39.0	38.3	42.2	39.0
25-29 pages	9.8	10.3	11.9	12.5	11.1	14.4
30 pages or more	3.0	4.4	4.2	4.7	3.7	2.5
<b>Article IV only staff reports</b>						
Average length of main text 2/	18.8	19.2	18.2	19.9	20.2	20.3
Percentage distribution						
14 pages or less	12.8	13.4	16.2	10.7	13.3	5.9
15-19 pages	47.9	45.4	36.5	41.7	36.7	42.2
20-24 pages	29.8	30.9	32.4	33.3	33.7	38.2
25-29 pages	6.4	6.2	12.2	8.3	12.2	10.8
30 pages or more	3.2	4.1	2.7	6.0	4.1	2.9
<b>Article IV and UFR reports</b>						
Average length of main text 2/	21.4	21.8	22.6	21.9	21.9	23.3
Percentage distribution						
14 pages or less	0.0	2.6	6.8	2.3	0.0	0.0
15-19 pages	42.1	33.3	25.0	27.3	24.3	18.8
20-24 pages	36.8	38.5	50.0	47.7	64.9	43.8
25-29 pages	18.4	20.5	11.4	20.5	8.1	37.5
30 pages or more	2.6	5.1	6.8	2.3	2.7	0.0
<b>Reports on Recent Economic Developments 3/</b>						
Average length (pages)	102.3	101.1	100.8	86.8	84.9	73.8
Percentage distribution						
50 pages or less	4.7	6.7	8.6	3.7	19.5	21.8
51-60 pages	2.3	3.4	5.7	14.8	7.3	17.9
61-70 pages	9.3	11.2	14.3	18.5	8.5	12.8
71-80 pages	9.3	10.1	8.6	22.2	12.2	10.3
81-90 pages	17.4	16.9	8.6	0.0	3.7	14.1
91-100 pages	11.6	10.1	11.4	14.8	14.6	6.4
101 pages or more	45.3	41.6	42.9	25.9	34.1	16.7
<b>Memorandum items:</b>						
Staff Report average total length 4/	51.4	53.3	55.9	56.5	57.2	53.4
Average length of main text of staff reports of the largest 25 members (in terms of quota) 2/ 5/	22.4	22.3	19.0	24.6	23.4	22.7
Average length of main text of staff reports of other members 2/ 5/	17.7	18.5	20.0	19.6	20.2	20.3

Source: Policy Development and Review Department

1/ Data refer to the year in which the staff report was issued.

2/ Main text up to and including staff appraisal.

3/ Includes text, tables and charts.

Category includes REDs and background papers, and excludes stand-alone statistical appendices.

4/ Text, tables, graphs and appendices.

5/ The figures are for stand-alone staff reports.

Table 8. Exchange Restrictions of Countries with Article VIII Status<sup>1/</sup>

Free of Exchange Restrictions/Practices			Maintain Approved Restrictions/Practices	Maintain Unapproved Restrictions/Practices Only
Algeria	Grenada	Pakistan	Argentina	Belize
Antigua & Barbuda	Guatemala	Palau	Bangladesh	Fiji
Armenia	Guinea-Bissau	Panama	Botswana	Guinea
Australia	Guyana	Papua New Guinea	Congo, Dem. Rep. of <sup>2/</sup>	India
Austria	Haiti	Paraguay	Dominican Republic	Jamaica
Bahamas, The	Honduras	Peru	Ecuador	Libya
Bahrain	Hungary	Philippines	Macedonia	Nepal
Barbados	Iceland	Poland	Serbia-Montenegro	Russian Federation
Belarus	Indonesia	Portugal	Uruguay	Seychelles
Belgium	Ireland	Qatar		Solomon Islands
Benin	Israel	Romania	Sub-Total:	St. Lucia
Bolivia	Italy	Rwanda	<b>9 countries</b>	Suriname
Brazil	Japan	Samoa		Tunisia
Brunei Darussalam	Jordan	San Marino		Zambia
Bulgaria	Kazakhstan	Saudi Arabia		Zimbabwe
Burkina Faso	Kenya	Senegal		
C.A.R.	Kiribati	Sierra Leone		
Cambodia	Korea	Singapore		
Cameroon	Kuwait	Slovak Republic		Sub-Total:
Canada	Kyrgyz Republic	Slovenia		<b>15 countries</b>
Cape Verde	Latvia	South Africa		
Chad	Lebanon	Spain		
Chile	Lesotho	Sri Lanka		Total, Article VIII Status:
China	Lithuania	St. Kitts-Nevis		<b>159 countries</b>
Comoros	Luxembourg	St. Vincent		
Congo, Republic of	Madagascar	Sudan		
Costa Rica	Malawi	Swaziland		
Cote d'Ivoire	Malaysia	Sweden		
Croatia	Mali	Switzerland		
Cyprus	Malta	Tanzania		
Czech Republic	Marshall Islands	Thailand		
Denmark	Mauritania	Timor-Leste		
Djibouti	Mauritius	Togo		
Dominica	Mexico	Tonga		
El Salvador	Micronesia	Trinidad & Tobago		
Equatorial Guinea	Moldova	Turkey		
Estonia	Mongolia	U.A.E.		
Finland	Morocco	Uganda		
France	Namibia	Ukraine		
Gabon	Netherlands	United Kingdom		
Gambia, The	New Zealand	United States		
Georgia	Nicaragua	Uzbekistan		
Germany	Niger	Vanuatu		
Ghana	Norway	Venezuela		
Greece	Oman	Yemen		
		Sub-Total:		
		<b>135 countries</b>		

Source: Policy Development and Review Department

<sup>1/</sup> Except in cases where the country has since accepted the obligations of Article VIII, the table is based on the last Article IV Consultation report. In some instances, restrictions or practices may have been removed or newly introduced since the issue of the last consultation report.

<sup>2/</sup> The country has both approved and unapproved exchange restrictions.

Table 9. Exchange Restrictions or Practices of Countries with Article XIV Status <sup>1/</sup>

Free of Exchange Restrictions/Practices	Maintain Approved Article VIII Restrictions/Practices	Maintain Unapproved Article VIII Restrictions/Practices	Maintain Article XIV Restrictions/Practices Only
Afghanistan Laos Maldives Mozambique Sao Tome & Principe Tajikistan  Sub-total <b>6 countries</b>	Ethiopia  Sub-total <b>1 country</b>	Angola Azerbaijan Bosnia & Herzegovina Burundi Colombia Eritrea Egypt Iran Iraq Liberia Myanmar Nigeria Somalia <sup>2/</sup> Syrian Arab Republic <sup>2/</sup> Turkmenistan Vietnam  Sub-total <b>16 countries</b>	Albania Bhutan  Sub-total <b>2 countries</b>  <b>Total, Article XIV Status : 25 countries</b>

Source: Policy Development and Review Department

<sup>1/</sup> Except in cases where the country has since accepted the obligations of Article VIII, the table is based on the last Article IV Consultation report. In some instances, restrictions or practices may have been removed since the issue of the last consultation; in other cases, new restrictions subject to Fund jurisdiction under Article VIII may also have been introduced.

<sup>2/</sup> Country also maintains Article XIV restrictions.

Table 10. Acceptance of Article VIII Status and Nature of Restrictions Maintained, 2002-2003

Country	Date of Acceptance	Free of Restrictions	Type of Restriction	Temporary Approval
Cambodia	1/1/02	Y		
Cape Verde	8/1/03	Y		
Congo, Dem. Republic of	2/10/03	N	a) Arising from the outstanding net debit position of the country vis-à-vis the other contracting members works inoperative CEPGL regional payments agreement. [Temporary approval until Dec. 31, 2003]. b) Multiple currency arising from broken cross rates resulting from the operation of the BPA with Zimbabwe. c) Arising from the requirement for the presentation of or tax clearance certificate before payments and transfers for current international transactions maybe made. [Temporary approval until Dec. 31, 2003].	Y*
Libya	6/21/03	N	a) Bilateral payments arrangements. b) Binding foreign exchange allowances for remittances.	N
Serbia & Montenegro	5/15/02	N	a) Restriction on payments and transfers resulting from the blocking of pre-1991 foreign currency savings deposits. [Temporary approval until Oct. 31, 2002]. b) Restriction arising from the transferability of profits being contingents on the fulfillment of "obligations under domestic law." [Temporary approval until Oct. 31, 2002].	Y
Sudan	10/29/03	Y		
Timor-Leste	7/23/02	Y		
Uzbekistan	10/15/03	Y		
Zambia	4/19/02	N	a) External payments arrears to commercial creditors. b) Multiple currency practice arising from the payments between the dealing window rate and the interbank rate.	N

\* Country also maintains unapproved exchange measures.



Kenya (SM/02/60)	VIII	Multiple currency practice.	Approval until December 31, 2003.
Table 11. Exchange Restrictions Approved by the Fund, 2002-2003 1/			
Country	Status	Approved Restrictions	Approval Status
Macedonia, FYR (SM/02/56)  (EBS/03/51)	VIII	Restrictions on withdrawals and transfers from certain foreign exchange accounts of residents and nonresidents.  Restrictions on withdrawals and transfers from certain foreign exchange accounts of residents and nonresidents.	Approval until June 30, 2003 or the completion of the next Article IV consultation, whichever is earlier.  Approval until June 30, 2004 or the completion of the next Article IV consultation, whichever is earlier.
Russian Federation (EBD/02/10)	VIII	Limitations imposed upon the convertibility of current proceeds held in nonresident ruble accounts and multiple currency practice.	Approval until March 31, 2002 or the completion of the next Article IV consultation, whichever is earlier.
Uruguay (EBS/03/93)	VIII	Reprogramming of certain banking system time deposits.	Approval until July 11, 2004 or the completion of the next Article IV consultation, whichever is earlier.

Source: Policy Development and Review Department.

1/ Restrictions based on national security considerations, which the Fund was notified of in accordance Decision 144-(52/53), are excluded.

INTERNATIONAL MONETARY FUND

**Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977  
Surveillance Decision—Content of Surveillance**

Prepared by the Policy Development and Review Department

In consultation with the International Capital Markets, Research, and other Departments

Approved by Mark Allen

July 2, 2004

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## I. INTRODUCTION

1. This paper examines the content of surveillance over the past two years in light of the Board guidance that emanated from the 2002 biennial review of surveillance and subsequent policy discussions, and reflects on ways to improve the content of surveillance with a view to increase its effectiveness across the whole membership. The paper consists of two parts: the first takes stock of the broad evolution of the coverage and content of bilateral surveillance in the last two years; the second takes a closer look at the treatment of four specific issues, namely global and regional spillovers, exchange rate issues, balance sheet analysis, and institutional underpinnings of growth.
2. The paper focuses on characteristics of the content of surveillance, such as focus of coverage, aspects of the quality of the analysis, degree of substantiation of the policy advice, and candor of the policy dialogue. On one topic, namely exchange rate issues, the paper also considers general characteristics of the policy recommendations. However, the paper does not seek to assess whether, in individual country cases, the Fund's policy advice was right or wrong.

## II. COVERAGE AND CONTENT OF FUND SURVEILLANCE<sup>1</sup>

### A. Introduction

3. Following their discussions of the 2002 biennial review of surveillance, Executive Directors reached the following main conclusions on the coverage and content of surveillance:<sup>2</sup>
  - **Over the years, the coverage of surveillance had expanded** from a relatively narrow focus on fiscal, monetary and exchange rate policies to a broader purview encompassing external vulnerability assessments, external debt sustainability analyses, financial sector vulnerabilities, and structural and institutional policies that have an impact on macroeconomic conditions. This broader coverage constituted a necessary and positive adaptation of surveillance to a changing global environment.
  - Under the expanded reach of surveillance, **it was important to keep individual Article IV consultations focused on key issues.** The twin objectives of breadth and focus could only be achieved by ensuring that selectivity of coverage is molded to country-specific circumstances.

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<sup>1</sup> The main author of this section is Jesmin Rahman.

<sup>2</sup> *IMF Executive Board Reviews the Fund's Surveillance—Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision* (Public Information Notice No. 02/44, 4/18/2002), available at [www.imf.org](http://www.imf.org).

- The selection of topics in individual consultations should be based on **macroeconomic relevance** and, within subjects meeting this criterion, **matters at the apex of the Fund’s hierarchy of concerns**, which were external sustainability, vulnerability to balance of payments or currency crises, sustainable growth and the policies to achieve it, and, for systemically important countries, conditions and policies affecting the global or regional economic outlook.
  - **Fund surveillance had succeeded in embracing a wider coverage without losing focus.** Issues covered in individual consultations had generally been chosen appropriately, based on country-specific circumstances.
  - **Further scope remained for enhancing selectivity in individual cases and areas, with trade policy being one such area.** Coverage of trade policy was critical where serious trade distortions hampered macroeconomic prospects, as well as in countries whose trade policies had global or regional implications.
  - **A thorough discussion of exchange rate issues was essential to Fund surveillance.** While welcoming the greater degree of candor in the evaluation of “soft” exchange rate pegs in countries with market access, Directors urged that exchange rate issues be treated candidly throughout the membership.
  - **The coverage of financial sector issues needed to be brought up to par with coverage of other core areas of surveillance.** Directors welcomed the expanded coverage of financial sector issues, but were concerned that, in the absence of an FSAP, the quality of financial sector surveillance had been uneven across countries.
  - **Two issues** related to external vulnerability assessments **deserved greater attention**, namely **the private sector’s balance sheet exposure to interest and exchange rate shocks, and debt sustainability.**
  - **There remained scope for better integration of multilateral surveillance with bilateral surveillance.** While Directors expressed support for the current modalities of multilateral surveillance, many Directors stressed that the spillover effects of policy changes in systemically important countries needed to be more carefully explored, and that the Fund should consistently bring a cross-country perspective to bear on bilateral surveillance.
  - **In countries with Fund-supported programs**, as in other countries, **there was a need for periodic reassessment of economic conditions and policies, which required stepping back from the program framework.** Many Directors noted that Article IV consultation discussions sometimes failed to do this, thereby limiting the potential effectiveness of surveillance.
4. **In several subsequent Board discussions, Executive Directors addressed selected aspects of the content and coverage of Fund surveillance.** In particular,

- in March 2003, in the review of the Financial Sector Assessment Program (FSAP), Directors emphasized the need for continuous and effective financial sector surveillance, and called for use of a range of complementary modalities to full FSAP exercises;<sup>3</sup>
- in March 2003, in response to the recommendations of the Independent Evaluation Office stemming from its evaluation of the prolonged use of Fund resources, Executive Directors introduced a systematic process of *ex post* assessment and forward planning linked to the Article IV consultation process;<sup>4</sup> and
- in July 2003, in the review of the application of the strengthened framework for assessing external and fiscal sustainability, Directors stressed the need to better integrate debt sustainability assessments with the rest of staff's analysis and policy discussions.<sup>5</sup>

5. In light of the above policy conclusions, this section of the paper considers (i) how the Fund has coped with the competing demands of breadth and focus in its surveillance activities since the 2002 review of surveillance; (ii) how the coverage of surveillance in program countries has evolved; (iii) what has been the focus of surveillance in low-income countries; and (iv) how the treatment in Fund surveillance of some of the topics highlighted above, particularly financial sector issues, has evolved. The coverage of the remainder of these topics, namely exchange rate issues, balance sheet analysis, and policy spillovers, is analyzed in some detail in the next section of the paper.

6. **The analysis presented in this section is primarily based on a review of the 140 Article IV consultation reports discussed by the Executive Board between January 1, 2003 and March 4, 2004.** The sample consisted of 29 advanced, 25 emerging market, 23 small island, 10 oil-producing, and 53 other developing countries (see Appendix). The starting date of January 1, 2003 was chosen to include only those consultations that were initiated following issuance of the *Operational Guidance Note to Staff following the 2002 Biennial Surveillance Review*. The review was based on a detailed questionnaire addressing four main aspects of coverage: (i) rationale for focus and scope, (ii) short-term macroeconomic developments, outlook, risks and policy discussion, (iii) macroeconomic and structural policies, and (iv) assessment of vulnerability and medium-term sustainability. The questionnaire consisted of 25 questions (see Appendix), which can be divided into two

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<sup>3</sup> *IMF Reviews Experience with the Financial Sector Assessment Program and Reaches Conclusions on Issues Going Forward* (Public Information Notice No. 03/46, 4/4/2003), available at [www.imf.org](http://www.imf.org).

<sup>4</sup> *IMF Concludes Discussion on Prolonged Use of Fund Resources* (Public Information Notice No. 03/49, 4/9/2003), available at [www.imf.org](http://www.imf.org).

<sup>5</sup> *IMF Discusses Applications of and Methodological Refinements to Assessments of Sustainability*— (Public Information Notice No. 03/111, 9/5/2003), available at [www.imf.org](http://www.imf.org).

groups. The first group sought to assess the adequacy of coverage in a particular area. These questions were posed in a way that defined the elements considered necessary for adequate coverage in a particular area, and allowed the assessor to identify which of these elements, if any, were not present in a particular report. The second type of question was designed to draw out more details on coverage of a particular issue, relevant background information or, for some areas of coverage, a qualitative summary assessment. This review of Article IV consultation reports was conducted internally by a team of PDR staff not involved in day-to-day review work. This section also contains selected information on the results of outreach activities, which are described in greater detail in a companion paper.<sup>6</sup>

7. **Adequate coverage was defined as clear, focused, and well-substantiated treatment of relevant issues with a candid and balanced account of the discussion with national authorities.** More specifically, the following elements were considered essential for adequacy of coverage in an Article IV staff report: a presentation of recent economic developments with a clear “story line”; discussion of authorities’ and staff’s views on the short-term economic outlook and risks to this outlook, taking into account global (or regional) economic and financial market developments; a crisp statement on the focus of the consultation; selection of issues guided by the criterion of macroeconomic relevance and the set of matters at the apex of the Fund’s hierarchy of concerns;<sup>7</sup> identification of key policy challenges and crisis vulnerabilities; and a well-substantiated and balanced dialogue on policy recommendations.

## B. Coverage

### General considerations

8. **The focus of Article IV consultation reports varied substantially across countries.** Establishing or maintaining macroeconomic stability was a central issue in most consultations. A significant number of consultations, for both developing and advanced countries, also focused on medium-term growth prospects or structural reforms. For emerging market countries, the policy discussions often centered around reducing crisis vulnerabilities and making further progress on medium-term structural reform agendas. Consultations in oil-producing economies focused on appropriate management of oil revenues and development of the non-oil sector. Reports on most small island economies concentrated on the fiscal situation and public debt sustainability.

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<sup>6</sup> *Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977 Surveillance Decision—Modalities of Surveillance*, available at [www.imf.org](http://www.imf.org).

<sup>7</sup> When a particular structural or institutional issue is covered, it is relatively straightforward to assess whether it has macroeconomic relevance on the basis of information provided in the staff report. It is harder to detect where issues not presented in the report ought to have been covered due to their macroeconomic relevance.

9. **In the assessors' views, in more than three quarters of the reports, the scope of coverage was broadly adequate**—that is, it was neither too broad nor too narrow, and the focus of the consultation was clearly set out and well justified. Staff used a flexible approach in covering short- and medium-term issues, providing greater details on key matters, and generally devoted substantial attention to a fairly limited number of issues, thus bringing focus to Article IV consultation reports (Box 1). Discussion of macroeconomic policies typically provided a clear identification of key policy challenges and a comprehensive discussion of potential remedies. Inadequate coverage of macroeconomic policies in a small number of reports reflected insufficient discussion of one of the main policy areas, most often exchange rate issues, or a failure to provide a consistent and integrated discussion of all main policy areas. For several countries, coverage of fiscal issues was informed by Fiscal Strategy Briefs, which discuss priority areas for fiscal reform and, in some cases, broad sequencing of measures.<sup>8</sup>

10. **In almost all cases where the scope of coverage was considered to be inadequate, it was perceived to be too narrow.** Typically, in such cases, assessors were of the view that, given their importance for growth prospects, one or more structural issues (e.g., labor market policies, regional integration, conditions for private sector investment) had not received the necessary degree of attention. Interestingly, the outreach to national authorities brought to light a parallel view on the issue of focus, with a number of officials regretting that insufficient attention was given to country-specific issues that were high on the authorities' agenda.

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<sup>8</sup> At the conclusion of their discussion on the follow-up on the recommendations of the IEO report on fiscal adjustment in IMF-supported programs, Executive Directors encouraged wider use of Fiscal Strategy Briefs (Public Information Notice No. 04/19, 3/11/2004), available at [www.imf.org](http://www.imf.org). As of June 30, 2004, 48 such briefs have been prepared and posted on FAD's website. More recently, FAD has prepared a guidance note for staff on the presentation of fiscal policies in staff reports.

## **Box 1. Focused Reports, Flexible Approach—Positive Examples**

### *Short-term versus medium-term outlook*

The 2004 Article IV staff report for **Canada** mostly focuses on the short-term outlook, trying to identify policies needed to foster economic recovery after a sharp slowdown caused by negative shocks. While the report succinctly weaves in the discussion of medium-term issues, such as fiscal sustainability and productivity growth, short-term issues take up most of the report. Another well-focused report, the 2003 Article IV staff report for **Morocco**, concentrates on medium-term structural issues against the background of broad macroeconomic stability and a daunting unemployment problem in the country. The **Switzerland** 2003 Article IV staff report blends the discussion of medium- and short-term issues as the report makes policy suggestions on how to lift the country out of a recession caused by investment collapse from weak external demand.

### *Macroeconomic vs. structural issues*

The 2003 **Hungary** Article IV staff report focuses almost entirely on monetary, exchange rate, fiscal, and wage policies that are relevant for short-term conditions as well as for the medium-term strategy to adopt the euro; yet it manages to flag key structural issues. In the context of broad macroeconomic stability, the 2003 staff report for **Tunisia**, on the other hand, devotes much of the discussion on how to strengthen the macroeconomic policy framework and implement accelerated broad-based reforms to make the economy more globally integrated and market-based. In the staff report for **Angola**, a country facing severe macroeconomic instability and a humanitarian crisis, the focus of the discussion is a split between medium-term issues, such as installing better governance, transparency and accountability, and how to address the entrenched three-digit inflation.

### *Level of detail*

The 2003 Article IV staff report for **India** provides detailed analyses on a number of issues, particularly in the financial and fiscal sectors, and six boxes giving rich insights into the country's economic outlook and vulnerabilities, while keeping the focus on enhancing medium-term growth and ensuring fiscal sustainability. The well-structured report on **Chile**, with a few boxes and key details, provides a comprehensive coverage of all relevant issues, including an-depth discussion of external and financial vulnerabilities. The 2003 **Poland** staff report provides a crisp, focused and balanced discussion of all main policy areas and vulnerabilities with a measured level of detail and no boxes.

11. The presentation of the policy dialogue between the authorities and staff was considered candid in most reports for non-program countries, though with some variance across policy areas.<sup>9</sup> For example, despite the Board's call for candor but reflecting the obvious sensitivities, discussions of exchange rate issues were often very cautious, with important elements of analysis lightly covered—such as possible differences between *de facto* and *de jure* regimes, the degree of flexibility in a flexible regime, and the appropriateness of the exchange rate level—and any view other than full support to existing policies extremely carefully worded (see Section III.B). Similarly, while reports usually placed the discussion of fiscal adjustment in the context of the medium-term fiscal outlook, a lack of genuine dialogue in a number of reports hampered readers' understanding of the authorities' views on the pace and extent of adjustment recommended by staff or on the feasibility of measures needed to achieve such adjustment.

12. In those cases where the presentation of the policy dialogue was not considered candid, the coverage of the authorities' views was quite limited. In these reports for non-program countries, the section on policy discussions tended to read like a monologue rather than a genuine policy dialogue. This is consistent with the conclusions of the survey of national authorities, which emphasized that the policy dialogue between staff and the authorities had become more balanced in recent years, but that there were still cases of limited interaction.

### **Coverage of surveillance in program countries**

13. **The 2002 review of surveillance revealed weaknesses in a number of areas regarding surveillance in program countries vis-à-vis non-program countries.**<sup>10</sup> Responding to these weaknesses, the *Operational Guidance Note Following the 2002 Surveillance Review* underscored the need for the following elements in surveillance in program countries (as in surveillance of non-program countries): a comprehensive assessment of recent economic developments; a candid analysis of the short- and medium-term outlook, including a thorough discussion of risks and vulnerabilities; a stock-taking of the policy strategy to date; and a candid account of the policy dialogue between staff and the authorities on key policy issues. To enhance effectiveness of surveillance in program countries, the Executive Board also endorsed flexibility in the Article IV consultation schedule to allow consultations to take place at a time when they are most beneficial in a program context, i.e., before a program is negotiated, when a program has clearly moved off-track, or in between programs.

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<sup>9</sup> A report was deemed to show a reasonable level of candor if it articulated the authorities' views in key areas well, and laid out areas of disagreement and the reasons for these differences of view.

<sup>10</sup> *Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Surveillance in a Program Environment* (Supplement 2, 4/18/2002), available at [www.imf.org](http://www.imf.org).



14. As indicated above, **the steps adopted at the conclusion of the 2002 review of surveillance to strengthen surveillance in program countries were complemented by the introduction of systematic *ex post* assessments (EPAs) for countries with a longer-term program engagement.** EPAs are to be prepared by an interdepartmental team prior to the Article IV consultation mission; reflect input from the World Bank; and cover an analysis of the problems facing the country, a critical and frank review of progress during the period of Fund-supported programs, and a forward-looking assessment that takes into account lessons learned and presents a strategy for future Fund engagement.

15. **The decision modifying consultation cycles for program countries adopted in July 2002 has helped time consultations better.**<sup>11</sup> Since then, most Article IV consultations with program countries have taken place either at the beginning of a program, in between two programs, or when the program moved off-track or expired; one-third of consultations in our sample were combined with a review.

16. **The 37 Article IV staff reports for program countries discussed by the Executive Board between January 1, 2003 and March 4, 2004 were reviewed to assess the impact of the steps adopted in 2002.**<sup>12</sup> Implementation of EPAs is too recent to allow for a review at this time.

17. **This review shows that there has been improvement with regard to the quality of coverage in the above-mentioned four areas since the last review of surveillance, albeit in different measures** (see Table 1).<sup>13</sup> The vast majority of these reports provided a

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<sup>11</sup> See *Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Follow-Up* (7/15/2002).

<sup>12</sup> This sample includes 27 countries that had a Fund-supported program, or were requesting use of Fund resources, at the time of the Board conclusion of the Article IV consultation. Among these, two countries had programs that were considered off-track. In addition, the sample includes 10 countries whose latest Fund-supported program had recently expired or that were in between programs at the time of the consultation.

<sup>13</sup> In Table 1, “adequate coverage” of recent economic developments means a substantial discussion with a clear storyline, which is not wrapped around program developments. “Adequate coverage” in stock-taking includes a discussion of policy strategy to date, identification of areas of strength and weakness and a discussion of implications for future policies. A “barely adequate coverage” falls short of providing recommendations, while “inadequate coverage” entails either an absence of discussion or a discussion that is completely *pro forma*. For the short- and medium-term outlook, an “adequate coverage” means a “yes” answer to questions 4 and 21-24 of the questionnaire (see Appendix); “barely adequate coverage” applies to cases where coverage misses one or more of these areas, but where an assessment can be made from the rest of the report; “inadequate coverage” misses one or more key areas (for example, short-term outlook or a key vulnerability area). For policy dialogue, the definition of adequacy is less clear-cut where readers often rely on the perception of the policy dialogue they extract from the reports. Reports with clear presentation of the authorities’ views in key areas are judged to have “adequate dialogue,” reports where authorities’ views are missing in some key areas but there is an implicit sense of agreement with the staff, dialogue is judged to be “barely adequate,” reports where authorities’ views are largely missing, the dialogue is considered “inadequate.”

**Table 1. Coverage of Specific Topics in Article IV Staff Reports for Program Countries 1/**

<b>Program/Report type (Sample Size)</b>	<b>Recent Economic Development</b>	<b>Stock-taking of Policy Implementation</b>	<b>Short- and Medium- Term Outlook</b>	<b>Policy Dialogue</b>
<b>All Programs (37)</b>				
Adequate	92%	78%	57%	51%
Barely adequate	0%	3%	14%	43%
Inadequate	8%	19%	30%	5%
<b>PRGF (24)</b>				
Adequate	88%	88%	67%	50%
Barely adequate	0%	0%	17%	46%
Inadequate	13%	13%	17%	4%
<b>Stand-by Arrangements (13)</b>				
Adequate	100%	62%	38%	54%
Barely adequate	0%	8%	8%	38%
Inadequate	0%	31%	54%	8%
<b>Active Programs (25)</b>				
Adequate	88%	76%	52%	45%
Barely adequate	0%	3%	14%	48%
Inadequate	12%	21%	34%	7%
<b>Combined report (19)</b>				
Adequate	84%	89%	58%	37%
Barely adequate	0%	0%	21%	58%
Inadequate	16%	11%	21%	5%
<b>Stand-alone report (18)</b>				
Adequate	100%	89%	56%	67%
Barely adequate	0%	6%	6%	28%
Inadequate	0%	6%	39%	6%
<b>Combined Article IV and Review mission (12)</b>				
Adequate	83%	75%	33%	33%
Barely adequate	0%	8%	25%	67%
Inadequate	17%	17%	42%	0%
<b>Mission at a strategic time (25)</b>				
Adequate	96%	80%	68%	55%
Barely adequate	0%	0%	8%	32%
Inadequate	4%	20%	24%	13%

1/ See footnote 6 for definitions of “adequate,” “barely adequate” and “inadequate” in various categories.

substantial discussion of recent economic developments, which was not simply wrapped around the narrow set of program targets. In addition, these Article IV consultation reports, which were often combined with a program request or review, presented a broad discussion of macroeconomic and structural issues, which was not limited to provision of program-related technical details.

18. **The most striking improvement relates to taking stock of the policy strategy to date**—i.e., the design and implementation of the authorities' program of economic policies. Many of the reports had a separate section dedicated to this issue, and more than three quarters of program country reports in our sample included one or more paragraphs in the background section on effectiveness of the policy strategy to date. The discussions, at a minimum, addressed past policy implementation and the success of previous programs in broad terms. Most reports also went into substantial details, laying out the policy objectives under past programs, identifying areas of weak implementation, discussing what factors contributed to the success or failure of the program, and shedding light on the remaining policy agenda (Box 2). Reports tended to identify the following as areas where policy implementation has fallen short of expectations: public expenditure management, revenue forecasting, capacity building, public enterprise restructuring, lack of progress in diversification, improving the quality of institutions and governance. Shortcomings were generally reported to stem from one or more of the following reasons: program design, resource constraints, limited implementation capacity, lack of political will or consensus, entrenched governance problems, or uneven growth performance.

19. Progress is more muted regarding candid presentation of the short- and medium-term outlook and candid account of the policy dialogue in Article IV consultations for countries with Fund-supported programs. Several staff reports reflected efforts to improve discussions of risks to the short- and medium-term outlook, supported by public or external debt sustainability analysis or both, available indicators of vulnerability, and alternative scenarios or analysis of sensitivity to shocks. Nevertheless, for a significant number of program country reports, the discussion of the short-term outlook remained unsatisfactory, with either limited or no coverage, lack of discussion of risks to the outlook, or absence of information on the authorities' views on the outlook. In some cases, the discussion of the medium-term outlook may be affected by the optimism of PRSPs on medium-term prospects. Similarly, regarding the policy dialogue, while it was relatively easy to sense or identify policy consensus among the authorities and the staff, areas of dissension or the path to consensus were often unclear.

**Box 2. Taking Stock of Past Policy Developments in Program Countries—  
Positive Examples**

The Article IV staff report for *Mauritania*, a country that has completed three PRGF/ESAF arrangements and is going into its fourth, provides an in-depth dialogue on performance under past programs that identifies areas of strong and weak performance, and lessons. The report recognizes that Fund-supported policies have helped the country in maintaining macroeconomic stability and promoting structural reforms in a number of areas, but has had little impact on diversifying the economy, attracting foreign direct investment, improving financial intermediation, and enhancing project implementation capacity. Looking forward, the report highlights the need for a deeper understanding of the political, social and economic structure of the country, more emphasis on governance issues, and a more focused structural conditionality. Given the assessment that Mauritania has not yet built a critical mass of institutional and technical capacity to implement, on a sustained basis, consistent macroeconomic policies, staff and the authorities see merit in continued Fund involvement with a new PRGF arrangement with small access.

The Article IV staff report for *Bangladesh*, a country where the Fund has recently resumed lending after several arrangements in the 1980s and 1990s, provides a discussion that identifies four key structural weaknesses that have constrained investment and kept growth below potential. These are a weak revenue base, bottlenecks in physical infrastructure and inadequate human capital investment, a weak banking system, and poor governance. Against the backdrop of broadly satisfactory macroeconomic performance, the report places priority on putting the public finances on a sound footing, strengthening the effectiveness of monetary policy, moving to a more market-oriented exchange system, strengthening the banking system and reducing the budgetary burden posed by the SOEs.

The Article IV staff report for *Kyrgyz Republic*, a country that has received continuous financial support from the Fund since 1993 under various arrangements, provides a rich discussion where the performance is marked by three distinct periods: the “euphoric” period following independence that lasted until 1994 with favorable policy climate and donor assistance, the period of “dismay and frustration” during 1995-2000 where reforms stalled, external debt arrears increased, fiscal discipline was lost and programs went off-track, and finally the period of “realism and pragmatism” starting in 2001 where constraints imposed by high external debt and poverty brought back the pursuit of macroeconomic stability on the agenda.

The Article IV staff report for *Lithuania*, a country where the Fund provided financial support in the mid-1990s and has more recently been involved in two successive stand-by arrangements, provides a retrospective on this long-term engagement that is drawn from broad consultations with the authorities and civil society. Fund-supported programs are viewed to have played a catalytic role in bringing about the turnaround of the economy in the midst of a political crisis and a recession. More specifically, Fund-supported programs are thought to have helped create consensus across a fragmented political spectrum on the economic policies needed to preserve the currency board arrangement and join the EU.

20. **Article IV consultations for program countries that were conducted on a stand-alone basis provided a somewhat richer account of the policy dialogue with the authorities.**<sup>14</sup> There were no noticeable differences in coverage in other areas (Table 1). The main explanation seems to lie in the nature of staff reports in a program context: policy consensus is reached through negotiations; and divulging the details of initial policy preferences may be avoided out of fears of undermining confidence in the program or the authorities' capacity to implement it.<sup>15</sup> Interestingly, according to the results of the outreach exercise, most authorities in program countries still failed to clearly differentiate Article IV consultations and program discussions.

### Coverage of surveillance in low-income countries

21. **With progress on macroeconomic stability, the dominant challenge in many low-income countries is to sustain high rates of growth and reduce poverty.** A large number of low-income countries have produced a Poverty Reduction Strategy Paper (PRSP), which lays out a country's medium-term development goals and strategy to tackle poverty, including a macroeconomic framework. In addition, the international community has adopted poverty reduction goals for low-income countries, known as Millennium Development Goals (MDGs).

22. **A review of 53 Article IV staff reports for low-income countries shows that the discussion of the medium-term outlook typically contains broad references to the level of growth, links to poverty reduction, and the means to achieve such growth.** When identifying sources of growth, reports placed emphasis on traditional sectors and envisaged a strengthened role for the private sector. In identifying the policies needed to reach these growth objectives beside macroeconomic stability, reports generally supported (i) reforms that improve the investment climate and competitiveness, such as simplifying the tax regime, implementing judicial reform, strengthening governance, improving physical infrastructure, and facilitating financial intermediation; and (ii) policies that reduce fiscal vulnerabilities, such as civil service reform, strengthened revenue collection, better monitoring of the budget, and privatization. In a few cases, preferential market access was viewed as a key ingredient to achieve higher medium-term growth. Most reports identified risks that can

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<sup>14</sup> As a result of greater flexibility in consultation cycles, about half of the Article IV reports for program countries were prepared on a stand-alone basis—a significantly higher proportion than in preceding years. Prior to the introduction of EPAs, a few Article IV consultations that were combined with discussions on use of Fund resources (UFR) were conducted using somewhat different procedures than usual: a senior staff member was added to the country team to lead the Article IV consultation (but not the UFR discussions); separate consultation and UFR reports were produced; or separate Board discussions on the Article IV consultation and UFR took place. For details, see *Enhancing the Effectiveness of Surveillance—Operational Responses, the Agenda Ahead, and Next Steps* (4/10/2003), available at [www.imf.org](http://www.imf.org).

<sup>15</sup> In a few cases, the reports mentioned the authorities' dependence on staff's technical expertise, which might have contributed to a muted dialogue.

hamper the growth prospects and jeopardize poverty reduction goals. Among these risks prominently featured terms of trade shocks, high dependence on aid, political instability, weak political commitment to reforms, and poor implementation capacity. However, reports rarely contained an explicit discussion of how recommended policy adjustments and reforms could help increase resilience to shocks.

23. **While Article IV staff reports for PRGF countries generally made references to PRSPs, the incorporation of PRSPs varied considerably across reports, and they very rarely played a central role in the medium-term discussions** (Box 3). This may be because PRSPs have not yet evolved into fully functioning vehicles for medium-term growth strategies for low-income or PRGF countries, or because PRSPs are seen to be more closely related to the design of PRGF programs and are assessed in that context in Joint Staff Assessments. As pointed out in the review of experience with PRSPs, it is also an instrument charged with multiple objectives, many of which can be in conflict—long-term ambition versus budget constraints, comprehensiveness in addressing different dimensions of poverty versus focus and prioritization, meeting the expectations of the international community versus country ownership and implementation capacity.<sup>16</sup> That review concludes that these tensions often result in documents that do not reflect proper coordination between ministries or an appropriate degree of realism. As they mature into documents that are more aligned and integrated with the country's budget preparation and donor activities, a more integrated role for PRSPs can be envisaged in surveillance of these countries.

24. **Some Article IV staff reports made references to MDGs.** A few reports reflected briefly on the country's prospects for meeting MDGs, but the discussion has remained very general so far.

## C. Content

### Financial sector issues

25. **Financial sector issues constitute a main area of Fund surveillance. Article IV consultations are the Fund's primary instrument of financial sector surveillance, and Financial System Stability Assessments, where available, feed into these consultations.** At the multilateral level, the Global Financial Stability Report (GFSR) is the main vehicle for surveillance of financial markets and systems. Main issues include financial sector vulnerabilities that could trigger a liquidity or solvency crisis, amplify macroeconomic shocks or financial market volatility, or hamper policy responses to shocks; and structural weaknesses in the financial sector that impede the mobilization or efficient allocation of savings. Its coverage is expected to vary according to country-specific circumstances. For

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<sup>16</sup> *Poverty Reduction Strategy Papers (PRSPs)—Progress in Implementation* (9/22/2003) available at [www.imf.org](http://www.imf.org).

### **Box 3. Examples of References to PRSPs in Article IV Reports**

The staff report for *Senegal* makes a connection between goals set in the PRSP and the medium-term economic program. The report candidly acknowledges that the scenario set in the PRSP appears to be too optimistic and that medium-term financial planning would require more realistic assumptions about implementation ability, the economy's absorptive capacity and the private sector's response.

The discussion of poverty reduction strategy sets the stage for discussion of the medium-term outlook in the staff report for *Burkina Faso*, drawing on the goals and strategy set forth in the PRSP.

The staff report for *Lesotho* notes that the PRSP then still under preparation provides policy priorities for the current and upcoming budgets.

The *Sri Lanka* staff report refers to the PRSP (*Regaining Sri Lanka*) in discussing the poverty situation in the country, its roots and the necessary measures for its reduction.

The *Cambodia* report contains a paragraph that notes that macroeconomic and key structural policies in the PRGF-supported program have been consistent with the policy agenda specified in the PRSP.

The *Bolivia* staff report contains a separate section on PRSP-related issues which notes developments and challenges in the consultation process as well as analytical work to support the PRSP agenda.

The *Honduras* report makes reference to the PRSP regarding performance of poverty-related social spending, including a detailed box on implementation status of actions to strengthen tracking of poverty-related public spending.

The *Yemen* staff report notes that PRSP implementation has been mostly limited to setting an administrative framework and no poverty indicators were available. The report also acknowledges broad consistency between the medium-term baseline scenario and PRSP objectives without going into any details.

example, in countries with relatively developed financial systems and extensive links to international capital markets, risks arising from volatile cross-border capital flows may be a dominant issue; in countries with systemically important financial systems, market developments that can affect other Fund members will need to receive particular attention; and in countries with rudimentary financial systems, greater weight may need to be given to medium-term developmental issues.<sup>17</sup>

**26. The review of Article IV staff reports shows that the coverage of financial sector issues had improved since the last biennial surveillance review but, in many country cases, was not yet at par with coverage in other main areas.**

- The scope of financial sector coverage varied substantially across countries. Many reports, particularly for industrial countries, provided a focused and selective discussion of financial sector issues. For systemically important countries, coverage of potential sources of volatility for other member countries, drawing on multilateral surveillance, had been limited. Coverage of the financial sector was generally broader for emerging market countries, with the discussion providing substantial insights into the macro-financial linkages. For developing countries, the coverage was uneven, varying from a thorough coverage of the health of the financial sector to a virtual absence of any discussion.
- The provision of financial soundness indicators (FSIs) varied across country groups. For industrial countries, the coverage was often limited to a few key categories, such as earnings and profitability.<sup>18</sup> For emerging market countries, the provision of FSIs tended to cover three or more key categories out of five. For developing countries, the provision of FSIs was mostly limited to one or two indicators or a qualitative assessment of non-performing loans. For all countries, including those with sophisticated capital markets, available FSIs are mostly limited to banking sector indicators. When provision of FSIs was limited, the reasons for this situation were typically not clarified, nor were the implications for effective surveillance.
- Three-quarters of the reports indicated whether the financial system was considered to be sound or not. However, this summary assessment was not always demonstrably backed up by substantial data and analysis—such as relevant FSIs or stress tests or discussion of the views of supervisory and regulatory agencies—and it is questionable, in any case, whether such definite judgment can be justified.

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<sup>17</sup> An operational guidance note to staff on financial sector surveillance in Article IV consultations is under preparation. It will reflect past Board discussions of this question, and seek to deepen understanding of the objective, scope, focus, and modalities of treatment of financial sector issues in Fund surveillance.

<sup>18</sup> There are five key categories of FSIs: capital adequacy, asset quality, earnings and profitability, liquidity and sensitivity to market risk.



27. **The unevenness in coverage of financial sector issues can be explained partly by the intensity of concerns about financial sector weaknesses. But it also reflects allocation of financial sector expertise, as can be seen from the additional quality and depth of coverage of financial sector issues in consultations benefiting from substantial input from expert staff** (Table 2). Coverage is most extensive in cases where the country has completed an FSAP. Substantial coverage is also achieved in many cases by inclusion of one (or more) MFD or ICM experts in the Article IV consultation missions. The discussion of financial sector issues in these reports is typically longer, providing key diagnostics and recommendations. A number of consultations for countries where financial sector issues have been prominent for some time, and thus have been studied in detail, also provide substantive coverage of the financial sector without benefiting from an FSAP, MFD, or ICM participation in the Article IV mission.

### **Trade policy**

28. **The 2002 biennial review of surveillance identified trade policy as one area where further scope for selectivity existed.** It concluded that coverage of trade policy is essential in countries where serious trade distortions hamper macroeconomic prospects, as well as in countries whose trade policies have global or regional implications. It was considered that selectivity would strengthen the coverage of trade issues.

29. **The coverage of trade issues has improved significantly for systemically important countries.** There has been a progressive strengthening of the depth and scope of trade policy coverage in the “Quad” countries, i.e. Canada, the European Union, Japan and the United States, which involved preparing selected issues papers on trade topics and including recommendations on trade policies in staff appraisals (See Section III.A. and Box 6).

30. **For a number of other countries, the coverage of trade issues remained unfocused or insufficiently selective.** In some cases, the discussion did not highlight important elements, such as significant changes in regional trade agreements or sizable foreign impediments to export performance. In some other cases, coverage was considered too lengthy given country-specific conditions—i.e., a largely open trade regime, no systemic impact, and no significant concern about market access.

### **Social sector developments and policies**

31. **In recent years, the Fund has increasingly focused on the coverage of social issues, particularly social spending and provision of poverty and social indicators.** The linkage of PRSPs to the medium-term policy framework provides a natural basis for coverage of social sector issues in PRGF countries. More recently, Executive Directors welcomed the staff’s efforts to focus, in close collaboration with the World Bank, on protecting social

Table 2. Coverage of Financial Sector Issues 1/

Type of report/mission (Sample size)	Average number of paragraphs in the staff report	Key structural weaknesses identified	Key vulnerabilities identified	Specific recommendations presented, including follow- up from FSAP
<b>MFD Participation in Article IV mission (26)</b>	4.2	88%	81%	88%
FSAP completed (11)	4.5	91%	91%	100%
FSAP underway (9)	4	100%	56%	78%
No FSAP (6)	4	67%	100%	83%
<b>FSAP completed (20)</b>	3.5	80%	80%	95%
No MFD participation in Article IV mission (9)	2.2	67%	67%	89%
<b>FSAP underway (14)</b>	3.3	93%	64%	64%
No MFD participation in Article IV mission (5)	2.2	80%	80%	40%
<b>No FSAP, No MFD participation in Article IV mission (9)</b>	2.3	56%	78%	44%

1/ Analysis in this table is based on a sub-sample of 69 randomly selected Article IV consultation reports

spending and incorporating the costs of social safety nets into program design.<sup>19</sup> The IEO has also recommended that, during Article IV consultations, staff invite country authorities to suggest what are the existing critical and social programs and social services they would like to see protected in the event of shocks.<sup>20</sup>

32. **The review of Article IV consultation reports shows that more than half of the reports included some discussion of social issues.** A majority of these concerned low-income countries, where coverage addressed poverty incidence and human development indicators. For other countries, the coverage was justified by consideration of the macroeconomic consequences of extreme income inequality, rising poverty, or entrenched unemployment problems. For a few countries, the discussion addressed social spending, pension reforms, or the social impact of price increase. In addition to discussion of social issues, a number of reports—particularly, for countries with repeated episodes of social instability—provided greater coverage of political developments than usual.<sup>21</sup>

33. **While the coverage of social sector issues was often relevant to macroeconomic developments, it was not always substantive.** Coverage was most meaningful in post-conflict countries and countries with endemic political and social instability. In these countries, the discussion provided a valuable context for policy discussions. For some other countries, the discussion was limited to a few passing references. Reports contained virtually no reference to information from outside experts.

### **Assessing vulnerabilities**

34. **In recent years, the Fund has undertaken substantial work to reinforce its capacity to identify vulnerabilities in member countries.** A strengthened framework for assessing public and external debt sustainability was adopted in June 2002 with further enhancements introduced in June 2003. A range of instruments has been defined to enable more continuous and effective financial sector surveillance. A large volume of analytical work has been produced to deepen understanding of factors contributing to the emergence of balance sheet fragilities, and the transmission of these weaknesses across different sectors. The staff has also progressively refined the high-frequency vulnerability exercise that provides a platform for an independent assessment by departments of key risks in individual countries and feeds into staff's analysis in Article IV consultations. However, more use could be made of this exercise in bilateral surveillance. In some cases, experts from ICM have

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<sup>19</sup> *Follow-Up on the Recommendations of the Independent Evaluation Office Report on Fiscal Adjustment in IMF-Supported Programs* (Public Information Notice No. 04/19, 3/11/2004), available at [www.imf.org](http://www.imf.org).

<sup>20</sup> *Independent Evaluation Office—Evaluation of Fiscal Adjustment in IMF-Supported Programs* (9/9/2003), available at [www.imf.org](http://www.imf.org).

<sup>21</sup> Assessors identified 16 such cases.

joined Article IV missions or provided headquarter-based inputs to strengthen assessment of vulnerabilities arising from capital market developments.<sup>22</sup>

35. **More than two-thirds of the 140 reports covered in this review provided views on elements of vulnerabilities to balance of payments, currency or financial crisis.** In most cases, these assessments were supported by debt sustainability analyses, relevant discussions of domestic policy developments, financial and corporate sector vulnerabilities, or, occasionally, domestic political economy factors. The discussion of vulnerabilities was most substantive for emerging markets. For a large number of developing countries, the discussion revolved around fiscal vulnerabilities, exposure to potential commodity shocks, and possible shortfalls in donor support.

36. **However, few reports provided an integrated assessment of crisis vulnerabilities or a clear view on the severity of these vulnerabilities.** In most cases, the discussion of vulnerabilities was distributed throughout the report in relevant sections. Reports that included a separate section on vulnerabilities tying together various components discussed elsewhere in the report gave a much clearer sense of vulnerabilities than other reports (Box 4).

#### **D. Conclusions and Recommendations**

37. The review suggests the following conclusions on the coverage and content of surveillance:

- The general guidance on **coverage of surveillance** set by the Executive Board at the conclusion of the 2002 review of surveillance (paragraph 3, first three bullets) remain valid. In particular, coverage of individual Article IV consultations should continue to be guided by the criterion of macroeconomic relevance and matters at the apex of the Fund's hierarchy of concerns.
- Fund surveillance has generally continued to succeed in embracing a broader purview without losing focus. Nevertheless, at the margin, in choices involving breadth and depth of coverage, it may be necessary to lean towards greater depth at the expense of less breadth—that is to say, to strive for still greater selectivity of topics. This may mean that some topics are examined in depth, but not every year.

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<sup>22</sup> In this review's sample of 25 emerging market countries, one third of Article IV missions included an expert from ICM.

- As concerns **surveillance in program countries**, (i) greater flexibility in consultation cycles for program countries has resulted in better timing of consultations; (ii) considerable improvement has been made regarding assessments of recent economic developments and stock-taking of the policy strategy to date; and (iii) there is room for further improvement in the coverage of the short- and medium-term outlook and the policy dialogue between national authorities and staff.
- Implementation of the policy on ex-post assessments is expected to help strengthen further surveillance in program countries and, in particular, to facilitate bringing a fresh perspective to the analysis of past developments and policy design. Progress in surveillance in program countries could be reviewed once substantial experience with EPAs has been gained.
- Article IV reports for **low-income countries** typically provide a general discussion of medium-term growth prospects and sources of growth. The use of PRSPs in the discussion of the medium-term outlook in these reports has generally been limited, and references to MDGs have typically been brief.
- Steps are being taken to reflect more fully the international community's efforts to achieve the MDGs in Fund surveillance. To help track progress toward the MDGs and facilitate consideration of such progress in Board discussions, an MDG table in Article IV consultation reports for relevant countries is being introduced. Article IV consultations for PRGF countries could also be used to analyze alternative macroeconomic frameworks aimed at meeting the MDGs. The Fund is currently working with the World Bank on a pilot MDG study; this and other planned pilot studies should provide valuable insight on coverage of MDGs in Article IV consultation reports.<sup>23</sup>
- For PRGF countries, integration and sequencing of the PRSP process, program discussions, Article IV consultations, and Ex Post Assessments pose a significant challenge. The different cycles applying to these exercises, uncertainties surrounding the timing of program reviews, and resource constraints make this issue particularly complex. Further consideration of this matter is needed.
- Coverage of **financial sector issues** has improved. Nevertheless, its scope or depth has not yet consistently reached that of other main areas of surveillance. Most importantly, assessments of the overall health of the financial sector, which are frequently provided in Article IV consultation reports, need to be better supported by provision of relevant data—including financial sector soundness indicators—and

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<sup>23</sup> Under this pilot country study, the World Bank is costing different sectoral programs designed to achieve the MDGs. Once this is done, the Fund will consider how to integrate these programs and their accompanying external resource requirements in a coherent macroeconomic framework.

analysis. While FSAPs significantly enhance the quality of surveillance in financial sector, this review indicates that when an FSAP cannot be accommodated, significant improvement in coverage can also be achieved by including MFD or ICM experts in Article IV missions. Thus, a variety of options—e.g., focused FSAP updates, MFD and ICM participation in Article IV consultation missions, separate MFD or ICM missions, monitoring of financial sector developments from Fund headquarters, training of area department staff by MFD—should continue to be used to bring necessary expertise to bear on analysis of financial sector issues. An operational guidance note on financial sector surveillance in Article IV consultations is under preparation, it should help further strengthen cooperation between area and functional departments in this area.

- The coverage of **social issues** could be more selective. As discussed later in this paper, this conclusion also applies to other issues that are not in the Fund's traditional areas of expertise. While social issues were typically discussed when macroeconomically relevant, coverage was not always substantive. Taking account of resource constraints, in the aggregate, it would be preferable to cover fewer issues in greater depth, perhaps every few years. Deeper treatment of relevant issues would likely require greater use of available information from outside experts.
- In countries where shocks could have a sizeable and sudden impact on social conditions, Article IV consultation missions—and other contacts between staff and member countries—may offer a valuable opportunity to solicit members' views on protection of social safety nets or other priority expenditures in times of economic stress. Such discussions would be conducted on a voluntary basis.<sup>24</sup>
- The 2002 call for greater selectivity of coverage of **trade issues** deserves to be reiterated. An effort should also be made to link the discussion of trade policy issues (where covered) to that of other economic developments and policies. A more focused approach would involve, on the one hand, more substantial treatment of market access and important developments in regional trade arrangements and, on the other hand, no coverage when no major trade issues arose since the last consultation, the trade regime is largely open, and the country neither faces major obstacles in accessing international markets nor has systemic importance.
- Recent initiatives designed to strengthen assessment of member countries' vulnerabilities to a currency, balance of payments or financial sector crisis remain appropriate. Efforts should concentrate on providing an integrated assessment of crisis vulnerabilities. Use of multi-sectoral analytical frameworks, such as the Balance Sheet Approach (see Section III.C.), should prove helpful in this area.

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<sup>24</sup> Article IV, Section 3(b) stipulate that the principles adopted by the Fund for guidance of all members with respect to exchange rate policies shall respect the domestic social and political policies of members.

### III. SELECTED ISSUES IN FUND SURVEILLANCE

38. This chapter focuses on the treatment in Fund surveillance of four issues that have received particular attention in recent policy discussions.

#### A. Global and Regional Spillovers<sup>25</sup>

39. **This section reviews the coverage of global and regional spillovers, with a particular focus on the integration of the Fund’s bilateral, regional, and global surveillance.** At the conclusion of the 2002 biennial surveillance review, Executive Directors stressed that conditions and policies in systemically important countries affecting the global or regional outlook were a matter at the apex of the Fund’s hierarchy of concerns. Directors also called for better integration of multilateral surveillance into bilateral surveillance.<sup>26</sup> This section reviews to what extent bilateral consultations conducted since then have focused on developments and risks in the global economy and/or in their region, and discusses the scope for strengthening the integration of bilateral, regional, and multilateral surveillance.

#### Global spillovers

40. **The Fund is in a good position to take advantage of synergies between bilateral and multilateral surveillance.** Many public and private institutions monitor macroeconomic developments and prospects of Fund member countries on a regular basis. However, the Fund is unique in its combination of comprehensive multilateral surveillance (through the WEO and GFSR), regular multilateral policy dialogue (in particular the IMFC), and in-depth bilateral policy discussions concluded by the Executive Board. This allows the Fund to use a consistent surveillance framework for its member countries and the world economy.

41. **The Fund’s quantitative macroeconomic analysis is already well integrated.** The WEO’s global database draws on the results of bilateral surveillance, while country teams use centralized WEO data as inputs for their quantitative work. These inputs include global assumptions about oil and commodity prices; partner country data available through the internal Economic Data Sharing System; and real effective exchange rate data available through the INS database. The interplay of bilateral and multilateral surveillance was also noticeable in recent work on debt sustainability, when efforts to develop a consistent

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<sup>25</sup> The main author of this section is Christian Mumssen.

<sup>26</sup> The operational guidelines for staff that emanated from the review noted that: “Article IV staff reports are expected to highlight the domestic consequences of global economic conditions and, where relevant, of developments in international capital markets. At the same time, surveillance in systemically important countries needs to pay close attention to the regional and global impact of economic developments and policies in these countries. Staff reports need to discuss these spillover effects.”

framework for bilateral consultations were complemented by an in-depth analysis of public debt in emerging markets in the September 2003 WEO report.

42. However, **most Article IV staff reports contained little explicit discussion of linkages between, on the one hand, global economic conditions and risks and, on the other hand, domestic conditions and risks.** About three-quarters of recent reports contained minimal if any references to global growth, inflation, non-oil commodity prices, interest rates, equity markets, emerging market financing trends, or geopolitical risks.<sup>27</sup> The types of global linkages that were described most often related to the impact of global economic growth on advanced economies; the impact of geopolitical conditions on tourism-dependent economies; and the impact of oil prices on oil exporters. By contrast, only about 10 percent of reports mentioned the depreciation of the U.S. dollar against the euro as relevant for the specific country; there was hardly any mention of the implications of the low inflationary environment worldwide; and less than 20 percent of reports on developing countries referred to the impact of non-oil commodity prices. All these issues were discussed in detail in WEO reports or GFSRs (Box 5).

43. **The near absence of references to conditions in global capital markets in Article IV reports is particularly striking.** There have been significant movements in capital markets in recent years, including the bursting of the equity bubble, the sharp decline in world interest rates, and the recent narrowing of spreads on emerging market debt. These events have had a profound impact on many economies, and the prospect of higher interest rates in advanced economies entails substantial risks for many countries, particularly those with high debt levels, as highlighted by the WEO and GFSR (Box 5). Nevertheless, less than 10 percent of all Article IV reports linked domestic financial conditions to movements in world interest rates; only about a quarter of emerging market reports referred to the impact of past or prospective capital market conditions for emerging markets; and less than 20 percent of advanced country reports mentioned the effects of movements on global equity markets.

44. **In some countries or in particular circumstances, global economic conditions may be of secondary relevance, which would justify limited coverage.** For instance, in countries that are experiencing a deep crisis, domestically-generated economic volatility may be so high as to marginalize the potential impact of global spillovers. Small countries with

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<sup>27</sup> There are some notable exceptions to this observation, such as the substantial coverage of domestic risks related to global growth and potential oil price shocks in the 2002 Article IV consultation reports for Korea (3/19/2003) and the United Kingdom (3/3/2003), both available at [www.imf.org](http://www.imf.org).



### **Box 5. Themes of WEO Reports and GFSRs**

The WEO and GFSR reports issued during September 2002 – September 2003 analyzed the ongoing global recovery. Global inflation was very subdued, but the risk of global deflation was considered remote. There was recurring uncertainty about oil prices, partly in connection with geopolitical conditions. The U.S. dollar continued to depreciate against the euro. Interest rates reached historical lows. Global equity valuations were gradually rebounding, but the reports noted vulnerabilities associated with weakened balance sheets and corporate governance concerns. After a period of decline, emerging market financing began rebounding in 2002 and interest rate spreads started narrowing significantly. In general, the reports were cautiously optimistic about global economic prospects, but stressed a number of key risks and uncertainties:

- Risks emanating from the large *global imbalances* were a key recurrent theme. The September 2002 WEO noted that the constellation of imbalances was unlikely to be viable over the medium term and stressed the potential for significant and disruptive changes in tradable sectors and real exchange rates. In this context, the September 2003 WEO discussed to what extent G-3 exchange rate volatility could adversely affect economic performance in other countries. The GFSR highlighted the potential risks arising from the magnitude and structure of portfolio flows into the United States.

- Uncertainties about the fallout from the *bursting of the equity bubble* were identified as a risk to the global recovery. The April 2003 WEO noted that the decline in output growth after the equity bubble burst was larger than in previous bust episodes, owing to sharper falls in private fixed investment, but that the timing of the recovery was broadly in line with historical experience. The WEO and GFSR stressed the risks of potential housing price bubbles and excessive corporate leverage in an environment of unusually low short-term interest rates.

- Risks to *external financing conditions in emerging markets* were another recurrent theme. The GFSR discussed the rebound in emerging market financing flows and the decline in interest rate spreads, but cautioned about a possible correction, given the likely rebound in world interest rates, possible volatility in certain emerging markets, and high public debt ratios. The September 2003 WEO concluded that sustainable debt ratios were substantially lower in emerging markets than in industrial countries, given more volatile public finances. The GFSR highlighted the benefits of extending public debt maturities and developing the local securities market.

- The September 2002 WEO emphasized that *trade openness* was needed to underpin international financial liberalization in order to reduce the risk of financial crises. The report stressed the substantial gains for developing countries from industrial country agricultural liberalization.

limited capital account openness and high dependence on one or two large trading partners may be only indirectly affected by global conditions. In these cases, explicit references to global economic conditions in reports would be expected to be limited, while global WEO assumptions would nevertheless be used for the underlying quantitative analysis.

45. **However, in general, the review of Article IV reports points to scope for strengthening the treatment of the impact of global economic and financial developments on national economies.** While global conditions and risks may be well known to many readers, they affect individual countries in different ways. Glossing over global linkages can distort the presentation of economic policies and fundamentals. For instance, reporting on a country's narrowing Eurobond spreads without mentioning the general decline in emerging market spreads can give a misleading impression about country-specific fundamentals. Attention to global spillovers is also crucial for assessing the full spectrum of vulnerabilities and identifying appropriate policy responses.

### **Surveillance of the G-3<sup>28</sup>**

46. **Economic policies and events in the G-3 have a major impact on the world economy.** The near-term risk of a balance of payments crisis in the G-3 countries is very low, but their macroeconomic policies have important and sometimes immediate consequences for financial stability in many other countries. The G-3 countries account for about half of world output and trade, and global economic trends are highly dependent on business cycles in the G-3.<sup>29</sup> International capital market developments often have their origin in events in the G-3. Volatility among the three major currencies has contributed to exchange rate misalignments in some countries and been identified in analyses of past financial crises as one contributing factor.

47. **Economic and financial conditions in the G-3 and their impact on global developments have been at the top of economic policy agenda over the past two years.** Key issues have included the uneven pattern of economic growth, current account imbalances, the decline in the U.S. dollar against the euro, the low interest rate environment, the bursting of the equity bubble, concerns about corporate governance, as well as trade and aid policies. Recently, movements in U.S. interest rates and their impact on world interest rates and emerging market financing have received considerable attention.

48. **The WEO and the GFSR are appropriate tools for analyzing the global impact of economic and financial developments in the G-3.** The WEO has provided in-depth analysis of spillovers from G-3 countries to the rest of the world. The risk of a disruptive

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<sup>28</sup> The G-3 are defined here as the EU/euro area, Japan, and the United States. The review of the EU/euro area surveillance focused primarily on the staff report on Euro Area Policies (9/16/2003), available at [www.imf.org](http://www.imf.org).

<sup>29</sup> For an analytical discussion of global spillovers, see, for example, Chapter II of the October 2001 World Economic Outlook. For a discussion of the impact of mature market interest rates on emerging market spreads, see Chapter II of the April 2004 GFSR. Both are available at [www.imf.org](http://www.imf.org).

adjustment to the large global imbalances has been a central theme of the WEO in recent years, highlighting the role of G-3 fiscal, monetary, and structural policies underlying the imbalances. The WEO has also analyzed the impact of G-3 exchange rate volatility on developing countries and emphasized the substantial gains for developing countries that would result from industrial country agricultural liberalization (Box 5). The GFSR has analyzed developments and risks in global capital markets, including the impact of mature markets on emerging markets. The channels considered in the GFSR have included the size and composition of portfolio flows into the United States; the impact of changing expectations about monetary policy actions in the major economies on global equity prices, credit spreads on bonds, and the availability of capital flows to emerging markets; and structural changes in mature markets, including the increasing role of non-bank financial institutions in the allocation of risk.

49. **Bilateral surveillance with G-3 countries has included some discussion of global linkages, focusing primarily on trade.** The discussion of trade policies has gained greater prominence in recent years, partly in connection with the Doha Round, and G-3 staff reports have focused increasingly on the global impact of G-3 trade policies in addition to analysis of their domestic effects (Box 6). Staff reports for leading industrial countries also routinely include a reference to the level of official development aid.

50. **Staff reports on the G-3 countries also contain limited references to the systemic impact of their economic situation and policies.** For instance, the staff report on euro area policies notes that the recent appreciation of the euro is welcome from a multilateral perspective and that more rapid demand growth in the euro area would facilitate the adjustment of international imbalances.<sup>30</sup> The Article IV report on Japan notes the yen's role in the global financial system and the need to consider the international repercussions of the staff's proposal that the Bank of Japan purchase a wider set of foreign assets. The report on the United States is an example of a somewhat fuller discussion, noting the role of the United States in supporting global growth; the potential global costs of a disorderly adjustment to the U.S. current account deficit; the potential spillover of U.S. public debt on world real interest rates; and the critical role of the United States in multilateral trade talks.

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<sup>30</sup> By contrast, the systemic dimension of economic developments and policies of the largest euro area members is not mentioned in their respective Article IV consultation reports.

### **Box 6. Global Impact of the Trade Policies of the “Quad”<sup>1</sup>**

Canada, the European Union, Japan, and United States—the “Quad” in world trade parlance—are responsible for US\$5.6 trillion in world trade and their imports amount to 39 percent of total world imports (excluding intra-EU trade). Their trade and trade-related policies therefore have a significant impact on other countries and the global economy. Apart from the structure of import tariffs, systemically important policies include non-tariff measures (such as anti-dumping action, textile quotas and technical standards), the regulation of services trade, agricultural support programs and export subsidies, preferential or reciprocal trade arrangements, and the Quad’s stance in multilateral trade negotiations.

A review of Article IV staff papers for the period 2000-2004 shows that the scope of trade policy coverage in consultations with Quad countries widened progressively, and there was a growing focus on the global impact of these policies in addition to analysis of their domestic effects. Coverage of trade issues in the 2000 staff reports tended to be brief, and the discussion of global implications limited. The depth and scope of trade policy coverage strengthened in 2001, when selected issues papers on trade topics were prepared for the United States, Canada, and Japan, and the Euro Area staff report contained a box on the EU’s agricultural trade regime. Staff appraisals in 2001 picked up trade issues in all the reports, highlighting the global impact of policies.

Following the initiation of the WTO’s Doha Round in late 2001, there was a further increase in both the detail and systemic perspective of trade policy coverage. The 2002 and 2003 staff reports for the United States and the Euro Area reviewed aspects of the U.S. and EU negotiating positions in the Doha Round and provided a critical assessment of the impact of their agricultural policies on developing countries. Other issues covered in some detail included trade disputes (especially steel), preferential access for LDCs, and regional trading arrangements. Selected issues papers for both the United States and the EU examined the impact of trade policies on third countries, discussing issues such as the 2002 U.S. Farm Act, lessons from NAFTA for economic integration in the Americas, U.S. regionalism/bilateralism, the impact of the European Union’s eastern enlargement, and EU CAP reform. While surveillance of EU policies was conducted primarily at the regional level, some recent staff appraisals for individual EU members stressed the importance of a commitment to trade and agricultural reform.

The 2003 Article IV staff report for Japan stepped up both the extent and frankness of the discussion of trade issues, reviewed Japan’s positions on key aspects of the Doha Round and pointed to the impact of its agricultural policies on third countries. The 2004 report for Canada had significant coverage of regional trading arrangements and their domestic and regional impact, while a selected issues paper examined developments and prospects for Canada-U.S. economic integration.

<sup>1</sup> The main author of this box is Nur Calika.

## Regional spillovers

51. **Regional spillovers have had a substantial impact on economic performance in a number of recent cases.** Dramatic examples of regional spillovers include the Asian and Russian crises, and more recently the regional transmission of shocks in successive crises in Brazil, Argentina, and Uruguay (Box 7). The correlation of business cycles is an important issue for economies that depend on import demand of large regional partner countries. Exchange rate policy and competitiveness issues are further potential channels for regional spillovers (Box 8).

### Box 7. Regional Spillovers in the Souther Cone

Recent experience from South America provides an illustration of some of the different channels of regional crisis transmission.

- *Competitiveness:* The sharp real depreciation of the Brazilian *real* in early 1999 was one of the factors affecting the sustainability of the Argentinean currency board.
- *Demand spillovers:* The severe recession in Argentina during 1999-2002 depressed demand for exports to Uruguay, contributing to Uruguay's prolonged economic recession.
- *Contagion on international capital markets:* The Brazilian and subsequently the Argentinean crises contributed to a heightened perception of regional risk among international investors and thus to increased spreads on the external debt of other countries in the region.
- *Financial sector spillovers:* Following the imposition of a deposit freeze and capital controls in neighboring Argentina, cash-strapped Argentine depositors began to withdraw their funds from Uruguay's banking system. The run on deposits rapidly spread to resident depositors, after problems developed in two large private banks with strong links to Argentina.
- *Public confidence spillovers:* The Brazilian and Argentinean crises also had an impact on public confidence in neighboring countries, leading in the case of Uruguay to increased dollarization.

52. **Many Article IV reports refer to economic conditions in large regional trading partners.** References to regional linkages were particularly frequent in European and South American countries, focusing primarily on trade links and, to a lesser extent, on confidence spillovers. In total, close to half of reports mentioned one or more regional linkages in their discussions of recent economic developments, and a similar share of reports referred to regional linkages in their discussion of economic prospects and risks.

**Box 8. A Case Study of Coverage of Regional Spillovers: China's Changing Role<sup>1/</sup>**

Spillover effects from China's changing role in the world economy have many dimensions. Trade patterns in Southeast and East Asia have undergone major shifts, with intra-regional trade booming and China a key driving force behind this change. Industrial production in the region has become more vertically integrated, with China often the last step in the production chain and final demand residing primarily in the G-3 countries. Foreign direct investment flows have also been affected, as investors have been attracted by China's large domestic market and its potential as a regional and global production base. China's strong growth has also contributed to an increase in world commodity prices. More recently, attention has focused on the impact of China's exchange rate policy on its trading partners.

Fund surveillance has repeatedly analyzed China's role in international *trade and investment flows*. A September 2003 cross-country study examined the likely impact of WTO accession on global and regional trade patterns, and the April 2004 WEO analyzed the various channels through which China's growth might affect the global economy. China's accession to the WTO was deemed to have a mixed impact on the region, with some diversion of trade and investment offset against increased access to China's large internal market and the benefits of greater regional integration. Looking ahead, the expiration of the Multi-Fiber Arrangement in 2005 has been the focus in analyzing export prospects for low- to middle-income garment producers in the region, with China expected to gain a large market share when the quota system is eliminated.

In the period reviewed, Article IV documents for Hong Kong SAR and Singapore discussed the medium-term challenges arising from intensified *regional competition*. Economic activity in Hong Kong SAR has been shifting towards high value-added services, as manufacturing and low-end services have been outsourced to the mainland as the two economies are becoming increasingly integrated. Singapore has been facing similar competitive challenges in both the services and manufacturing sectors, as well as in attracting foreign investment. In these and other economies in the region, the Fund has advocated meeting these challenges through structural reforms, such as financial sector reform, labor market reform, and the liberalization of trade and investment regimes, in order to enhance productivity and boost competitiveness.

China's *exchange rate policy* also has important implications for the region. The decision to maintain the exchange rate of the renminbi stable during the Asian crisis was recognized as pivotal to warding off further repercussions from the crisis. The current debate on the future of China's exchange rate regime has been closely monitored within the region. The Fund has long recommended increased exchange rate flexibility for China, as it would allow more room to pursue an independent monetary policy, help cushion China's economy against adverse shocks, and facilitate adjustment to the major structural reforms that are underway. It has also been noted that increased flexibility of the renminbi could encourage similar moves by other countries in the region and thereby facilitate the adjustment of global external imbalances.

<sup>1</sup> The main author of this box is Piyabha Kongsamut

53. **However, reports where coverage of regional spillovers and related vulnerabilities is substantially developed are relatively rare.** Examples include the Article IV report for Uruguay with an extensive coverage of regional spillovers; the staff report for New Zealand with a box on spillovers from Australia and the US; the report on the Czech Republic, which highlights the critical role of conditions in the EU for the economic outlook; and the report for Canada, which provides a detailed discussion of the business cycle and investor sentiment spillovers from the United States; and, reports for a number of Asian countries, which consider China's changing role in the world economy (Box 8). Typically, while baseline projections take regional growth prospects into account, few reports spell out these underlying assumptions. References to regional risks are more frequent (in about a third of all reports), but the probability of shocks, the mechanism of shock transmission, and the potential magnitude of spillovers are rarely explicitly analyzed. Moreover, it is not clear whether vulnerability analyses are based on assessments of the nature and scale of spillovers that are consistent across countries within a given region.

54. **Area departments have made very significant efforts to strengthen regional surveillance.** Most area departments are preparing regional economic outlook papers on a regular basis, as well as occasional seminars and research papers. The Fund also holds annual discussions with regional authorities in four currency unions and participates in meetings of a number of regional economic groups (see Section IV of the companion paper on modalities of surveillance). These initiatives have been useful in highlighting common economic issues and facilitating cross-country analysis.

### **Conclusions and recommendations**

55. **The Fund's bilateral and multilateral surveillance has become more integrated over time.** Bilateral surveillance usually reflects WEO projections for the real sector, in particular commodity prices and economic growth, and generally takes into account developments in major regional trading partners. Bilateral surveillance in the G-3 countries takes into account the global importance of their trade policies. Multilateral surveillance, the WEO in particular, has been an effective tool for highlighting global risks and analyzing the global ramifications of economic policies in the G-3. Since 2002, there has been progress in developing the GFSR, expanding regional surveillance initiatives, and strengthening the analysis of trade policy spillovers from the G-3.

56. **Enhanced focus on global and regional spillovers would strengthen the Fund's surveillance.** While key linkages are taken into account in baseline scenarios, discussions of the economic outlook and risks in many Article IV reports contain limited or vague references to the impact of global or regional economic developments, including potential shocks. More in-depth discussion of such spillovers would make vulnerability analysis more comprehensive and consistent across countries. Coverage of the global ramifications of economic policies and conditions in the G-3 countries in bilateral surveillance would provide opportunities to enhance the dialogue between the Fund and national (or regional) authorities on these issues.

57. **The following areas deserve particular attention:**

- **Fuller discussion of the systemic consequences of the policies G-3 countries in bilateral surveillance of these countries**, expanding on the approach already adopted for coverage of trade policies. Article IV consultations could regularly discuss the impact of their fiscal, monetary, exchange rate, and key structural policies on global growth and capital market conditions, building on treatment of these issues in the WEO reports and the GFSR.
- **In bilateral surveillance of all countries, more explicit links of past and prospective economic performance to global economic and financial conditions.** Depending on country circumstances, this might involve references to the impact of global growth trends, commodity/oil price trends, movements in G-3 exchange rates, or trends in global capital markets, such as the low level and expected increase in world interest rates.
- Also in bilateral surveillance of all countries, enhanced identification and analysis of key country-specific vulnerabilities related to specific global economic and financial risks. The latest WEO, GFSR, and IMFC communiqué noted a number of global risks, including the large global imbalances; public debt sustainability; the transition to a higher interest rate environment; oil market developments; and geopolitical uncertainties. The vulnerability analysis in Article IV reports should highlight which global risks, if any, could translate into significant country-specific shocks. For countries where a specific global shock (or shocks) would have serious macroeconomic implications, reports could present a relevant alternative scenario (or scenarios) or stress test (or tests), similar in nature to the alternative scenarios or stress tests currently used in the internal vulnerability exercise. These scenarios and stress tests would help illustrate the potential magnitude of global shocks on the domestic economy.
- **More systematic use of existing regional surveillance initiatives to analyze regional spillovers and risks.** This would strengthen vulnerability analyses in bilateral consultations, and provide for a more consistent treatment of risks across countries.
- **Fuller exploitation of multilateral surveillance exercises to ensure that capital account projections for individual countries consistently reflect current thinking about prospective conditions in global capital markets.**

58. **It may be desirable to boost specific mechanisms for encouraging greater integration of bilateral, regional, and global surveillance.** Possibilities include (i) strengthening internal procedures to facilitate consideration of key risks identified in the WEO reports, GFSRs, and IMFC communiqués in bilateral surveillance activities, including broader dissemination within staff of high-frequency assessments of global conditions and risks currently done by RES and ICM and greater use of pre-brief meetings for this purpose;



(ii) discussing regional developments at the Board, possibly annually, based on inputs prepared by area departments—inputs could include standardized indicators for all countries in the region; and (iii) strengthening elements pertaining to global capital market conditions, including in the WEO’s analytical apparatus, in cooperation with ICM (e.g., addition of medium-term projections of ten-year benchmark bond yields in mature markets, enhanced reviews of capital account projections for individual countries against global developments).

## **B. Exchange Rate Analysis<sup>31</sup>**

59. This chapter considers three related issues: the extent of coverage of exchange rate issues in Fund surveillance over the last two years; advice on exchange rate regimes during that period; and conclusions of assessments of external competitiveness. It does so in light of research findings on exchange rate regimes and Board guidance on exchange rate issues.

### **Research findings**

60. **Over the past decade, new considerations for choosing an appropriate regime—and on its impact on economic performance—have emerged.** While regime choice had previously been related mainly to the nature of shocks that a country faced and to its trade linkages, the role of exchange rate regimes as a mechanism of policy commitment became more prominent. For example, for countries with a history of inflation, a pegged exchange rate regime was viewed as a stronger and more visible anchor for prices and expectations than any alternative anchor. However, as the decade proceeded, pegs were increasingly seen to hinder countries’ ability to handle volatile capital flows and to invite speculative attacks.

61. **The currency crises of the 1990s prompted advocacy by some of a bipolar view of exchange rate regimes,** according to which only regimes at the polar ends of the flexibility spectrum—“hard” pegs and free floats—would prove sustainable over the longer term (Fischer, 2001). Proponents of this view argued that soft pegs reduced policymakers’ flexibility in responding to unexpected events but, at the same time, lacked sufficient resilience in the face of speculative attacks. In practice, evidence of a shift towards polarization of exchange rate regimes is not clear: MFD’s 2002 review of exchange rate arrangements and foreign exchange markets concluded that there had been such a shift during the previous decade, which had been more pronounced in countries that have gained access to international capital markets;<sup>32</sup> by contrast, using a different classification of *de facto* regimes, Rogoff et al (2004) find no evidence of a generalized bipolar propensity.

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<sup>31</sup> The main authors of this section are Ashoka Mody and Tania Reif.

<sup>32</sup> *Exchange Arrangements and Foreign Exchange Markets—Development and Issues, World Economic and Financial Surveys*, March 2003, available at [www.imf.org](http://www.imf.org)

62. **A recent generation of papers offered more nuanced assessments of the relationship between regime choice and economic performance.** Using data for the post-Bretton Woods era for over 100 countries and focusing on regimes as they are actually operated (*de facto* regimes) as distinct from the announced (or *de jure*) regimes, the analysis initiated by Ghosh, Gulde, Ostry, and Wolf (1997) and Ghosh, Gulde, and Wolf (2003), found that inflation under fixed exchange rate regimes is significantly lower than under intermediate or freely floating arrangements, due to greater confidence in the currency (a credibility effect) and lower money growth (a discipline effect). They did not, however, find evidence of a strong link between exchange rate regimes and economic growth, especially after controlling for country-specific effects and possible simultaneity bias. This result contrasts with Levy-Yeyati and Sturzenegger (2002) who used their own “de facto” classification of regimes and found that flexible exchange rates are associated with higher growth in developing countries. They did not find a similar association between exchange rate regime and growth among industrial countries.<sup>33</sup>

63. **Fresh evidence presented by Rogoff et al (2004) suggests that the performance of alternative exchange rate regimes, and hence the choice of the appropriate regime, depends importantly on the maturity of member countries’ economies and their institutions.** Developing economies that have limited interactions with international capital markets appear to benefit from policies that imply strong commitment to stable exchange rate and monetary policies. The harder end of the commitment in exchange rate regimes delivers lower inflation without sacrificing economic growth.<sup>34</sup> For emerging market countries, policy commitment in the form of a pegged (or nearly pegged) regime may also deliver lower inflation on average, but those gains may unravel in periodic crises, as the likelihood of financial crises is high with these regimes. When countries graduate to the status of advanced economies, the evidence suggests they benefit from flexibility with higher growth and lower inflation. For these countries, the credibility of their economic policies derives from their institutional framework rather than from special instruments designed to severely limit the discretion of policymakers.

64. **Account must also be taken of the literature on optimal currency areas, which points to conditions that may favor the hardest form of peg over exchange rate flexibility** (see Mongelli 2002 for a recent survey). Broadly speaking, the literature on optimal currency areas seeks to identify conditions under which the gains from greater economic integration resulting from adoption of a common currency exceed the costs of reduced flexibility. It typically points to high mobility of factors of production, price/wage

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<sup>33</sup> How to classify exchange rate regimes remains a debated issue. Accordingly, several missing and inconclusive observations in the Levy-Yeyati and Sturzenegger (2003) classification have raised concerns about their conclusions.

<sup>34</sup> This result is also consistent with the finding that relatively poor and small countries benefit from currency unions in the form of enhanced trade (Rose, 2004, and Thom and Walsh, 2002).

flexibility, economic openness, diversification in production and consumption, and fiscal and political integration.

65. **Overall, the economic literature offers useful, but limited, guidance on exchange rate regimes.** It indicates that, for countries that maintain their own currency, the degree of maturity of the economy is an important factor to consider in the choice of exchange rate regime. It also strongly suggests that the choice of exchange rate regime is complex; it cannot be reduced to a simple exercise of selecting “the” right regime on the basis of a limited set of country characteristics.

### **Board guidance**

66. **Executive Directors have repeatedly stressed that a thorough discussion of exchange rate issues is essential for Fund surveillance.**<sup>35</sup> At the conclusion of the 2002 biennial surveillance review, Directors urged that exchange rate issues be treated candidly throughout the membership. Directors had earlier emphasized that the Fund must take into account the provisions in the Articles of Agreement that it is for members to choose their exchange rate arrangements; and that the Fund should continue, in the context of Article IV consultations, to discuss with country authorities the requirements for making a chosen exchange rate regime function reasonably well in the particular circumstances of that country and to actively advise on the suitability of the exchange rate regime.<sup>36</sup>

67. **In their 1999 discussion of exchange rate regimes, Directors reached a number of conclusions on regime choice,** including the following:<sup>37</sup>

- no single exchange rate arrangement was appropriate for all countries or in all circumstances;
- the system of flexibility among the exchange rates of the dollar, the euro, and the yen was not expected to change;
- for a significant number of countries, the widespread liberalization and expansion of capital movements has made it more difficult to sustain pegged rates; for these

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<sup>35</sup> These appeals have been reinforced by calls for the Fund to intensify its surveillance over members' exchange rate regime and supporting policies, underscoring the importance of an improved understanding of the macroeconomic performance of alternative regimes (Calomiris, 1998; International Financial Institution Advisory Commission, 2000; Mussa, 2002; and IMF, Independent Evaluation Office, 2002).

<sup>36</sup> *Exchange Regimes in an Increasingly Integrated World Economy* (Occasional Paper No. 193, 8/10/2000), available at [www.imf.org](http://www.imf.org).

<sup>37</sup> *Ibidem*.

countries, a tendency toward either more flexible arrangements or more constraining exchange rate systems was perceived;

- for many emerging market economies, a substantial degree of flexibility was desirable; however, freely flexible exchange rates were not a viable option for all emerging market countries, and, in practice, many would want to use intervention and domestic monetary policy to guide exchange rate movements; and
- for smaller more open economies, and especially those with limited involvement in global capital markets, a peg would likely continue to be the preferred course.

68. These conclusions appear to be generally consistent with the recent research findings described above. One exception may be the tendency toward movement to the “extremes”, where evidence is unclear.

#### **Review of Article IV consultation reports**

69. The following paragraphs provide an analysis of the coverage of exchange rate issues in Article IV consultation documents discussed by the Executive Board between January 1, 2003 and March 4, 2004.<sup>38</sup> These issues are among the most sensitive topics addressed in Fund surveillance. It is therefore possible, and indeed likely, that the treatment of exchange rate issues in Article IV consultation reports do not always fully reflect discussions between country authorities and staff. This caveat likely applies even if country authorities chose not to publish the Article IV consultation reports: experience during the period that preceded publication of staff reports suggests that staff exercises great caution regarding inclusion of highly sensitive material in staff reports. Thus, the following paragraphs may underreport treatment of exchange rate issues in bilateral contacts.

70. **Discussions of exchange rate regimes typically focused on consistency of the given regime with underlying macroeconomic and structural policies, institutional conditions, and the external environment**—rather than on the choice of exchange rate regime *per se*. An exception to this rule was provided by EU accession countries; in the perspective of an eventual adoption of the euro, the choice of the exchange rate (and monetary) regime was a key issue in these Article IV consultations.

71. **A pegged exchange rate was the only regime whose sustainability was ever questioned.** When this issue arose, discussions typically focused on the threat of a weak fiscal position or concerns about external competitiveness. In addition to policy consistency, **discussions of exchange rate policies sometimes addressed management of the exchange rate regime.** This was particularly common for emerging market countries whose regime

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<sup>38</sup> See Appendix for the questionnaire.

was a managed float. For these countries, the focus of discussions typically was on the extent of exchange rate intervention.

72. **Very seldom was the *de facto* regime identified as different from the *de jure* regime.** This was done in 8 out of 140 cases. Hence, the difference between *de facto* and *de jure* classification stressed in research work was not found in Article IV consultation reports. This discrepancy may be due to the sensitivity of the matter or lack of clarity in existing guidelines on the importance of considering this issue.

73. **When offered, policy advice leaned towards greater exchange rate flexibility, except when the current regime was a hard peg or movement toward a hard peg was considered. For hard pegs, advice was generally on seeking greater flexibility in other sectors of the economy (e.g., labor market flexibility) or fiscal tightening.** Greater flexibility was generally recommended on the grounds that it would protect external competitiveness and facilitate diminution of external imbalances.

74. **Assessments of external competitiveness were often limited to an analysis of movements of a real effective exchange rate indicator.** Use of a broad range of competitiveness indicators (e.g., market shares, comparative cost measures) or of econometric methods (e.g., estimations of a long-run relationship between the exchange rate and fundamentals) was not common. In many cases, this may be the consequence of significant data constraints.

75. **Real exchange rates were often found to be ‘about right’ or in line with fundamentals.** However, when a misalignment was identified, reports typically concluded that the exchange rate was overvalued. Cases where the exchange rate was assessed to be undervalued were very rare. Furthermore, in these few cases, the degree of undervaluation was typically considered to be slight or insignificant. This suggests a bias in staff’s estimates since the prevalence of currency undervaluation—i.e., its frequency across countries (weighted by size) multiplied by its magnitude—should be commensurate with the prevalence of currency overvaluation. Alternately, it may indicate that staff is more sensitive to the risks of overvaluation than of undervaluation.

76. **When advice on exchange rate adjustment was given, i.e. on the need for greater exchange rate flexibility or for an exchange rate depreciation, authorities tended to disagree.** Authorities generally stressed the benefits of a stable exchange rate for price stability and the potential negative impact of exchange rate volatility on sectoral balance sheets and growth.

77. **When staff and the authorities disagreed on exchange rate policies, Executive Directors usually held divergent views.** In such cases, a number of Executive Directors typically shared the authorities’ views that the current exchange rate policy continued to be appropriate; while a number of other Directors saw merit in staff’s calls for an eventual policy change.

## Conclusions and recommendations

78. **The above review indicates that pointed discussions of exchange rate issues are rarer than may be warranted and, when they do take place, can be controversial. It suggests that candid treatment of exchange rate issues is, and will likely remain, a significant challenge.**

79. Mindful of this challenge, a few practical steps are worth considering:

- **greater candor in the description of the *de facto* exchange rate regime;**
- **more systematic use of a broad range of indicators, extending beyond real effective exchange rate series, and other analytical tools to assess external competitiveness;**
- **deeper scrutiny of alternative monetary and exchange rate regimes, including institutional requirements for making different regimes work well, when the views of the authorities and of the staff differ; and**
- **brief discussions of exchange rate issues within each region could be part of the proposed Board informal discussions of regional developments (paragraph 58).**

80. The above review also suggests that **it would be worth exploring further** (i) **whether the lessons of the past decade on the dangers of fixed exchange rates are being applied too broadly**, as research findings suggest that pegged regimes may be worth considering for developing countries with limited exposure to private capital markets; (ii) **whether, in the aggregate, there is some bias towards finding exchange rates overvalued**; and (iii) **what are the most promising paths to achieve a successful move towards greater flexibility**, as economies mature.

### C. Balance Sheet Analysis<sup>39</sup>

81. **In recent years, balance sheet issues have featured prominently in debates on economic developments in both advanced and emerging market economies.** In advanced economies, much attention was paid to the balance sheet effects of asset price movements (e.g., equity, real estate) and to the impact of population aging on public liabilities. In emerging market economies, debt sustainability (encompassing both debt level and structure), exposure to exchange rate shocks, vulnerability to shifts in market sentiment, and transmission of shocks from domestic balance sheets to the external sector have continued to be active issues.

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<sup>39</sup> The main authors of this section are Nicolas Blancher and Ioannis Halikias.

82. **At the Fund, policy and analytical work is supporting implementation of balance sheet analysis in surveillance.** Over the past two years, these activities have covered the balance sheet approach (BSA), debt sustainability assessments (DSAs), financial soundness indicators (FSIs), FSAP exercises, and work on liquidity management.<sup>40</sup> The WEO chapters on asset price booms and busts (April 2003), public debt sustainability (September 2003), and credit booms (April 2004) and the systematic focus in the GFSR on balance sheets in industrial countries (and the implications for financial markets) are examples of a focus on such issues in multilateral surveillance. A framework to promote balance sheet analysis in the Fund is being implemented, which cover data compilation issues, as described in the February 23, 2004 note on *Integrating the Balance Sheet Approach into Fund Operations*.

83. This section takes stock of the initial impact of these efforts on the depth of coverage of surveillance, and identifies the challenges ahead. While implementation of several of the individual initiatives mentioned above has been or will be considered separately by the Board, this chapter focuses primarily on their integration into the analysis and focus of bilateral surveillance. It is based on the review of Article IV staff reports described in Section II.A., as well as on closer scrutiny of a few surveillance cases. These cases help illustrate how comprehensive balance sheet analysis can be conducted, what it can bring to individual surveillance exercises, and what operational challenges are faced.

#### **Review of recent Article IV staff reports**

84. Article IV consultation reports provide an increasingly substantial coverage of sectoral balance sheets:

- **Reliance on a full balance sheet framework that cover assets and liabilities of the government, financial, nonfinancial, and external sectors is still exceptional.**<sup>41</sup> It remains limited to a few staff reports, including Peru and Thailand. Staff expects some additional full balance sheet matrices to be incorporated into forthcoming Article IV staff reports in the near future.
- **However, recent initiatives have helped strengthen substantially the coverage of balance sheet issues in key sectors.** In particular:
  - **Implementation of the strengthened framework for debt sustainability assessments (DSA) has helped sharpen attention to public and external balance sheets.** A majority of 2002-03 staff reports provided a DSA

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<sup>40</sup> See Box 1 in the report on the *Review of Data Provision to the Fund for Surveillance Purposes* (4/12/2004), available at [www.imf.org](http://www.imf.org), for a presentation of the coverage of, and articulation between, these initiatives.

<sup>41</sup> For a full description of such a framework, see *The Balance Sheet Approach and its Application at the Fund* (6/30/2003) and *A Balance Sheet Approach to Financial Crisis* (Working Paper No. 02/210, 12/1/2002), available at [www.imf.org](http://www.imf.org).

(63 percent), especially reports for advanced and emerging market economies (72 and 88 percent, respectively).

- **Progress is also evident in financial sector surveillance based on FSIs and FSAPs.** Overall, 44 percent of recent Article IV consultation reports either provide some FSIs or make use of analysis presented in FSSA reports. This proportion increases to 78 percent for reports on advanced and emerging market economies.
  - **Overall, selective coverage of balance sheet issues is frequent.** While coverage of external and public sectors is most frequent across the membership (in line with the use of DSA), balance sheet conditions in other key sectors are often addressed, particularly in advanced and emerging market economies. Financial sector balance sheets are covered in a majority of staff reports, and corporate sector balance sheets in about half of them. Household balance sheets are discussed in many staff reports on advanced economies. Overall, all staff reports on advanced and emerging market countries include at least some balance sheet analysis.<sup>42</sup>
85. Balance sheet analysis in a number of Article IV staff reports goes beyond consideration of individual sectoral balance sheets. Specifically:
- **Some coverage of channels of transmission of shocks across sectoral balance sheets is provided in a majority of staff reports on advanced and emerging market countries.** Interestingly, the cross-sector balance sheet analysis in emerging market economies often focuses on a larger number of transmission channels than in advanced economies (see Box 9).
  - **Most importantly, balance sheet analysis increasingly informs staff’s macroeconomic analysis and policy advice.** This degree of integration is particularly evident in staff reports on emerging market economies where balance sheet analysis is almost systematically an explicit input into the macroeconomic analysis (e.g., macroeconomic conditions and outlook) and policy recommendations (e.g., monetary or fiscal policy stance) as well as, in a majority of cases, into assessments of the role of institutions (e.g., financial regulation and supervision). Such integration is more limited in advanced economies.<sup>43</sup>

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<sup>42</sup> For example, in advanced economies, the following topics have been a focus of surveillance: foreign exchange loans to households in Austria; household saving in Canada and the U.S.; bank international linkages and foreign exposures in Germany, Portugal and Spain; corporate sector vulnerabilities in Japan (including stress tests); and pension fund issues in the Netherlands and the U.S. In emerging market economies, corporate sector balance sheets have been a focus of staff reports on Malaysia, Mexico, and South Africa.

<sup>43</sup> Mirroring this, integration of balance sheet analysis is absent in 24 and 44 percent of staff reports in advanced and developing economies—against 4 percent in emerging market economies.



**Box 9. Coverage of Balance Sheet Issues in Article IV Staff Reports—  
Positive Examples**

**United Kingdom** – Staff report for the 2003 Article IV consultation

This staff report provides an example of close integration between the analysis of a particular sector's balance sheet on the one hand, and the discussion of core macroeconomic and policy issues on the other. A quantitative and qualitative analysis of household balance sheets illustrates the risks posed by the combination of highly leveraged households, a possible house price bubble, and the traditional sensitivity of consumption to house price developments. Available information on the distribution of debt and liquid assets within the sector also points to the existence of more severely exposed segments. A key immediate policy challenge is to engineer a soft landing, i.e., to avoid an abrupt correction in housing and credit markets. Various channels through which monetary tightening could trigger a rapid weakening of household balance sheets (and consumption) are addressed, including: on the liability side, the increased difficulties for households to service their debt—possibly triggering a credit crunch; on the asset side, the negative impact of a drop in house prices; and, also, the impact of rising unemployment. Against this background, staff and the authorities agree that asset price considerations should be factored into the inflation targeting framework and, specifically, that the unusually high household debt level necessitates gradualism in monetary policy adjustments.

**Peru** – Staff report for the 2003 Article IV consultation

In this case, staff implemented the balance sheet approach based on the matrix provided in *Allen et al.* This allows for a systematic and quantified assessment of currency and maturity mismatches within and across the balance sheets of all sectors, and a good understanding the potential macroeconomic implications of such exposures. These findings are used in particular to: (i) put some of the vulnerabilities into perspective, e.g., by highlighting that the risks associated with substantial currency mismatches are mitigated by favorable maturity structures and, therefore, relatively high foreign currency liquidity; (ii) identify specific potential weak spots, e.g., significant foreign currency lending by banks to non-exporting firms; (iii) identify the most likely channels of transmission of crisis pressures, e.g., from the nonfinancial private sector to banks to the government; and (iv) recognize the key factors accounting for the economy's resilience during past periods of regional turbulence, e.g. its high level of reserves that cover not only short-term external debt but also domestic dollar deposits. The main conclusions of the analysis are closely reflected in the discussions with the authorities, as they inform staff's policy advice in the areas of bank supervision, exchange rate policy and reserve adequacy.

86. **Balance sheet issues have received substantial attention in Fund surveillance of both advanced and emerging market economies.** In advanced economies, the focus has been on private balance sheet vulnerabilities in connection with risks stemming from house prices and mortgage lending (e.g., Australia, Ireland, the Netherlands, Norway, Portugal, the U.K. and the U.S.). Corporate balance sheets have also received attention, particularly in the largest advanced economies. In emerging market economies, staff reports have focused on the potential transmission of shocks across sectors under crisis conditions (e.g. from corporate sector to banks to government), the key factors promoting resilience in such circumstances, and ensuing policy advice in the areas of banking supervision, exchange rate policy and reserve adequacy assessments (e.g., Peru). Box 9 provides some examples of staff reports where balance sheet analysis was particularly substantive or well integrated into macroeconomic analysis and policy advice.

87. **While data availability is generally known to be an obstacle to detailed balance sheet analysis (especially corporate and household sector data), staff reports rarely identified specific data constraints.** As noted above, the generalization of DSA has provided a greater focus on public and external sector data, and FSAP exercises and the FSI initiative has contributed to strengthen the reporting of financial sector data. However, efforts are still needed to make available more comprehensive balance sheet data, as evidenced by the difficulties in implementing the full balance sheet matrix or in obtaining key indicators essential for vulnerability analysis, such as indicators on maturity and currency mismatches.<sup>44</sup> Staff reports rarely addressed these data issues explicitly.

### Conclusions and recommendations

88. **Efforts to strengthen balance sheet analysis in Fund surveillance are already making an important contribution to enhancing the quality of Fund surveillance. These efforts deserve to be pursued diligently and pragmatically, recognizing constraints stemming primarily from data weaknesses.** Balance sheet analysis constitutes a useful complement to flow-based analysis, helps provide a fuller picture of countries' vulnerabilities, and thus strengthens further the risk-orientation of surveillance.

89. **In the short-term, significant progress is possible based on information already available in member countries.** Staff increasingly use balance sheet concepts to focus surveillance on key vulnerabilities, especially in advanced and emerging market countries, and in the public and financial sectors. Implementation of other related initiatives (DSA, FSIs) is also well advanced. However, there is more room to systematically:

- **Cover key balance sheet issues, including cross-sectoral transmission channels, in countries where the required data exist.** More systematic attention could be paid

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<sup>44</sup> See *Review of Data Provision to the Fund for Surveillance Purposes* (4/12/2004), available at [www.imf.org](http://www.imf.org).

to these data, especially in advanced economies. At the same time, such a focus should remain selective, reflecting each country's specific circumstances. For instance, one may expect household balance sheets to be more relevant to macroeconomic analysis in advanced countries than in emerging market countries; and, conversely, the external balance sheet to have more significant implications for vulnerability analysis for emerging market countries than for advanced economies.

- **Integrate the results of balance sheet analysis into macroeconomic analysis and policy advice, especially in advanced economies.** While the review shows a high degree of integration in staff reports for emerging market countries, there is room for greater reflection of analysis of balance sheet vulnerabilities in policy discussions in surveillance of advanced economies.

90. **Looking further ahead, increased data availability will allow for a more widespread and precise focus on balance sheet analysis across the membership.** Analysis that can underpin the formulation of finely-calibrated, convincing policy advice requires a comprehensive coverage of sectoral balance sheets, which in practice is hampered by data limitations. For instance, the lack of detailed balance sheet data on the corporate sector is a frequent impediment to proper analysis of financial sector soundness—if not, by extension, of public debt and fiscal sustainability. Staff reports can contribute to identify priorities for data compilation to fill these gaps progressively, according to each country's specific context.

91. **In light of the above, it is recommended to continue with a selective implementation of balance sheet analysis in surveillance activities.** Overall data and resources constraints that affect the implementation of balance sheet analysis in the Fund were discussed by the Board in the context of the latest review of the Data Provision policy. Priority for implementation should be for countries where risks are more prevalent, countries whose economic developments have systemic or regional implications, or countries where experimentation is facilitated by better availability of data.

#### **D. Institutional Underpinnings of Growth<sup>45</sup>**

##### **Introduction**

92. **Over the past decade, the view that “institutions matter for growth” has gained considerable credence.** Many factors in different regions of the world have contributed to this development. The experience of transition economies showed that sound institutions and legal framework were essential ingredients in the transformation to a market economy. The Asian crisis demonstrated that weaknesses in supervisory regimes, reserves management, corporate governance, and other institutional issues could threaten economic stability and

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<sup>45</sup> The main authors of this section are Lynn Aylward, Anton Op de Beke, and Todd Schneider.

hurt growth. The debate on globalization has brought renewed attention to the distribution and determinants of international private capital flows, including to institutional conditions that promote domestic and foreign investment. The international community's focus on achievement of the Millennium Development Goals (MDGs) has strengthened attention to the conditions necessary to spur higher growth and reduce poverty and, among these, to sound economic institutions. Many activities carried out by the Fund, including FSAPs, ROSCs, offshore financial center assessment reports, and technical assistance (TA) reports, have extensive coverage of institutional issues and can inform surveillance in this area.

93. **This section considers the treatment of the institutional underpinnings of growth in Fund surveillance, focusing on three distinct but inter-related and overlapping areas, namely institutions, the investment climate, and governance**—Box 10 provides a selected definition of each of these three areas, whose characterization in the literature and in usage varies considerably. The chapter begins by a broad review of coverage of institutional reforms in Fund surveillance. It then pays closer attention to issues that relate specifically to the investment climate. It ends with a review of coverage of governance, in light of previous guidance from the Executive Board. The first two sections of this chapter focus on low and middle-income countries, while the third encompasses the whole membership as governance issues are of concern to all.

**Box 10. Selected Definitions of Institutions, Investment Climate,  
and Governance**

**Institutions:** the organizations, markets, regulatory frameworks, and practices that governments, businesses, and individuals use when they carry out economic and financial activities.

**Investment Climate:** the macroeconomic conditions and policy, regulatory, and institutional frameworks that have a direct bearing on the ability of investors to assess risks and maximize risk-adjusted returns.

**Governance:** the practices and institutions through which power is exercised in the management of a country's economic and social resources.

## **Institutions**

### ***Background***

94. **As stressed in the chapter on *Growth and Institutions* in the April 2003 WEO report and the World Bank's 2002 World Development Report on *Building Institutions for Markets*, the importance of institutions for economic development and growth has**

**long been understood.**<sup>46</sup> Thus, it is no surprise that, in the years following the adoption of the 1977 Surveillance Decision, institutional issues are one of the main areas that Fund surveillance came to cover, in addition to fiscal, monetary, and exchange rate policies.

95. **The fact that “institutions” is such a wide-ranging concept raises several pointed questions for surveillance.** Does surveillance manage to focus on the institutional issues of macroeconomic import and, more specifically, on issues that bear relation to the apex of the Fund’s hierarchy of concerns? Is it successful in linking this coverage to the overall assessment of economic conditions and policy recommendations made in Article IV consultations? In order to assess how institutional issues are being covered in Fund surveillance, the survey of Article IV reports done for this review included a set of questions on this area (see Appendix).

#### *Review of Article IV staff reports*

96. **Institutional issues were covered in a high share of surveillance reports (over ninety percent).** Reports with no coverage of institutional issues all pertained to small island economies.<sup>47</sup>

97. **The balance between the coverage of short-term macroeconomic and longer institutional issues was deemed appropriate for most countries.** Where macroeconomic instability was of immediate concern, institutional issues received relatively less attention, unless they were directly linked to relevant vulnerabilities. In contrast, in post-crisis, low-income countries, surveillance reports identified the main steps to achieve macroeconomic stability, but also gave great attention to priorities for building or rebuilding institutional capacity. However, in a small but non-negligible share of reports, there were suggestions that institutional issues had not received sufficient coverage.<sup>48</sup>

98. **The coverage of institutional issues was greatest in three areas: financial supervision and regulation and corporate governance; fiscal policy and operations; and legal and judicial reforms.** In the financial area, coverage most often related to the supervision and regulation of banks. It also addressed deposit insurance, anti money

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<sup>46</sup> A growing body of economic literature stresses that economic institutions are not exogenous (or so-called state) variables. It puts emphasis on the distribution of political power, which shapes economic institutions, and on its determinants, namely political institutions and distribution of resources, as ultimate determinants of differences in economic development (see, for instance, Acemoglu, Johnson, and Robinson (2004).

<sup>47</sup> This does not mean that all reports for small island economies had little or no coverage of structural issues. Institutional issues were covered extensively in reports for several small island economies (e.g., Antigua and Barbuda, Samoa, and Tonga).

<sup>48</sup> For instance, it was noted in one Article IV consultation that the report had limited coverage of institutional issues while the Executive Director’s Buff Statement emphasized their importance in fostering growth.

laundering and combating the financing of terrorism (AML/CFT), and corporate governance. This coverage often benefited from references to existing or forthcoming FSAPs. In the fiscal area, the most common issues were the transparency and operational efficiency of public enterprises and the management of public resources. Judicial and legal reforms were raised frequently across different types of member countries. Central bank institutional issues were mentioned about one-third as often as financial and fiscal institutional concerns; this likely reflects the relative strength of central banks across the membership, compared to other institutions in the financial and fiscal sectors. Even institutional issues in the social sector, such as the institutional capacity for pro-poor spending and social security institutions, received more coverage than central banks.

99. **Institutional issues were regarded as having potential macroeconomic implications in most cases.** For a number of countries, the link was through the impact of the poor management of public enterprises on growth. However, in about a quarter of cases, the macroeconomic import of an institutional issue could not be easily discerned from the overall content of the report. In some of these cases, the lack of clarity was because a specific institutional issue, such as the need for judicial reform, was mentioned early on in the Article IV report but never followed up; in some others, the institutional issues seemed important but their coverage was not well integrated with the overall assessment.

100. **Surveillance reports were generally successful in linking the coverage of institutional issues to the impact of institutions on growth and stability.** In some cases the link drawn by staff between institutional strengthening and growth was somewhat general. In others, institutional reforms were clearly identified as necessary for fostering private sector development, reducing high unemployment, or allowing the government to perform its most basic functions. For some low-income countries (e.g., the Republic of Congo, Namibia), institutional reforms were also explicitly linked to a country's poverty reduction efforts, PRSP, and/or plans to achieve the MDGs, giving greater prominence to the importance of these issues and their link to the overall policy strategy. These cases were, however, relatively rare.

101. **Reports on the Observance of Standards and Codes (ROSCs) are making a contribution to the frequency or depth of coverage of institutional issues.** There is some correlation between discussion of institutional issues and the number of completed ROSCs for a given country. Substantial references to completed ROSCs occurred in about fifty percent of reports. Fund technical assistance studies were also cited frequently.

102. **The coverage of institutional issues in areas outside the Fund's core expertise (e.g., corporate governance, accounting and auditing, insolvency) continues to be generally weak.** As noted in the last Biennial Surveillance Review, this probably reflects both that Fund staff may feel that they lack expertise in these areas; and that fewer ROSCs in these areas, in which the World Bank takes the lead, have been done. However, completed ROSCs

in areas where the World Bank takes the lead were never mentioned in the reviewed reports.<sup>49</sup>

103. **The staff's use of the work of external bodies to inform the coverage of institutional issues in surveillance is moderate.** External reports such as the EBRD's Business Environment and Enterprise Performance Survey, the World Bank-IFC's Foreign Investment Advisory Service, the private sector PRS Group's International Country Risk Guide, and reports by multilateral banks (e.g., an Asian Development Bank study on tax reform) and the United Nations were sometimes cited. However, the breadth and quantity of available material suggests that there could be more use of external work on institutional issues, especially in areas outside the Fund's traditional expertise.

104. **Article IV reports generally provided little information on implementation of previous recommendations for institutional reforms.** A few reports presented boxes that summarized the country's implementation of the body of recent Fund recommendations on institutional reforms; this was done almost always in a program context.

### *Conclusions*

105. **Appreciation for the importance of institutional issues in surveillance is manifest.** Institutional issues receive substantial attention in Fund surveillance.

106. **Institutional issues are being selectively covered.** Supporting this conclusion is the fact that in about 75 percent of cases, the macroeconomic implications of an institutional issue were made clear, and that coverage focused on areas at the top of the Fund's hierarchy of concerns.

107. Nevertheless, **greater selectivity in the coverage of institutional issues outside the Fund's core areas of expertise appears desirable.** Greater selectivity would allow deeper treatment of fewer issues even within a given resource envelope and, thus, help improve the quality of coverage of key issues outside the Fund's traditional areas of expertise. It would also facilitate coverage of institutional issues in areas or countries where existing background information may be more limited (for instance, due to the absence of ROSCs).

108. **There is a wide range of credible information available on institutional issues, and mission teams should be encouraged to draw on more of it.** Information from ROSCs, FSAPS, and TA is informing Fund surveillance, but its integration in surveillance could be improved. Information from the World Bank, EBRD, UN, and multilateral development banks is drawn on in only a small share (about 20 percent) of surveillance reports.

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<sup>49</sup> The potential contribution of ROSCs (and FSAPS) to coverage of institutional issues in surveillance is also affected by the voluntary nature of these initiatives.

109. **Fund surveillance could do a better job of reporting on a country’s implementation of past Fund advice on institutional reforms.** The relatively limited extent to which Article IV reports alluded to the authorities’ progress in this regard suggest that the Fund may be foregoing an opportunity to help keep a country focused on necessary institutional reforms and to acknowledge progress.

**Investment climate<sup>50</sup>**

*Background*

110. **Private investment is an essential contributor to growth and poverty reduction.** Thus, much attention has been paid to the investment climate, i.e., the macroeconomic conditions and policy, regulatory, and institutional frameworks that have a direct bearing on the ability of investors to assess risks and maximize risk-adjusted returns. Table 3 lists selected investment climate determinants.

**Table 3. Key Determinants of the Investment Climate**

<b>Macroeconomic Factors</b>	<b>Microeconomic Factors</b>	<b>Structural/Institutional Factors</b>
Macroeconomic stability and growth prospects	Financial system	Political stability
Exchange regimes	Corporate taxation	Governance/rule of law
	Trade and customs regime	Regulatory framework
	Labor markets	Legal framework

111. **Many different members of the international community work on understanding, measuring, and improving the investment climate in low- and middle-income countries.** The World Bank plays a major role (through, for example, the World Bank-IFC Private Sector Development Vice-Presidency and the Foreign Investment Advisory Service), and has recognized the improvement of the investment climate as a key pillar of World Bank Group work.<sup>51</sup> UNCTAD, the multilateral development banks, and many private organizations are also engaged in this work, as is the Fund.

<sup>50</sup> In addition to the review of Article IV consultation reports, this section draws heavily on the paper on the *Investment Climate—Concept and Selected Issues for Fund Surveillance*, available at [www.imf.org](http://www.imf.org).

<sup>51</sup> “Investment climate issues are to be part of systematic and regular analysis in preparation of country strategies and will be considered routinely in the Bank Group’s assistance strategies.” Private Sector

(continued...)



112. **A wide range of factors determine the investment climate.** These determinants include macroeconomic, microeconomic, structural, and institutional factors. While the list of determinants of the investment climate vary somewhat across different studies, Table 3 is representative of the factors that are typically highlighted.

113. **Treatment of the investment climate in Fund surveillance can be approached from the general principles on coverage of surveillance.** Macroeconomic conditions and policies have obviously always been at the heart of Fund surveillance. In addition, structural and institutional issues are treated in Fund surveillance to the extent that they have a bearing on macroeconomic developments and, more precisely, to matters at the apex of the Fund's hierarchy of concerns, which include sustainable growth and the policies to achieve it. Apart from its impact on growth, the investment climate is also a potential topic for Fund surveillance because of its relationship to foreign direct investment and, more broadly, the stability (or volatility) of capital account flows.

114. **The importance of the investment climate for the work of the Fund is reflected in a variety of initiatives adopted over the past few years.** Fund competencies in the financial and corporate sector have been strengthened with the creation of the Financial Sector Assessment Program (FSAP); Reports on the Observance of Standards and Codes (ROSCs); the International Capital Markets Department; and the Capital Markets Consultative Group (CMCG), to name just a few initiatives.<sup>52</sup> The Executive Board has encouraged the staff to continue its efforts to improve the assessment of investor sentiment in a country context.<sup>53</sup>

115. **This section takes stock of whether information on the investment climate is informing Fund surveillance and, if so, how.** To this end, the survey of Article IV reports included a set of questions on the investment climate (see Appendix).

#### *Review of Article IV staff reports*

116. **Coverage of determinants of the investment climate in Article IV staff reports on low- and middle-income members is common.** While generally not treated as a discrete subject of analysis or evaluated exclusively from the perspective of private investment, key determinants of the investment climate—beyond macroeconomic policies and financial sector issues—were covered in about 70 percent of reports for such members.

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Development Strategy – Directions for the World Bank Group, (World Bank Group 4/9/02), available at [www.worldbank.org](http://www.worldbank.org).

<sup>52</sup> See, for example, the CMCG report *Foreign Direct Investment in Emerging Market Countries*, September 2003, available at [www.imf.org](http://www.imf.org).

<sup>53</sup> *IMF Discusses Applications of and Methodological Refinements to Assessments of Sustainability* (Public Information Notice No. 03/111, 9/5/2003), available at [www.imf.org](http://www.imf.org).

117. **The coverage of issues related to the investment climate was considered useful and relevant in most of these reports.** There appeared to be some room, however, for a greater sense of the priority of investment climate-related reforms and more specific staff advice in this area.

118. **There are variations in the coverage of the investment climate across regions. Coverage of the investment climate was especially strong in transition economies and low-income countries in Africa.** In the former, extensive coverage was related to the focus of these reports on progress in market-oriented reforms. In the latter, it was linked to a clear recognition of the need for private sector-led investment to spur growth and poverty reduction. Coverage was lighter in Western Hemisphere countries and small island economies, which, for many countries and for the covered period, may reflect an appropriate focus on achievement and maintenance of macroeconomic stability.

119. **Outside expertise or information was cited in about 25 percent of the surveillance reports that covered the investment climate.** The main sources of internal or external information that staff cited as informing their analysis of the investment climate were ROSCs, PRSPs, Fund TA studies, Transparency International, and the EBRD Business Climate Indicators. For the nine countries for which **World Bank Investment Climate Assessments** exist (and for which an Article IV report has followed the issuance of the Assessment with a sufficient time lag for the Assessment to be incorporated), the assessments were not drawn on to any significant extent.

### *Conclusions*

120. **Coverage of determinants of the investment climate is quite common in Fund surveillance.** This certainly reflects the fact that a number of institutional issues receive substantial attention in Fund surveillance and that some of these are considered to be institutional determinants of the investment climate.

121. **Article IV consultation reports point to a number of cases where improving the investment climate is seen as important for growth and poverty reduction.** For example, some reports pinpoint that a more supportive environment for investment is needed to address macroeconomic problems such as underemployment or inefficient and excessive government involvement in the economy.

122. **The importance of the investment climate for growth might justify greater coverage in Fund surveillance. However, a selective and focused approach to coverage of this area will remain essential, given limits to staff's expertise and resource constraints.** In some country cases, conditions appeared to justify drawing attention to needed improvements in the investment climate, but coverage was limited or not informed by a clear set of priorities. Given resource constraints and limited expertise, meaningful coverage of determinants of the investment climate requires careful selection of its scope.

123. **The Fund’s coverage of the investment climate could draw more on external sources, especially World Bank’s expertise in this area.** Efforts are underway to compile information available from the World Bank, UNCTAD, and other providers; to step up discussions on investment climate issues through ongoing contacts with foreign investors; and to channel that information to Fund country teams on a more systemic basis.<sup>54</sup>

## Governance

### *Background*

124. **The Guidance Note on governance adopted by the Executive Board in 1997 promoted greater attention to governance issues in the Fund’s policy advice and technical assistance. The note identified two main areas for the Fund’s attention:**

- **improving the management of public resources** through reforms covering public sector institutions (e.g., the treasury, central bank, public enterprises, civil service, and the official statistics function), including administrative procedures (e.g., expenditure control, budget management, and revenue collection); and
- **supporting the development and maintenance of a transparent and stable economic and regulatory environment** conducive to efficient private sector activities (e.g., price systems, exchange and trade regimes, and banking systems and their related regulations).

125. The guidance note directed that the modalities for enhanced attention to governance issues would include:

- a more comprehensive treatment in the context of both Article IV consultations and IMF-supported programs of those governance issues within the Fund’s mandate and expertise;
- a more proactive approach in advocating policies and the development of institutions and administrative systems that embody good governance;
- an evenhanded treatment of governance issues in all member countries; and
- enhanced collaboration with other multilateral institutions, in particular the World Bank, to make better use of complementary areas of expertise.

126. **The 2001 review of the Fund’s experience with governance issues covered all strands of that work**—i.e., activities in the context of use of Fund resources, technical

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<sup>54</sup> See the paper on the *Investment Climate—Concept and Selected Issues for Fund Surveillance*, available at [www.imf.org](http://www.imf.org).

assistance, and surveillance. As regards the last of these, **the review found that such issues were receiving greater prominence in Fund surveillance**, which benefited from input from new initiatives such as standards and codes and safeguards assessments, **and that coverage was largely in areas where the Fund had expertise**, notably transparency and accountability in public resource management. More than half of Article IV consultation discussions in the period 1998–99 mentioned these issues, compared to around one-fifth in the pre-guidance-note period of 1994–95.

127. **Executive Directors welcomed the Fund’s heightened attention to governance as a key factor influencing economic performance.** They noted that coverage of governance issues had evolved in line with the Guidance Note. Directors agreed that governance issues with macroeconomic significance should continue to be raised in the context of surveillance and that there may be some instances where the Fund would have to be involved with specific remedial measures.<sup>55</sup> They were generally of the view that the Fund should explore ways to pay more attention to the two-sided nature of corruption, including by following up in Article IV discussions on the status of implementation of OECD-led initiatives to combat the bribery of foreign public officials (i.e., the supply side of international corruption), and in similar such initiatives. Directors indicated that subsequent reviews of the IMF’s experience with governance should be integrated into future reviews of surveillance, technical assistance, and conditionality.

128. **In order to assess how governance has been covered in Fund surveillance since the last Biennial Review of Surveillance, the survey of Article IV reports included a set of questions on governance, related to the scope of coverage and modalities specified by the guidance note** (see Appendix). In addition, additional analysis was carried out on the latest Article IV reports for all members to shed more light on variations in coverage across regions; the correlation of governance coverage with perceived governance quality; and the content of policy recommendations on governance.

#### *Review of Article IV staff reports*

129. **Governance issues continue to be raised in a significant share of surveillance reports.** The results of the questionnaire-based review of the Article IV reports showed a further increase in the coverage of governance in surveillance since the 2001 Review, with governance issues raised in about 70 percent of Article IV consultation reports.

130. **For all but advanced economies, the primary area of coverage of governance issues is the fiscal domain.** Transparency and accountability of the budget and public enterprises were prominent topics. Fiscal governance of extractive or other key sectors (e.g.,

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<sup>55</sup> The Fund has on several occasions interrupted or delayed financial support to member countries with Fund-supported programs because of the failure of the members to address specific governance concerns of the Fund and the international community.

forest sector) was raised in almost all relevant cases (Box 11).<sup>56</sup> Legal and judicial reforms, as well as broad-based anti-corruption strategies constituted another major area of coverage of governance issues. Other areas covered included nontransparent exchange rate systems, and financial institutional arrangements open to rent-seeking.

**131. Corporate governance was the issue most likely to be raised in surveillance of advanced economies.**<sup>57</sup> Further enhancements to fiscal transparency and governance issues related to EU accession were also raised.

**132. Coverage of the supply side of corruption was frequent.** The OECD Convention on Combating the Bribery of Foreign Public Officials in International Business Transactions is referred to in 29 surveillance reports, representing four-fifths of countries that have ratified this convention (Box 12). However, the reporting tends to be brief and descriptive. It does not appear to have received much attention in Board discussions of individual Article IV consultations.

**133. Overall, the focus of coverage was on the development of policies, institutions, and administrative systems that “embody good governance,” as the Guidance Note advocates, rather than on identifying cases of actual corruption.** This focus recognizes that corruption, the abuse of public power for private gain, is a particular subset of governance concerns. While governance issues were raised in about 70 percent of staff reports, corruption is raised in about 10 percent of reports.

**134. Differences in the extent of coverage of governance issues across individual Article IV can be largely explained by difference in country characteristics.** For instance, the degree of coverage of governance issues is reasonably well correlated with a World Bank corruption indicator (see Box 13). Differences in coverage across regions is also partly correlated with participation in the standards and codes initiative.

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<sup>56</sup> Box 11 provides additional information on the Fund’s role in governance initiatives relating to extractive industries.

<sup>57</sup> The GFSR has addressed the importance of corporate governance. This is another area where multilateral surveillance can inform bilateral surveillance.

### **Box 11. Governance in Natural Resource Exporting Countries**

The special challenges faced by developing countries exporting substantial natural resources are being addressed by a number of international initiatives that pursue revenue transparency as an important part of the solution. In 2003, the UK government launched the *Extractive Industries Transparency Initiative (EITI)*, building on the earlier NGO campaign *Publish What You Pay (PWYP)*.

The *EITI* is broader than the *PWYP*. Unlike the *PWYP*, which strives for mandatory disclosure by oil and gas companies of their payments, the *EITI* aims for voluntary disclosure not just by companies but also by governments. Companies would disclose in the aggregate, but according to the same templates as governments, so that a reconciliation would be possible.<sup>58</sup>

Experiences from many countries show that transparency is the key to accountability and efficiency in the use of the government's "rent" income from extractive industries. The transparent management of natural resource revenues establishes policy credibility and informs the domestic political debate. For these reasons, the IMF strongly promotes policy transparency, including through its transparency codes for fiscal and monetary and financial policies. Staff actively encourages transparency in revenue management in resource rich countries.

Fund staff is supporting the *EITI* in a way that fits within its existing or already planned activities. Fund staff advised on the reporting templates, a first version of which is now being tried out in a few pilot countries. A supplement to the fiscal transparency manual with good practices on resource revenue management is under preparation. Where appropriate, Fund staff has suggested to authorities to consider discussing participation in the *EITI* with their extractive industries. When information emerges from the *EITI*, staff expects to be able to use it for more comprehensive and accurate assessments of members' budgetary outlooks. During Article IV discussions, the Board has welcomed the plans of several countries to participate in the *EITI*, e.g., Ghana, Sao Tome and Principe, and Trinidad and Tobago. In the case of Ghana, the Board also asked that the fiscal ROSC concentrate on resource revenue transparency.

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<sup>58</sup> For information on *PWYP*, see <http://www.publishwhatyoupay.org/>, and for information on the *EITI*, see <http://www.dfid.gov.uk/>.

**Box 12. Follow-up of Implementation of the OECD Anti-Foreign Bribery Convention<sup>59</sup>**

At the February 2001 governance review, the Board asked that staff use Article IV consultation missions and reports as vehicles to follow up on members' implementation of the *OECD Convention on Combating the Bribery of Foreign Public Officials in International Business Transactions*. Adopted in 1997, and effective as of 1999, this *Convention* was seen by many as a promising development in the fight against international corruption. It requires ratifying countries to criminalize the bribery of foreign officials, and to treat it with the same severity as the bribery of domestic public officials. The *Convention* emphasizes the responsibility of developed countries in stemming the supply of bribery to developing countries.

By now all thirty OECD members, and five non-members, have ratified the *Convention*. The OECD's monitoring of the implementation of the *Convention* follows the peer-review model. A first phase focused on whether all signatories had brought their legislation up to the standards of the *Convention*. While quite a few recommendations coming out of that phase still need to be implemented, the monitoring has now entered a second phase. This phase focuses on enforcement, and includes on-site consultations with officials and a broad range of private sector and civil society representatives. External observers have concluded that there has been little enforcement of the new laws by national governments so far, other than by the United States.<sup>60</sup> However, several investigations are ongoing and may lead to trials and possibly convictions.

In the period from March 2001-April 2003, 60 percent of staff reports made mention of the *Convention*. The references were typically short. All in all, the *Convention* has been referred to in an Article IV report at least once for 29 of the 35 countries that ratified it.

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<sup>59</sup> For an analysis of the genesis and content of the *Convention*, see *OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions* (9/18/2001), available at [www.imf.org](http://www.imf.org).

<sup>60</sup> See *Global Corruption Report 2004*, Transparency International (page 128) which can be found at <http://www.transparency.org/>.

### **Box 13. Additional Analysis of the Coverage of Governance Issues in Surveillance**

#### **Analysis**

A more extensive analysis of the treatment of governance issues in surveillance was carried out by assessing the most recent Article IV staff report for each of the Fund's 184 member countries, starting in January 2004 and proceeding backwards in time.

The occurrence of governance references was assessed for: coverage by per capita income level; coverage by region; coverage in surveillance of program versus nonprogram members; and a comparison of Fund coverage with an outside indicator of corruption (e.g., one of the World Bank governance indicators)

The substance of the governance/corruption references was also assessed, in terms of: the economic policy categories in which they fall; whether they contain general or specific comments; whether they are descriptive or proscriptive (advise, recommendation); whether they have institutional dimensions (to address concern that Fund neglects institutions); whether they are linked to a Fund-supported program; whether the involvement of another institution is mentioned.

#### **Results**

- Coverage is broad: governance references occur in roughly 75 percent of Article IV staff reports and in 60 percent of those the issue is picked up in the staff appraisal.
- Coverage of governance is inversely related with a World Bank indicator of corruption. Only reports for one out of six countries in the lowest corruption control category did not raise governance as an issue.
- Governance was covered in reports for several OECD countries (i.e., Australia, Canada, France, Japan, The Netherlands, Spain, Switzerland, Turkey, UK and the US). In most of them, the references are to corporate governance.
- Using the World Bank indicator as a control variable, coverage appears to exhibit regional variations. For example, coverage for Middle East and Central Asia region is below the average in the lowest and highest corruption control groups. Coverage in Europe is low compared to Africa, Asia, and Western Hemisphere for the two highest corruption control categories of countries.
- Frequently the references to governance are of a general nature. Most references are descriptions of actions or intentions and staff endorsement is only implicit. Moreover, reports rarely evaluate past improvements in governance as a result of specific actions.
- Most governance references deal with the establishment or reinforcement of institutions.



135. **The macroeconomic relevance of the governance issues raised was generally obvious.** There may be cases where the import of governance issues would deserve a fuller treatment, since a number of reports mentioned governance as a main obstacle as growth in general terms but included few specific references to particular issues.

136. **One aspect of the coverage of governance issues, namely treatment of past and current policy recommendations, appeared relatively weak.** In many cases, references to governance tended to be limited to descriptions of what the authorities were planning to do, or had done; they stopped short of assessing whether these steps would be or have been sufficient and effective, or indicating what additional measures might be needed.

137. **Staff's reliance on the information and expertise available from external bodies appeared limited, except as regards cooperation with the World Bank in a program context.** Explicit references to use of World Bank expertise or information in stand-alone surveillance reports were rare. This contrasts with evidence in combined Article IV-UFR reports that the Fund is coordinating well with the Bank in a program context on governance issues where the Bank takes the lead, such as civil service and public enterprise reforms. The staff appeared to draw on other outside information only occasionally. Some Article IV documents reported governance indicators compiled by other institutions or groups (e.g., the World Bank, Transparency International). The staff report for Azerbaijan provided a good example of the use of external information on governance, drawing on the governance-related work of the World Bank and reports from the EBRD, the IFC, and the Heritage Foundation. Other country reports cited the EBRD Business Indicators and TA-type reports by multilateral development banks. The discussion of governance issues also drew on fiscal ROSCs, but rarely on other types of ROSCs.<sup>61</sup>

### *Conclusions*

138. **The basic requirements of the Fund's policy on governance are being well met in the context of surveillance.** The treatment of governance in surveillance is generally fulfilling the objective of identifying issues of actual and potential macroeconomic significance in areas within the IMF's mandate and expertise, when these exist.

139. **Coverage of governance issues should remained selective, based on country-specific circumstances and the criterion of macroeconomic relevance, and focused on issues within the Fund's expertise.** To promote selective but evenhanded coverage, staff could be encouraged to take into consideration governance indicators published by other institutions (e.g., the World Bank, Transparency International) more systematically, when deciding upon coverage of governance issues in Article IV consultations.

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<sup>61</sup> While monetary and financial policy transparency ROSCs were not frequently cited in the survey staff reports, governance generally receives prominent coverage in such ROSCs.

140. **The substance and consistency of the treatment of governance in staff reports could be strengthened, where relevant, with greater specificity and more focus on policy recommendations and actions.** As noted, identification and description of governance issues in Article IV consultation reports seem generally satisfactory. To raise the impact of the Fund's attention to governance issues in surveillance where warranted, improvements in coverage could focus on provision of more specific policy recommendations; better reflection in staff appraisals of discussions of governance issues; and more attention to the authorities' responses to past advice on governance, in order to highlight achievements and implementation difficulties.

141. **The supply-side of corruption could be covered more effectively through revised modalities.** Reporting on the OECD Anti-Foreign Bribery Convention in Article IV consultation reports tends to be brief and purely descriptive, and has generated little discussion at the Board. Alternative approaches to the coverage of the supply side of corruption are worth considering. One possibility would be (i) to use Article IV consultations or alternative vehicles to collect information on implementation of the OECD Convention;<sup>62</sup> and (ii) to disseminate information on such activities to the Board through periodic, cross-country reports. This approach could help give greater prominence to the Fund's treatment of the supply side of corruption.

142. **Staff should draw more systematically on ROSCs and on the wealth of other material on governance that is available externally, including from the World Bank.** Drawing on credible external information would support many of the Guidance Note's directives (increased attention to governance; even-handedness; proactiveness; a preventative approach; and enhanced collaboration with other multilateral institutions), while limiting further strains on staff resources. Fund staff would continue, per the Guidance Note, to be expected to make their own independent assessment of governance issues in a given country.

### **Conclusions and recommendations**

143. **Institutional reforms, the investment climate, and governance are receiving substantive, though selective, coverage in Fund surveillance.** This coverage suggests that staff have taken on board the importance of institutional issues for stability, growth, and poverty reduction, when these issues are of macroeconomic importance.

144. However, **there could be still greater selectivity in coverage of institutional issues, i.e., fewer issues treated in greater depth; more focus on progress in accomplishing institutional reforms; and greater use of external sources of information.** More awareness of the wealth of information on institutional issues, governance, and the investment climate, including ROSCs, could help staff focus and strengthen the quality of surveillance in these areas within a given resource envelope.

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<sup>62</sup> Information would be provided by members on a voluntary basis.

Appendix Table 1: Survey of Article IV Consultation Reports – Country Coverage

<i>Major Advanced Economies</i>	<i>Other Advanced Economies</i>	<i>Emerging-Market Countries</i>	<i>Small Developing Countries</i>	<i>Oil-Exporting Countries</i>	<i>Other Developing Countries</i>
Canada 1/	Australia	Argentina	Antigua & Barbuda	Azerbaijan	Afghanistan
France	Austria	Brazil	Aruba	Bolivia	Albania
Germany	Belgium 1/	Chile	Bahamas	Brunei Darussalam	Algeria 1/
Italy	Cyprus	China P.R.	Barbados	Equatorial Guinea	Angola
Japan	Finland	Colombia	Grenada	Gabon	Bangladesh
United Kingdom 1/	Greece	Czech Republic	Kiribati	Kazakhstan	Belarus
United States	Hong Kong SAR 2/	Estonia	Maldives	Kuwait	Bhutan
	Iceland	Hungary	Malta	Oman	Bosnia & Herzegovina
	Ireland	India	Marshall Islands	Saudi Arabia	Burkina Faso
	Israel	Latvia	Mauritius	U.A.E.	Burundi
	Korea 1/	Lebanon	Micronesia		Cambodia
	Netherlands	Lithuania	Netherlands Antilles 2/		Congo, Dem. Rep. of
	New Zealand	Malaysia	Palau		Congo, Rep. of
	Norway	Mexico	Samoa		Costa Rica
	Portugal	Peru	Seychelles		Djibouti
	Spain	Philippines	Solomon Islands		Dominican Republic
	Sweden	Poland	St. Kitts & Nevis		Ecuador
	Switzerland	Romania	St. Lucia		El Salvador
		Russian Federation	St. Vincent		Eritrea
		Slovak Republic	Suriname		Georgia
		Slovenia	Timor Leste		Ghana
		South Africa	Tonga		Guinea
		Thailand	Trinidad & Tobago		Haiti
		Ukraine			Hondurus
		Uruguay			Iran
					Jamaica
					Kenya
					Kyrgyz Republic
					Lesotho
					Liberia
					Libya
					Macedonia, FYR
					Mali
					Mauritania
					Moldova
					Morocco
					Mozambique
					Namibia
					Nepal
					Papua New Guinea
					Paraguay
					Senegal
					Sri Lanka
					Sudan
					Swaziland
					Syrian Arab Republic
					Tunisia
					Uganda
					Uzbekistan
					Vietnam
					Yemen
					Zimbabwe

1/ These countries had two Article IV staff reports during the period covered (Jan. 1, 2003 – March 5, 2004) which were both reviewed.

2/ Region or territory of member country for which separate Article IV consultations are conducted.

## I. Questions for the Coverage Paper

### A. Rationale for coverage of macroeconomic and structural issues

1. *Does the report clearly sets out the focus of the consultation and the rationale for its coverage of core and non-core areas?*

Yes (please provide specifics, as deemed necessary)

No, because

The report does not provide a clear rationale for why it focuses on a particular subcomponent of an issue

The report does not provide a clear rationale for why it takes a specific angle on a policy issue

The rationale for the coverage of structural issues (i.e. macrorelevance) is not clear

Other explanations

2. *In your views, is the scope of coverage appropriate?*

Yes (please provide specifics, as deemed necessary)

No, because

The coverage is too broad (please specify why)

The coverage is too narrow (please specify why)

Other explanations

*Please provide your assessment of the report's focus on a scale of 1 to 4 (1- highly satisfactory, 2- satisfactory, 3- somewhat satisfactory, 4- unsatisfactory)*

### B. Macroeconomic Developments and Policy Discussion

#### a. Recent Economic Developments and Policies

3. *Is the coverage comprehensive and meaningful?*

Yes (please provide specifics, as deemed necessary)

No, because

There is no clear story line

Discussion presented only in the context of program targets and objectives

Other explanations (including, inadequate data or knowledge)

#### b. Short-Term Economic Outlook

4. *Are the authorities' and staff's views on the short-term economic outlook, including risks to this outlook, presented in a clear and substantiated way taking into account both global and regional economic and financial market developments?*

Yes (please provide specifics, as deemed necessary)

No, because

The staff's/authorities' views are not well substantiated (please specify)

The areas of consensus and areas of disagreement between staff and the authorities are not well delineated, particularly with respect to upside and downside risks to the outlook

There is no discussion of the risks to the outlook

The discussion does not take into account global financial market developments

Other explanations (including, inadequate data or knowledge)

*Please go to section II for questions on regional and global spillovers*

**c. Coverage of Macroeconomic Policy Areas**

5. *Is there an adequate coverage of all core macroeconomic policy areas (i.e., exchange rate, monetary and fiscal policies), including identification of key policy challenges, and a candid and balanced account of the report of policy discussions with the authorities?*

Yes (please provide specifics, as deemed necessary)

No, because

One or more of the core areas are not adequately addressed (for example, an assessment of the exchange rate regime and level is missing or superficial)

All three core areas are covered but not in an integrated and consistent manner.

Key policy challenges are not well-articulated

The discussion is lacking candor and/or balance

The country has systemic importance, but the coverage of policy spillovers is insufficient

Other explanations (including, inadequate data or knowledge)

6. *Does the report provide adequate rationale for the magnitude, composition and pace of proposed fiscal adjustment (if any) along with a discussion of political feasibility of such adjustment and authorities' reactions? Are fiscal policy recommendations for the short term put in the context of a clear medium-term fiscal road map?*

Yes (please provide specifics, as deemed necessary)

No, because

There is limited or no discussion of medium-term fiscal objectives

There is no justification of the recommended magnitude, composition, or pace of fiscal adjustment

There is limited or no discussions of possible measures to achieve the desired fiscal adjustment in the short term (current and next fiscal year)

Authorities' reactions to or discussion of political feasibility of proposed measures is missing

Other explanations (including, inadequate data or knowledge or not applicable)

7. *Does the report contain a substantial discussion of the composition of public expenditures, including spending on health, education, and social services? (Please describe)*

8. *Where relevant, does the staff report identify the causes of past failures in fiscal reforms and/or identify longer-term reform priorities?*

*Please rank the report's coverage of macroeconomic policies 1-4 (1- highly satisfactory, 2- satisfactory, 3- somewhat satisfactory, 4- unsatisfactory)*

***Please go to section III for questions on exchange rate analysis***

**C. Structural Issues**

**a. Financial Sector Issues**

9. a. *Has this country had an FSAP or FSAP update? If so, when?*

9. b. *Did MFD staff participate in the Article IV consultation mission?*

9. c. *Does the report provide a meaningful coverage of the findings of FSAP?*

10a. *Is there a description of the structure of the financial system that indicates the relative importance of the main segments of the financial sector?*

*10b. Does the discussion of financial sector issues permit conclusions as to whether the financial sector is a potential source of macroeconomic instability (i.e., by affecting the conduct of fiscal or monetary policy) and/or inefficiency (i.e., poor financial intermediation)?*

Yes (please provide specifics, as deemed necessary)

No, because

Discussion of financial sector issues is missing or inadequate to permit the above assessment.

The discussion of financial sector issues is centered around a few key program benchmarks.

Other explanations (including, inadequate data or knowledge)

*11. Does the report provide a set of financial soundness indicators and a discussion of the adequacy of the supervisory infrastructure in place?*

Yes (please provide specifics, as deemed necessary)

No, because

The discussion is missing/inadequate

The financial soundness indicators are missing or are presented in a table without supportive discussion

Other explanations (including, inadequate data or knowledge)

*12. Does the report make recommendations and/or identify the need for technical assistance or other means to address existent financial sector vulnerabilities/inefficiencies, where applicable?*

***Please go to section IV for questions on Balance Sheet Analysis***

**b. Trade Policy Issues**

*13. Is there an adequate coverage of trade policies in the report that links the discussion to overall macroeconomic assessment and outlook?*

Yes (please provide specifics, as deemed necessary)

No, because

The discussion is limited to information on a few indicators or passive description of developments in tariffs and NTBs

The country has systemic importance but the report does not cover this ground well

The country has liberalized to the point where trade policies are no longer an issue

Other explanations (including, inadequate data or knowledge)

*14. Does the report identify barriers to market access faced by the country (please specify if this is a non-issue for the country)?*

**c. Institutional Issues**

*15. Does the staff report draw attention to key institutional weaknesses relevant to growth and crisis vulnerability and identify potential sources of remedy?*

Yes (please provide specifics, as deemed necessary)

No, because

The report expresses a lack of expertise on staff's part to make such a diagnosis

The report simply refers to work done by other organizations

Other explanations (including, inadequate data or knowledge or cases where this question is not applicable)

*16. Which of the ROSC modules has this country completed?*

*17. Does the report make any reference to the findings of these modules? If so, in what way?*

*Please go to section V for questions on Growth and Institutional Issues*

**d. Social Sector Issues and Political Instability**

18. *Is there a discussion of social sector issues and/or political instability?*

Yes, because

The country has a PRGF program, the coverage is in the context of pursuing objectives set in the PRSP

Past macroeconomic and structural policies have contributed to social unrest and there is a need for policy debate to reflect this

There are one/more specific issues that have a clear macroeconomic relevance (such as HIV/AIDS prevalence or an environmental catastrophe in a country that heavily depends on tourism)

The country is a low-income country, the discussion refers to MDGs.

Staff proposes fiscal adjustment with likely negative implications for the poor

Other

19a. *If the answer is yes, in your views, how substantive and meaningful is the coverage?*

19b. *If the answer is "no", in your views is there a case for coverage of social sector issues? Why?*

20. *Does the report include a table on social sector indicators or provide some social indicators as part of another table in the text or in the appendix (please indicate)?*

*Please rank the report's coverage of this issue, 1-4 (1- highly satisfactory, 2- satisfactory, 3- somewhat satisfactory, 4- unsatisfactory)*

**D. Assessment of Vulnerability and Sustainability**

21. *Is there a candid and clear presentation of staff's and the authorities' assessment of vulnerabilities to a currency, balance of payments or financial sector crisis*

Yes (please provide specifics, as deemed necessary)

No, because

The discussion does not allow readers to make a clear judgment as to the extent (short- vs. long-term, extremely vs. moderately vs. potentially vulnerable) of vulnerabilities faced by the country

Staff's assessment does not seem candid

The assessment misses one of the above areas

Authorities' assessment/reactions to staff's assessment is missing

Other explanations (including, inadequate data or knowledge or cases where this question is not applicable)

22. *Does the above assessment takes into account (i) global economic and capital market developments, (ii) soundness of the financial and corporate sector, (iii) domestic policy developments and (iv) relevant political economy factors (please specify)?*

23. *Is there a clear, candid and adequate presentation of staff's and the authorities' assessment of the country's external and public debt sustainability?*

Yes (please provide specifics, as deemed necessary)

No, because (mark all that is applicable)

The discussion does not provide readers with a clear judgment as to whether the debt burden is sustainable or not

The discussion lacks candor

The discussion excludes key stress tests (in light of the country's historical experience)

The analysis uses less-than-realistic medium-term assumptions

The coverage seems incomplete (such as central vs. consolidated government) creating uncertainty about the overall position of the public or external sector

Other explanations (including, inadequate data or knowledge or cases where this question is not applicable)

*24. Where unsustainability is detected, does the report discuss staff's recommended course of action to achieve sustainability anchored in a medium-term framework with an adequate discussion of political feasibility of the recommended course?*

Yes (please provide specifics, as deemed necessary)

No, because

The recommended course of action is not well-substantiated

There is a lack of prioritized presentation of the envisaged reforms

An analysis of political feasibility (authorities' reactions) is missing

Other explanations

*Please rank the report's coverage of this issue, 1-4 (1- highly satisfactory, 2- satisfactory, 3- somewhat satisfactory, 4- unsatisfactory)*

*25. Please identify areas of exceptional strengths and weaknesses of this report.*



## II. Questions for the Paper on Global and Regional Spillovers

### A. Integration of multilateral and bilateral surveillance

1. Does the report's backward-looking section refer to the impact of global economic conditions (or conditions in economic groups of countries), in particular:

- (a) the global economic recovery;
- (b) subdued global inflation;
- (c) the decline/low level of world interest rates;
- (d) improved capital market conditions for emerging markets (reduction in interest rates/spreads, renewed capital inflows)
- (e) change in country differentiation in emerging market spreads according to perceived risk;
- (f) the bursting of the global equity bubble;
- (g) the incipient recovery in global equity markets;
- (h) the depreciation of the US\$ against other major currencies;
- (i) changes in oil/energy prices;
- (j) changes in food/commodity prices;
- (k) global geopolitical conditions, in particular the war in Iraq;
- (l) other?

2. Do the report's forward-looking sections refer to baseline global projections (or projections for economic groups of countries), in particular:

- (a) the continuation of the global economic recovery;
- (b) pick-up in growth in US, Japan, Asia, transition economies;
- (c) the continuation of subdued global inflation;
- (d) outlook for global interest rates;
- (e) outlook for capital market conditions for emerging markets;
- (f) outlook for global equity markets;
- (g) outlook for the G3 exchange rates (\$/euro, yen/\$);
- (h) changes in oil/energy prices;
- (i) changes in food/commodity prices;
- (j) a relatively quick resolution of geopolitical uncertainties, in particular a quick war in Iraq;
- (h) other?

3. Do the report's forward-looking sections refer to global risks (or risks for economic groups of countries) and their potential impact on the country, in particular:

- (a) a lackluster or delayed global economic recovery;
- (b) global deflation;
- (c) an rebound in world interest rates;
- (d) a deterioration in capital market conditions for emerging markets (increase in interest rates/spreads, decline in capital flows);
- (e) significant emerging market volatility and/or financial crises (specifically South America, Turkey);
- (f) reversals in the recovery of global equity markets and/or significant global stock market volatility;
- (e) a disorderly unwinding of global imbalances, in particular a steep fall in the US\$;
- (f) a sharp change in oil/energy prices;
- (g) a sharp change in food/commodity prices;
- (h) a protracted phase of geopolitical uncertainty resulting from the war in Iraq
- (i) other?

4. Does the staff appraisal mention global economic conditions/outlook (or conditions/outlook for economic groups of countries)? If so, is the potential impact on the country considered (a) significant, or (b) not very significant?

5. Overall, how would you characterize the degree of integration of multilateral surveillance issues into the report: (a) extensive (b) selective, or (c) minimal? In your view, would the report have benefited from a more extensive (or higher quality) discussion of multilateral surveillance issues? Please explain.

**B. Integration of G3 issues into bilateral surveillance**

6. Does the report's backward-looking section refer to economic/financial conditions in the US, EU, and/or Japan (indicate which)?

- If so, are these conditions considered to have a significant impact on the country's economy (yes/no/not clear) and what are the main transmission channels:
  - (a) exchange rates;
  - (b) demand for the country's exports;
  - (c) commodity prices;
  - (d) interest rates;
  - (e) equity valuations and corporate governance issues;
  - (f) availability/cost of external financing, either directly through G3 official/private financing or indirectly through the potential impact of G3 developments on international capital markets;
  - (g) other?

7. Do the report's outlook or risk sections identify the economic outlook/risks in the US, EU, and/or Japan (indicate which)?

- If so, is the US/EU/Japan outlook considered to have a potentially significant impact on the country (yes/no/not clear) and what are the main potential transmission channels:
  - (a) exchange rates;
  - (b) G3 demand for the country's exports;
  - (c) commodity prices;
  - (d) interest rates;
  - (e) equity valuations and corporate governance issues;
  - (f) availability/cost of external financing, either directly through G3 official/private financing or indirectly through the potential impact of G3 developments on international capital markets;
  - (g) other?

8. Does the report mention the impact of current or prospective trade policies by the EU, US, and/or Japan (y/n)? If so,

- Are EU/US/Japanese trade policies deemed to have a significant impact on the country's economic performance/outlook (yes/no/not clear)?
- What type of trade policies are mentioned: (a) the general trade regime in the EU/US/Japan (i.e. tariffs, quotas, subsidies, market access), (b) regional free trade agreements involving the EU/US/Japan, (c) preferential access agreements (e.g. EU Association, EU EBA, US AGOA, GSP)?

9. Does the staff appraisal refer to G3 (a) economic conditions/prospects/risks and/or (b) trade policies?

10. Overall, how would you characterize the degree of integration of G3 economic/financial issues: (a) extensive, (b) selective (c) minimal. In your view, would the report have benefited from more (or higher quality) discussion of G3 issues? Please explain.

**C. Regional linkages**

11. Please indicate the key regional partners mentioned in the paper.

12. Does the report's backward-looking section refer to the impact of economic conditions in its region or in specific countries in its region?

- If so, did regional economic conditions have a significant impact on the country's performance (yes/no/not clear) and what were the main transmission channels:
  - (a) terms of trade;
  - (b) demand for the country's exports;
  - (c) import competition;
  - (d) commodity prices;
  - (e) interest rates;
  - (f) risks perceived by investors;
  - (g) spillovers of public confidence or lack thereof;
  - (h) financial sector spillovers;
  - (i) other?

13. Do the report's forward-looking sections refer to baseline projections for its region or for specific countries in its region?

- If so, what are the main transmission channels:
  - (a) terms of trade;
  - (b) demand for the country's exports;
  - (c) import competition;
  - (d) commodity prices;
  - (e) interest rates;
  - (f) risks perceived by investors;
  - (g) spillovers of public confidence or lack thereof;
  - (h) financial sector spillovers;
  - (i) other?

14. Do the report's forward-looking sections refer to risks for its region or for specific countries in its region, and their potential impact on the country, in particular:

- If so, do these risks have a potentially significant impact on the country's prospects (yes/no/not clear) and what are the main potential transmission channels:
  - (a) terms of trade;
  - (b) demand for the country's exports;
  - (c) import competition;
  - (d) commodity prices;
  - (e) interest rates;
  - (f) risks perceived by investors;
  - (g) spillovers of public confidence or lack thereof;
  - (h) financial sector spillovers;
  - (i) other?

15. Overall, how would you characterize the degree of integration of regional issues into the report: (a) extensive (b) selective, or (c) minimal? In your view, would the report have benefited from a more extensive (or higher quality) discussion of regional issues? Please explain.

### III. Questions for the Paper on Exchange Rate Analysis

#### **Type of regime**

*1a. What is the current “official” ER regime?*

*1b. What is the staff’s appraisal of the “de facto” ER regime? (i.e. does the staff state if they agree or disagree with the official classification of its regime)*

#### **Length of Regime**

*2. Has the ER regime been in place for short term (less than 3 months), medium term (between three months and 2 years), long term (2-5 years) or very long term (above 5 years)?*

*3. If there has been a change in regime since the last Article IV consultation, does the current report discuss events surrounding this development as well as implications (for example, was the change associated with a currency/banking/political crisis? was there a major devaluation associated with the change?)*

#### **Assessment of the Regime**

*4 In exchange rate regimes with some flexibility, which of the following best describes the country's monetary regime?*

- i) full-fledged inflation targeting*
- ii) low inflation is the primary goal, although not a formal inflation targeting*
- iii) monetary regime is primarily used to counter business cycles*
- iv) monetary regime is geared toward a range of objectives (low inflation, creation of employment, keeping competitiveness etc.)*
- v) monetary policy is subservient to fiscal policy*
- vi) other, please specify*

*5. Do the staff deem the current exchange rate regime as sustainable (i.e. compatible with other macroeconomic policies, policy objectives (e.g., growth), and structural conditions (e.g., capital account openness))*

*6. Does staff’s assessment of the regime take due consideration of the country’s fiscal stance, monetary policy objectives and other relevant structural factors (development of the financial market, extent of capital market openness, trade structure etc.?)*

*Please indicate which factors have been given consideration*

*7. Does the report present an adequate assessment of competitiveness based on REER, unit labor costs and/or other indicators (please specify the tools)?*

#### **Assessment of the level of exchange rate**

*8. In less than free floating regimes, is there a discussion on the appropriate exchange rate level?*

*9a. If yes, what is the staff’s conclusion (e.g., overvaluation, about right, undervaluation)? (please describe)*

*9b. If yes, what are the main issues (i.e. competitiveness, reserves, current fiscal policy, trade and financial liberalization measures etc.)?*

9c. How does staff measure over/undervaluation (i.e. cointegration analysis, discussion of trend levels, comparison with competitor countries, etc.)?

**Policy Advice**

10. Was there specific policy advice given to the authorities?

11a. What is the specific advice:

- i. a level/band adjustment
- ii. an immediate movement to a free float
- iii. a progressive transition to a float
- iv. a move towards more flexibility in other markets (e.g. labor markets) keeping the peg untouched.
- v. keeping the rate fixed but tighten monetary/fiscal policies to better support the rate
- v. other (specify)

11b. How was the advice supported (main argument)?

11c. Is staff's language/advice emphatic and compelling or mild and hesitant?

11d. If mild and hesitant, is it due to political sensitivity regarding the discussion of exchange rate issues?

14. Do the authorities agree with staff's appraisal and advice of the exchange rate regime and level?

#### IV. Questions for the Paper on Balance Sheet Analysis

1. *Does the staff report analyze the situation and risks within individual sectors' balance sheets?*
  - a) Public sector (e.g., public debt management; implication for public debt sustainability and reserves adequacy; impact of population aging)
  - b) Financial sector (e.g., asset/liability dollarization; exposures to rollover, interest rate, exchange rate or asset price shocks; capital structure mismatch)
  - c) Non-financial corporate sector (e.g., liability dollarization; exposures to rollover, interest rate or exchange rate shocks; capital structure mismatch)
  - d) Household sector (e.g., exposures to interest rate, housing and financial asset price shocks)
  - e) External sector—i.e. country's aggregate balance sheet position vis-à-vis non-residents (e.g., exposure to interest rate or exchange rate shocks)
  
2. *Does the staff report analyze the (actual or potential) transmission of vulnerabilities across balance sheets of individual sectors?*
  - a) From non-financial corporate or household sectors to financial sector (credit risk)
  - b) From financial sector to non-financial corporate or household sector (e.g., credit crunch)
  - c) From corporate or financial sectors to external sector (e.g., depositor flight to foreign currency)
  - d) From financial or non-financial corporate sectors to public sector (public contingent liabilities—e.g., SOEs, private banks)
  - e) From public sector to financial sector (e.g., through banks' holdings of public debt)
  - f) From public sector to external sector (e.g., public external debt burden)
  - g) (Other:\_\_\_)
  
3. *How is the above balance sheet analysis linked to the other key focuses of the staff report?*
  - a) Through impact on macroeconomic conditions or risks
  - b) Through policy recommendations (e.g., on exchange rate policy, debt and reserve management, local capital market development to provide hedging instruments)
  - c) Through role of institutions (e.g., role of transparency, prudential supervision or capital controls in reducing/exacerbating above risks)
  - d) (Other:\_\_\_)
  
4. *Is the staff's analysis supported by provision of key data/indicators?*
  - a) Public sector data
  - b) Financial sector data
  - c) Non-financial corporate sector data
  - d) Household sector data
  - e) External sector data
  
5. *If not, does the staff report provide recommendations for prioritizing data compilation in order to obtain the data required for balance sheet analysis?*
  
6. *Does the staff report include information related to other initiatives that are directly relevant to the balance sheet approach?*
  - a) DSA
  - b) FSAP/FSSA
  - c) FSIs
  - d) Enhanced focus on reserve adequacy (e.g., augmented reserve ratios)?

e) (Other:\_\_\_)

*7. Does the staff report include authorities' views on the balance sheet risks? If yes, are they different from the staff assessment?*

*8. In light of the country's economic circumstances, do you consider the coverage of balance sheet issues as adequate (qualitatively and/or quantitatively)?*

## V. Questions for the Paper on Institutional Underpinnings of Growth

*Note: Questions in Sections 1 and 2 will be assessed against low- and middle-income members only; questions in Section 3 will be assessed for all members.*

### Section 1

1. *How much coverage is there of institutional issues? (Low, medium, high)*
2. *What institutional issues are covered:*
  - (a) Central bank
  - (b) Financial Supervisory and Regulatory institutions
  - (c) Other Financial Sector Issues
  - (d) Fiscal institutions/operations
  - (f) Governance (general)
  - (g) Judiciary
  - (h) Rule of law/private property rights/controls on the executive
  - (i) Social sector
  - (j) Other
3. *Does the report indicate if the institutional issues it raises have potential macroeconomic implications? Does it seem links between institutional issues and the broader macro environment and policy challenges are sufficiently developed?*
4. *Assess the balance between short-term macroeconomic and medium-term institutional issues: given information in the rest of the report (economic indicators, staff's appraisal of main challenges to the economy), does it appear that institutional issues received sufficient attention for this country's case?*
5. *How are institutional issues/reforms linked to the Millennium Development Goals in particular, or to poverty reduction and growth in general?*
6. *What sources of information does the report draw on to assess institutional issues? Indicate if the report uses mainly the staff's analysis during the Article IV mission; if it draws on ROSCs; or if it draws on external information (World Bank, other).*
7. *In discussing institutional issues, to what extent does the report recommend that new ROSCs be undertaken; update existing ROSCs.*
8. *Please comment on how previous recommendations for institutional strengthening in Article IV or program documents have been implemented by the authorities?*

### Section 2

9. *Is the investment climate covered? Even if the investment climate is not specifically mentioned, are the suitability of economic and institutional conditions for private sector investment addressed?*
10. *If so, is the level of coverage useful, and how is it integrated with the rest of the report?*
11. *If the investment climate is covered, what outside information/expertise did staff draw on?,*



12. *If the investment climate was not covered, does the report suggest if this was because of lack of expertise/information, because it was not judged a priority for the analysis, or other reason?*

13. *Does the rest of the report suggest that it would have been useful to cover the investment climate?*

**Section 3**

14. *Was governance and/or corruption covered? If so, in the context of which sectors were these issues raised:*

- (a) fiscal sector
- (a) monetary sector
- (a) financial sector
- (a) external sector
- (e) real sector, including oil, extractive, and other industries
- (f) relations with the Fund (e.g., reporting to the Fund)
- (g) OECD Convention on the Combating of Bribery of Foreign Public Officials in International Business Transactions
- (h) Other

15. *If so, did the report make it clear whether the governance/corruption issues had macroeconomic importance?*

16. *Were governance issues addressed in sufficiently clear and direct language, or were they treated obliquely, to an extent that their significance was difficult to interpret?*

17. *Did the staff mainly draw on its own analysis, or did it use external information, such as external governance indicators (e.g., Transparency International) and external assessments?*

18. *Did the staff cite ROSCs in relation to governance issues?*

19. *Was transparency in extractive industries or in other key industries raised? Please note if the issue was not raised, but seemed relevant for this country.*

20. *Did the staff make specific recommendations related to governance/corruption?*

21. *Did the report give a sense of whether governance issues were being addressed or ignored by the authorities? For example, were response of the authorities to earlier recommendations related to governance covered?*

## VI. Questions for the Paper on Modalities of Surveillance

### A. Policy Dialogue

#### 1. Reporting the authorities' views

##### 1.1 Are the authorities' views on major policy issues presented in the staff report?

*If yes, please characterize the description:*

- it is balanced and identifies possible merits of the authorities' views
- it is clear
- it seems more ambiguous than warranted under the circumstances
- it is dismissive of the authorities' views
- it is not critical enough of the authorities' views

##### 1.2 Are the authorities' views on particularly sensitive issues, e.g., assessments of exchange rate and vulnerability, described?

*If yes, please characterize the description:*

- it is balanced and identifies possible merits of the authorities' views
- it is clear
- it seems more ambiguous than warranted under the circumstances
- it is dismissive of the authorities' views
- it is not critical enough of the authorities' views

##### 1.3 Are the authorities in agreement with staff on major policy issues?

*If not, in which policy area(s) did disagreements arise?*

- Fiscal
- Monetary
- financial sector policies
- labor market reforms
- other (please specify)

##### 1.4 Are the differences between the authorities and staff policy preferences clearly explained?

*Are the reasons for these differences explained?*

- substantive difference
- difference on the recommended pace, timing or sequencing
- difference on pre-conditions, including institutional or data weaknesses
- constraints on policy implementation
  - lack of political support
  - weak institutional capacity
  - data inadequacy
  - other (please specify)
- other (please specify)

##### 1.5 Is the authority's plan of action clearly explained?

#### 2. Reporting on the dialogue with the authorities itself

##### 2.1 Did staff try to formulate a second-best approach that would take into account the authorities' main concerns?

##### 2.2 Does the staff report point to ways to alleviate constraints on policy implementation (if applicable)?

- outreach to parliamentarians, labor unions, etc.
- technical assistance
- other (please specify)

##### 2.3 Did the staff use cross-country analysis in discussions with the authorities or present it in the staff report or the selected issues paper?

- 2.4 *Did some of the staff 's arguments convince the authorities?*
- 2.5 *Did some of the authorities' arguments convince staff?*
- 2.6 *Does the staff report makes an assessment of the quality of the dialogue?*
- 2.7 *Did staff undertake special activity to foster the dialogue (internal conference, workshop)? Please specify.*
- 2.8 *Does staff identify follow up action to continue the dialogue (conference, TA, staff visit)? Please specify.*

3. *Is the consultation cycle tailored to the national timetables, e.g., budget cycle, medium-term economic plans?*

4. *Dialogue with non-governmental actors*

- 4.1 *Does the staff report identify the key themes of the domestic policy debate?*
- 4.2 *Are these themes the same as the key themes of the consultation?*

*If not, why:*

- they are non macroeconomic/staff has little expertise
- the authorities were reluctant to discuss them with staff
- other (specify)

4.3 *Are the views of non-governmental actors reported by staff?*

- Parliamentarians
- Financial sector
- Non-financial business sector
- Labor union representatives
- Representatives from the academia/think tanks
- Members of other non-governmental organizations

4.4 *Do they occupy a meaningful place in the report?*

- They have an influence on staff's policy recommendations
- They are mentioned by staff in the discussion with the authorities
- They are mentioned by the authorities in their discussion with staff

4.5 *Is any external dissemination activity mentioned in the staff report?*

5. *General assessment of the quality of the policy dialogue*

5.1 *Overall, and beyond the necessary degree of ambiguity, do you believe the staff's policy advice during the consultation was candid, especially on sensitive issues concerning vulnerabilities and exchange rates?*

*If not, why?*

5.2 *Overall, and beyond the necessary degree of ambiguity, do you believe the authorities' response in discussions as presented in the staff report was candid and open?*

*If not, why?*

6. *Effectiveness of the past dialogue*

6.1 *Does the staff report clearly and meaningfully assess the authorities' response to the Fund's previous policy advice?*

6.2 *Does the assessment describe the authorities' policy actions in response to Fund's previous advice?*

6.3 *Does the assessment discuss the reasons for the authority's actions?*

6.4 *Based on this backward-looking assessment, does the Fund surveillance appear to have been effective in this country?*

6.5 *Is there any evidence suggesting that staff has adjusted its mode of operation?*

7. *The authorities' views on the dialogue with the staff (as presented in the authorities' BUFF)?*
- 7.1 *Did the authorities view the dialogue as candid and open?*
- 7.2 *Did the authorities believe that discussions with the staff were useful?*
- 7.3 *How exactly?*
- contributing to public policy debate
  - helping identify the appropriate policy response through analytical work
- 7.4 *Did the authorities identify major areas of disagreement? If yes, in which areas?*
- 7.5 *What is the nature of the disagreement (the appropriateness of the policy action, its timing, or its feasibility given policy constraints, etc.)?*
- 7.6 *Did the authorities make any suggestions on how effectiveness of Fund consultations can be enhanced?*

**B. Surveillance in Program Countries**

1. *Was a program in place at the time of the consultation?*
2. *Are A4 issues clearly separated from UFR issues*
- No, because
- The discussion of recent economic developments focuses on program performance
  - An EPA has been produced or is expected to be produced in the near future that would provide a stock-taking of the policy strategy to date
  - Other explanation
3. *How is the PRSP/I-PRSP/PRSP Progress Report integrated in the Article IV Staff Report?*
- Mentioned in a separate paragraph without integration in the main text
- Made references to in certain sections of the staff report (such as short and medium-term outlook, fiscal and structural policies, and social sector analysis)
- Takes on a central role in the Article IV Consultation acting as a springboard for policy discussion
- Other
4. *How much space is given to the discussion of medium-term prospects and policies in the report?*
- it has a prominent place in the report and discussion
  - it is mentioned but not crucial to the discussions
  - it is irrelevant to the discussion
  - other (specify)
5. *Qualify the section on medium-term prospects and policies*
- it is credible and interesting
  - it is acceptable
  - it is overoptimistic
  - it is pro forma, without much interest

**C. Cross country experience/ Knowledge transfer**

1. *Does the report contain references to other countries?*
- if yes, specify which country
2. *What is the context of such references?*
- possibility of spillovers
  - main trading partner

cross country analysis  
other (specify)

3. *How extensive is the reference?*

quite extensive (box, several paragraphs)  
significant  
rather superficial

4. *If cross-country analysis is used, please specify the issue/area covered*

5. *Does the report refer to or make use of analysis done by other individual/institutions/think tanks?  
if yes, specify which*

World Bank or other multilateral organizations (specify)  
Bilateral donor organizations (such as USAID, DFID)  
Papers done by members of the academia  
Think tanks  
other (specify)

6. *Please specify the structural/policy area where the above analysis is used*

7. *Did the report contain references to other Fund work?*

if yes, specify which type:  
previous country documents  
other type of document, same department (WP, OP)  
document for another department

8. *Does the report refer to/make use of/follow up the diagnosis made in the context of Fund TA missions?*

9. *If so, in what areas (fiscal, statistics, monetary policy instruments etc.)?*

10. *Does the report include an assessment of effectiveness of past Fund TA?*

**D. Format of report**

1. *What is its length in pages (without annexes)?*

it felt too long to read, dwelled too much on minor issues  
it felt too short, did not address issues in sufficient depth  
length was appropriate  
other (specify)

2. *Was there too much repetition?*

if yes, what was the reason, in your view?

3. *Did the report use proforma sentences (e.g., the exchange regime has served the authorities well)*

if yes, give example

4. *Did the introduction section add important information, or was the material repeated elsewhere?*

5. *Were "housekeeping issues" (date of last consultation, Article VIII status, etc):*

effectively consolidated in one place (e.g., on the cover page)  
sprinkled throughout the text

6. *Were charts, text tables, boxes inserted in the main text of the report?*

6.1 If yes: did they

clearly underlined the main messages of the report

broadly support the main messages, but not always in the most clear/effective way

did not seem clearly illustrative of the main messages

6.2 If text tables were included : was the amount of data included in these tables

too much

broadly adequate

too little

7. *Were standard end tables and charts helpful to the reader?*

no, I had all the information I needed in the text and did not consult them

yes, I consulted them and found the information I needed

8. *Was the amount of data included in the end tables*

too much

broadly adequate

too little

9. *Were appendices/annexes relevant to the report?*

I never had to look at them

I looked at some (specify which) but ignored others

I found them all useful

10. *Were boxes and appendices*

used to provide useful additional information on central issues

used to describe issues that were not central to the discussion

11. *Were boxes and appendices*

too long

about right

too short

too many/few (identify topics for addition/subtraction)

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## **IMF Executive Board Reviews the Fund's Surveillance**

On July 23, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the latest biennial [review of the IMF's surveillance activities](#).

### **Background**

Under Article IV of its Articles of Agreement, the IMF has a mandate to oversee the international monetary system in order to ensure its effective operation; to oversee the compliance of each of its members with their obligations under Article IV, Section 1; and, in order to fulfill these functions, to exercise firm surveillance over the exchange rate policies of members. A member's obligations under Article IV, Section 1 include to endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances; to seek to promote stability by fostering orderly underlying economic and financial conditions, and a monetary system that does not tend to produce erratic disruptions; to 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; and to follow exchange policies compatible with the above undertakings.

The IMF fulfills this mandate through bilateral, regional, and multilateral surveillance. In accordance with Article IV of its Articles of Agreement, the main instrument of bilateral surveillance is consultations, normally held every year, with each of the Fund's members. These consultations are complemented with regular analysis of economic and financial data provided by members and, as needed, informal contacts between the Fund and national authorities. At the regional level, the IMF holds regular discussions with economic institutions of currency unions and participates in the activities of regional bodies. The pillars of the Fund's multilateral surveillance are the [World Economic Outlook](#) report and the [Global Financial Stability Report](#), which are produced twice a year. The reports are complemented by more frequent, informal reviews of global economic and market developments.

The Executive Board of the IMF reviews the principles and the implementation of the Fund's surveillance every two years. This review revolved around one central question: how can surveillance be made more effective across the whole membership? It analyzed the focus and depth of the IMF's economic analysis and policy advice in its surveillance activities, with a particular attention to the selectivity of coverage; global and regional spillovers; exchange rate policy; financial sector issues; vulnerability assessments; and institutional issues. The review also examined the nature of the policy dialogue with country authorities; communication of the Fund's policy messages, including provision of signals to creditors and to donors; and assessments of the overall effectiveness of IMF surveillance. The review consisted of an in-house assessment complemented with additional perspectives. The in-house assessment looked at the experience with Article IV consultations over the past two years as well as other surveillance activities. External views were obtained from country authorities, market participants, think tanks and other nongovernmental entities, and the media.

### **Executive Board Assessment**

Executive Directors thanked staff for its thorough and candid review of surveillance, which is central to the Fund's responsibilities in the international monetary system. They welcomed the opportunity to review its implementation over the past two years. They confirmed that the 1977 Surveillance Decision continues to provide an appropriate basis for Fund surveillance over members' exchange rate policies. They considered that the Fund's surveillance function should be seen as evolving and adapting continuously, as warranted by the evolution of the world economy and the requirements of the Fund's membership.

Directors welcomed the progress that the Fund has made in strengthening surveillance since the previous review. Directors underscored, however, that challenges remain. They focused their discussions on one central question—How to make surveillance more effective across the whole membership. Mindful of the IMFC's call for proposals to enhance the focus, quality, persuasiveness, impact, and overall effectiveness of surveillance, they approached this question by analyzing four different facets of Fund surveillance and related activities: the focus and depth of the Fund's economic analysis and policy advice; the nature of the policy dialogue with country authorities; communication of the Fund's policy messages, including signaling to creditors and donors in the context of surveillance; and assessments of the overall effectiveness of surveillance.

### **Focus and Quality of Analysis**

Directors stressed that well-focused surveillance exercises and high-quality analyses remain essential for effective surveillance. They reaffirmed the conclusions of the 2002 review of surveillance, which addressed how, under the expanded reach of surveillance, individual Article IV consultations must be kept focused on key issues. This is to be done by ensuring that coverage is adapted to country-specific circumstances, and that the selection of topics is based on macroeconomic relevance. Specifically, the matters at the apex of the Fund's hierarchy of concerns are external sustainability; vulnerability

to balance of payments or currency crises; sustainable growth and the policies to achieve it; and, for systemically important countries, conditions and policies affecting the global or regional economic outlook.

Directors agreed that the Fund has generally succeeded in covering a broader range of topics without losing focus. Nevertheless, they considered that individual Article IV consultations would benefit from more discriminating coverage of issues outside the Fund's traditional areas of expertise, greater use of information from appropriate outside sources such as other multilateral agencies, and more selective coverage of trade matters, focused on issues that have an important influence on stability and growth prospects. In addition, they saw scope for streamlining some of the formal requirements relating to coverage of Article IV consultations and staff was asked to explore carefully possible options for using alternative channels to provide to the Board some elements of information currently included in Article IV staff reports.

Directors encouraged staff to exchange views with members to define priority topics to be featured in Article IV consultations at an early preparatory stage, while stressing that staff retains ultimate responsibility and accountability for selection of topics. To promote debate while retaining accountability, they suggested that each Article IV staff report should spell out the strategic focus of the consultation. Directors also saw merit in disseminating to the Board multi-year country work programs, articulated around a limited set of priorities.

Directors stressed that Fund surveillance is an ideal vehicle to analyze global and regional spillovers. They saw substantial room to improve treatment of these issues through greater integration of bilateral, regional, and multilateral surveillance. For consultations with the largest Fund members, Directors called for fuller treatment of the global impact of their economic conditions and policies, which would build upon discussions of systemic risks in multilateral surveillance. For all consultations, they called for more pointed treatment of risks to the short and medium-term outlook. This would require linking past and prospective economic performance more explicitly to global economic and financial conditions, highlighting the global risks of most significance to individual members, and quantifying their potential impact through greater use of alternative scenarios. Directors agreed that informal Board discussions of issues affecting different regions would be valuable complements to the multilateral and bilateral surveillance exercises. Such discussions would provide useful opportunities to undertake comparative analysis of major developments and policies within each region, and if supported by the provision of standardized indicators, could shed further light on regional transmission of shocks.

Directors observed that clear and candid treatment of exchange rate issues remains a challenge. While recognizing the sensitivity of these questions, they stressed that a thorough discussion of exchange rate issues remains critical for surveillance. To enhance such discussions, Directors endorsed the following steps: clear identification of the *de facto* exchange rate regime in staff reports; more systematic use of a broad range of indicators and other analytical tools to assess external competitiveness; and thorough and balanced presentation of the policy dialogue

between staff and the authorities on exchange rate issues, particularly when views diverge. Some Directors indicated that discussion of exchange rate issues in a regional context would also be helpful. Directors reiterated that no exchange rate regime is appropriate for all countries or for all circumstances. Thus, they stressed that discussion of exchange rate issues should permit consideration of a variety of options and take full account of country-specific circumstances, most importantly the macroeconomic framework. They underscored the need to assist countries that are contemplating a move toward greater exchange rate flexibility.

Directors welcomed recent improvements in the coverage of financial sector issues, but noted that this is not yet on a par with coverage of other main areas. Recalling the conclusions of the 2003 FSAP review, Directors pressed staff to make use of all available options to bring necessary expertise to bear on analysis of financial sector issues. These could include, for example, encouraging participation in the FSAP (through full FSAP assessments or focused updates), separate MFD or ICM missions (with the authorities' consent), MFD and ICM participation in Article IV missions, and training of area department staff by MFD and ICM. A few Directors also noted the importance of improving coverage of fiscal issues.

Directors reiterated that vulnerability to balance of payments or currency crises and external sustainability are matters at the apex of the Fund's hierarchy of concerns. They observed that the current strategy to improve vulnerability assessments and balance sheet analysis is having a positive impact, and urged staff to continue refining the analytical techniques, while recognizing data constraints. A few Directors considered that debt sustainability assessments would be enhanced if they are conducted independently of regular country work. Some other Directors considered that high-quality vulnerability assessments are dependent upon close analysis of country-specific conditions, which require area departments' expertise. All Directors saw a need for better integrating various components of vulnerability assessments to provide a clearer view in staff reports on the extent of vulnerabilities. A number of Directors pointed out that balance sheet analysis is relevant to assessments of vulnerabilities in advanced as well as in emerging market economies.

Directors noted that areas outside of the Fund's traditional areas of expertise, such as issues related to the investment climate, institutional reforms, and social issues, receive substantial attention in Fund surveillance. They considered that, in addition to greater selectivity and wider use of appropriate outside sources of information, coverage of the first two of these issues would benefit from greater attention to past and current implementation of policy recommendations. In members where shocks could have a sizeable impact on social conditions, most Directors were of the view that Article IV consultations and other contacts can offer an opportunity to solicit interested members' views on protection of social safety nets or of other priority expenditures in times of economic stress.

Directors viewed the implementation of the 1997 guidance note on governance as broadly satisfactory. Staff should explore ways to refine the coverage of such issues in Article IV consultations, including through greater use of existing governance indicators;

draw more systematically on ROSCs and other available material; and pay closer attention to policy recommendations and their implementation.

Directors noted that Article IV consultation reports for low-income countries typically contain a broad treatment of growth objectives. This reflects the fact that as progress is made on macroeconomic stability, the dominant challenge in many low-income countries is to sustain high rates of growth and to reduce poverty. In particular, most Directors considered that, where relevant, Article IV consultations could be used to analyze alternative macroeconomic frameworks under different aid flow assumptions, and, thus, help shed light on sustainable macroeconomic scenarios. Directors looked forward to further consideration of this issue. A few Directors also called for targeted empirical research on sources of growth. Directors urged staff to pay greater attention to external shocks that can derail growth in low-income countries and actions that might help improve their resilience to such shocks. Directors underscored the importance of close monitoring by the international community of progress toward the achievement of the Millennium Development Goals and suggested that for this purpose Fund surveillance in low-income countries should draw as much as possible on information compiled by the World Bank.

Directors observed that the quality of surveillance in program countries had improved since 2002, with progress being made with respect to stocktaking of the economic policy strategy. They noted that progress on discussions of the short and medium-term economic outlook has been more muted, but were hopeful that more systematic use of alternative scenarios would foster advances in this area. Directors were encouraged by the results of the first Ex Post Assessments (EPAs), and looked forward to reviewing surveillance in program countries after substantial experience has been gained with EPAs.

### **Policy Dialogue with Country Authorities**

Directors underscored that a close and frank policy dialogue between the Fund and its members is an essential ingredient of effective surveillance. They were encouraged that most officials interviewed for this review rated the quality of the policy dialogue positively, and like these officials, they pointed to the scope that exists to enhance it further. Directors encouraged staff to make increased use of cross-country studies in an appropriate context, as a way of adding value to policy discussions and strengthening the sense of collaboration between the Fund and members. A number of Directors considered that, to strengthen engagement in Article IV consultations, member countries could be encouraged to prepare policy statements, which would be an input into policy discussions. A few Directors were of the view that, to enhance country ownership for responsible policies, the policy statement could become a centerpiece of the Article IV consultations. A few other Directors cautioned, however, that this approach should not unduly constrain the scope of Article IV consultations, affect the candor of discussions, or overburden the authorities.

Directors stressed the importance of surveillance based on a close rapport with authorities based on trust. In this context, they noted that frequent contacts outside of

Article IV consultations can help build such trust. A number of Directors suggested that greater continuity of staff assignments would be helpful to maintain continuity and coherence in the policy dialogue and allow staff greater opportunities to build up country-specific knowledge. Directors also supported the suggestion that staff should explore where the use of one-page notes might be useful to enhance communications with senior policymakers as a complement to the Article IV mission's concluding statements.

Directors reviewed the modalities of surveillance in currency unions. They considered that the formal procedures for surveillance of the euro area had worked well. They noted that modalities of surveillance of the other currency unions—the West African Economic and Monetary Union, the Central African Economic and Monetary Community, and the Eastern Caribbean Currency Union—have also moved toward greater formalization. They agreed that it would be desirable to establish an appropriate framework for policy discussions with regional institutions in these three currency unions, which would recognize that these discussions form part of the Article IV consultations with concerned members. Such steps would strengthen surveillance over monetary and exchange rate policies, trade policies, and financial sector regulation and supervision.

### **Communication**

Directors stressed that effective communication of the Fund's policy messages is essential for enhancing the overall effectiveness of surveillance, as it helps inform economic discussions in member countries and encourages informed decisions by market participants. Directors emphasized that communication, including publication—while crucial for transparency—should not come at the expense of the role of the Fund as a confidential advisor to members by reducing the candor of the dialogue with them and in reporting to the Board. Most Directors were of the view that publication will remain crucial for transparency. They also noted that publication is now widespread, and that initial fears of adverse market impact have not been realized.

To strengthen communication of the Fund's policy messages, Directors encouraged staff to develop outreach programs and enhance contacts with local think tanks. Furthermore, they suggested that members should not hesitate to use of the “right of reply” provided for in the transparency policy. Directors also favored a more active internal dissemination of best practices and innovations in the modalities of Article IV consultations, and encourage further experimentation with the formats and styles of staff reports. Directors looked forward to further reflecting on issues relating to interactions with the various audiences of surveillance in the context of the forthcoming review of the Fund's external communication strategy.

### **Signaling**

Directors discussed how best Fund surveillance can respond to requests from some members for policy monitoring at high frequency and for delivery of a signal on the strength of a member's economic policies. They recognized the difficulties in designing appropriate signaling mechanisms. They mentioned different instruments and

modalities, including low-access precautionary arrangements and low access PRGFs, and various forms of Fund and staff monitoring. Directors also considered whether, in a surveillance context, presentation by a member of its own quantitative economic framework, possibly complemented by a detailed policy agenda, might facilitate assessment by the Fund of the member's policies. No conclusions were reached, but these exchanges of views have pointed to a few key characteristics of signaling mechanisms that will need to be considered in future discussions. These include, for example, whether a signaling mechanism should be based on a minimum standard for activation or not; whether an assessment is to be made by the staff or by the Fund (i.e., the Board); and whether publication is presumed or not. Independently of future discussions on new or updated mechanisms, Directors agreed that messages on members' policies delivered through surveillance could be made clearer.

### **Assessing the Effectiveness of Surveillance**

Directors underscored the importance of regular assessments of effectiveness of surveillance. They recognized, however, that assessing the effectiveness of surveillance is a daunting task, in part because, with the broadening of the purview of surveillance and its transformation into a more public process, the chain of reactions to Fund policy advice has become more complex. In this context, Directors appreciated that the staff's papers for this review were based not only on an in-house assessment but also on outreach to external audiences, including country authorities, market participants, and think tanks. Some Directors were of the view that the effectiveness of surveillance needs to be assessed not only from the perspective of the outcome but also from the perspective of the process: that is, whether it provides an effective mechanism for members to express their views on the policies of other members, and whether members feel that other members live by mutually agreed and accepted obligations. Many Directors regretted that the present review had not examined the quality of advice in individual surveillance exercises and looked forward to staff addressing this topic in the next review.

To make further progress in assessing effectiveness of surveillance, Directors strongly supported setting monitorable strategic objectives in reviews of surveillance such as this, which would guide the staff in the period until the next review. They also encouraged greater discussions of effectiveness in individual Article IV consultations, including, as needed, the relevance or appropriateness of past policy recommendations by the Fund and the authorities' responses, as well as clearer delineation and planning of the focus of individual consultations. Directors agreed to maintain the requirement that Article IV consultation reports include a brief assessment of the authorities' response to the key policy challenges identified in previous consultations. They looked forward to more thorough exchanges of views at the Board on the effectiveness of individual Article IV consultations. Directors urged staff to continue methodological work on assessing effectiveness of surveillance, and pointed, in particular, to the value of case studies to supplement this type of review.

## **Use of Staff Resources**

Directors welcomed information on the use of staff resources on surveillance and tentative cost estimates for the review's recommendations. Some Directors observed that the total costs are large and saw little scope for implementing the recommendations fully without devoting additional resources to surveillance. A number of other Directors were of the view that strengthening surveillance could be achieved through more strategic management of resources, better prioritization, and additional contributions from functional departments to Article IV consultations. A few Directors suggested that functional departments might be oriented to primarily supporting area departments' operations. Many Directors called for further consideration of resource savings and offsets, such as greater selectivity in the coverage of individual surveillance exercises, and a few Directors also suggested adopting longer consultation cycles on a selected basis as well as considering the possibility of moving the surveillance review to a three-year cycle. Directors agreed to pursue discussions on the allocation of resources to surveillance in the context of the FY05 budget.

Given resource limitations, Directors saw a need to define priorities among strategic objectives and specific recommendations, while recognizing that the effectiveness of Fund surveillance depends on its even-handed implementation. Thus, they supported assigning immediate Fund-wide priority to sharpening the focus of Article IV consultations, and, within this, ensuring a deeper treatment of exchange rate issues; enhancing financial sector surveillance; and deepening the coverage of regional and global spillovers in bilateral surveillance. These will be the monitorable objectives for the next surveillance review. In addition, as suggested by the IMFC, further progress on improving debt sustainability and reducing balance sheet vulnerabilities and further work on surveillance in low-income countries will also be monitored in the next review of surveillance.

## **Next Steps**

The Board endorsed today a number of important steps designed to enhance the effectiveness of surveillance, which will be reflected in a revised operational guidance note to staff. In addition, the Board has had fruitful exchanges of views on a number of issues, such as signaling, modalities of surveillance in currency unions, and resources devoted to surveillance, to which it will have the opportunity to return to in the period ahead.

**Public Information Notices (PINs)** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.