INTERNATIONAL MONETARY FUND

Modernizing the Legal Framework for Surveillance—Building Blocks Toward an Integrated Surveillance Decision

Prepared by the Strategy, Policy and Review Department and Legal Department

Approved by Siddharth Tiwari and Sean Hagan

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- **What is the problem?** The legal framework for Fund surveillance is out of tune with the goal of modernizing surveillance. In particular, the framework for bilateral surveillance does not adequately capture economic realities, suffers from an exchange rate bias, and hampers the discussion of policy spillovers across countries. Furthermore, surveillance lacks a clearly defined framework to tackle global issues requiring collective action.
- **Why does it matter?** As any institution, the Fund operates on the basis of its legal framework. A framework aligned with the objective of surveillance can more effectively, evenhandedly, and consistently deliver the kind of surveillance demanded by the Fund's membership.
- **What is the objective?** It is to provide the basis for more effective and relevant surveillance in an integrated world. This means focusing surveillance on economic and financial stability; ensuring that the views taken on global and local issues are fully integrated; recognizing that all economic and financial policies matter for stability and may have a global impact; and providing a framework to foster policy coordination.
- **What is the approach?** An Integrated Surveillance Decision (ISD) would fill the gaps in bilateral surveillance by bringing in multilateral surveillance and bridging the two activities. The Fund would, for the purposes of its policy discussions with individual members, rely not only on its legal authority under bilateral surveillance but on its authority under multilateral surveillance as well. While the two legal mandates would continue to co-exist, surveillance operations would have greater scope for adopting an integrated approach in fulfilling these mandates.
- **What would change?** An ISD would: (i) establish a conceptual link between bilateral and multilateral surveillance and clarify the importance of focusing on global economic and financial stability; (ii) make Article IV consultations a vehicle not only for bilateral surveillance but also for multilateral surveillance, allowing the Fund to discuss the full range of spillovers from a member's policies on global stability; (iii) add guidance on domestic policies, thereby alleviating the exchange rate bias; and (iv) fill in the missing framework for the discussion of issues requiring collective action.
- **What would remain the same?** An ISD would not change the scope of members' obligations. This could only be done by amending the Articles. An ISD would retain a strong focus on stability issues in individual members. It would also preserve the emphasis on exchange rate policies, which is both legally required and economically needed. But it would at the same time elevate the focus on domestic policies.

Contents **Page**

I. INTRODUCTION[1]

1. **Modernizing the legal framework for surveillance is important to strengthening the effectiveness of surveillance.** The legal framework for surveillance (as laid out in Article IV and the relevant Executive Board decisions) has been extensively discussed in recent years within and outside the Fund.[2, 3] Most recently, a Review of the 2007 Decision on Bilateral Surveillance and the Broader Legal Framework for Surveillance was conducted in parallel to the 2011 Triennial Surveillance Review (TSR).[4] All these discussions highlighted the need for modernizing the legal framework including to better integrate all surveillance activities, better cover all policy spillovers, and clarify the framework for multilateral surveillance.

2. **This paper responds to calls from the Executive Board for work toward an Integrated Surveillance Decision (ISD) covering both bilateral and multilateral surveillance.** In the context of the 2011 TSR discussion, most Executive Directors supported or were open to the adoption of an ISD that would reflect a broader approach to global stability and looked forward to a follow-up paper on this topic. The IMFC also called in September 2011 for a "more integrated, evenhanded, and effective surveillance framework."[5] Furthermore, the G-20 Leader's Summit communiqué in November 2011 "recognized the need for better integration of bilateral and multilateral surveillance and looked forward to IMF proposals for a new integrated surveillance decision."

3. **The paper is organized as follows.** Section II provides an overview of the objectives of an ISD, the problems with the current legal framework, and the overall approach in designing a new decision. Section III discusses the scope of surveillance, Section IV surveillance modalities and procedures, and Section V guidance to members in the conduct of their economic and financial policies.

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[1] This paper was prepared by a team comprising Ritu Basu, Era Dabla-Norris, Gilda Fernandez, Tetsuya Konuki, Meron Makonnen, Nadia Rendak and led by Jean-François Dauphin and Ross Leckow.

[2] Internally, following a call from the IMFC in 2009 for the Fund to "review its mandate to cover the full range of macroeconomic and financial sector policies that bear on global stability", ways to ensure that the legal framework adequately supports surveillance were discussed in a series of Board meetings on the Review of the IMF Mandate: *The Fund's Mandate—An Overview*, *The Fund's Mandate—The Legal Framework*, *Modernizing the Surveillance Mandate and Modalities*, *Review of the Fund's Mandate—Follow Up on Modernizing Fund Surveillance*, *Financial Sector Surveillance and the Mandate of the Fund*; and *Strengthening the International Monetary System—Taking Stock and Looking Ahead*.

[3] For external studies, see for instance *Palais Royal Initiative, Reform of the International Monetary System: a Cooperative Approach for the Twenty First Century* (Camdessus, Lamfalussy, Padoa-Schioppa et al., January 2011), and *Strengthening IMF Surveillance: A Comprehensive Proposal* (Truman, December 2010).

[4] See *2011 Triennial Surveillance Review—Review of the 2007 Surveillance Decision and the Broader Legal Framework for Surveillance*. See also *2011 Triennial Surveillance Review—Overview Paper*.

[5] IMFC Communiqué, September 24, 2011.

II. Overview

4. **Simply stated, the objective of an integrated surveillance decision is to provide the basis for a more effective and relevant surveillance in an integrated world**. In today's world, seemingly localized issues can have a global impact, shocks in one sector or economy can spread quickly to others, and physical geography matters less than the networks of trade and financial interconnections. To remain relevant, surveillance needs to better recognize this reality. The global and individual views of the world need to be integrated through improved understanding and recognition of policy spillovers and interactions, with the goal to better promote economic and financial stability. The problem is that the current legal framework hampers efforts to modernize surveillance. As explained below, it does not adequately capture economic realities, suffers from an exchange rate bias, and hampers the discussion of policy spillovers across countries.

5. **Is a change in the legal framework truly necessary—could the Fund not simply get on with it and produce the kind of surveillance needed?** The short answer to this practical objection is that all organizations operate on the basis of their legal frameworks. For precisely the same reasons that the Fund felt impelled to update the 1977 Bilateral Surveillance Decision with the 2007 Decision in order to strengthen exchange rate surveillance, a further revision is needed to address the gaps laid bare by the crisis since 2008, especially with regard to financial and fiscal policies. Reforming the legal framework is necessary to ensure that, by setting clear expectations for the Fund and its members, the necessary evolution of surveillance operations is conducted evenhandedly.

A. Motivation

6. **The global crisis demonstrated how close economic and financial integration can amplify shocks and magnify the cross-border impact of individual country policies**. While globalization brought about significant benefits, it has also been manifested in more potent and long-lasting shocks.[6] From the subprime crisis that ignited it to the current turmoil in Europe, the global crisis is a manifestation of this new order. Transmitted rapidly through globally integrated markets, it highlighted as never before the importance of interconnectedness and policy spillovers, including from domestic policies, in facilitating the buildup of systemic risks.

7. **The crisis also highlighted that, to be truly effective, surveillance needs to focus on global economic and financial stability and how individual countries contribute to it.** On substance, there is a need for surveillance to identify and forestall risks that a localized shock or idiosyncratic policy propagates through the global network and turns into a large-

[6] See *Understanding Financial Interconnectedness* and *Supplementary Information*.

scale crisis. To achieve this goal, surveillance should be reoriented to better capture the implications of members' policies on global stability. More specifically,

- ***Surveillance should focus on global economic and financial stability, in addition to the stability of individual economies.*** Learning from the crisis, these objectives can only be achieved if the Fund promotes economic and financial stability at the levels of both individual economies and globally.
- ***Surveillance needs to ensure that views on global issues and at the level of individual economies are fully integrated***. Understanding how global developments impact local conditions, and how individual circumstances may, by chain reactions or aggregation, lead to global problems is crucial to the effectiveness of surveillance.
- ***Surveillance should recognize that all economic and financial policies are important in promoting stability***. While the legal framework for bilateral surveillance treats exchange rate and other policies differently (see below), in reality, all policies conducted by a member, taken together, contribute to determining economic outcomes.
- ***Issues related to policy spillovers and interactions need to be addressed in surveillance***. At the heart of reorienting surveillance is the understanding of how, including through what channels, policies in individual countries may impact other economies (spillovers) or affect or be affected by policies conducted by other members (interactions). Understanding and discussing such policy spillovers and interactions is crucial in the promotion of stability.
- ***The Fund needs to be able to effectively foster policy coordination to play an effective crisis prevention role***. Beyond the analytical work on policy spillovers and interactions, the Fund needs to highlight policy externalities, suggest alternative policy options, and facilitate policy discussions among members as needed. A clear framework should be in place for the Fund to play such a role effectively and evenhandedly.

8. **Actions are being taken to strengthen surveillance operations.** Building on the TSR, work is ongoing to implement the Managing Director's action plan to strengthen surveillance. Concrete actions include continuing with the voluntary pilot of spillover reports; preparing an external sector report; designing a strategic plan for financial sector surveillance; and strengthening the analytics of interconnectedness and other relevant issues.

9. **But there is also a crucial need to reform the legal framework for surveillance**. As discussed below, the current legal framework suffers from a number of weaknesses that need to be addressed to more effectively support surveillance operations. While some problems are rooted in the Articles of Agreement and would require amending the Articles to be addressed at their core, significant progress could be achieved through revisions in the framework laid out in Board decisions.

B. Issues with the Current Framework

10. **The current legal framework is out of tune with the objectives of surveillance.** It distinguishes between two separate activities: bilateral surveillance whose purpose is to assess members' compliance with their policy obligations under Article IV, Section 1, and multilateral surveillance under which the Fund oversees the international monetary system in order to ensure its effective operation. While the legal framework for bilateral surveillance is subject to important limitations, these do not apply to multilateral surveillance. However, the legal framework for bilateral surveillance has been developed far more extensively through Board decision than has been the case with multilateral surveillance. In contrast to the 2007 Surveillance Decision, which lays out a comprehensive framework for the conduct of bilateral surveillance, there is no functional equivalent for multilateral surveillance.[7] Furthermore, no Board decision has fully clarified how the two activities relate to each other.

11. **The core of the problem with bilateral surveillance lies in the asymmetric treatment of exchange rate and domestic policies under Article IV.** 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." As examples of this general obligation, it imposes more specific obligations on members' exchange rate policies and their domestic economic and financial policies. However, these differ in two important respects. First, exchange rate obligations are "hard" and require members to achieve certain results while domestic policy obligations are "soft" and only require best efforts. Secondly, members are always required to take into account the spillover effects of their exchange rate policies but are only required to conduct domestic policies to promote their own domestic stability, regardless of the potential spillover effects. Furthermore, Article IV, Section 3 requires the Fund to give heightened scrutiny to members' exchange rate policies in its bilateral surveillance by exercising "firm surveillance" over these policies and adopting principles for the guidance of members in the conduct of these policies. While the Fund may adopt corresponding principles for the guidance of members in the conduct of their domestic policies, it is not required and has never been done.

12. **The asymmetric treatment of policies in Article IV creates a number of important problems.** In particular, the framework for *bilateral* surveillance:

- ***Focuses on too narrow an objective***. By focusing on promoting a stable system of exchange rates, it deemphasizes the broader objective of an effectively operating IMS and, in particular, global economic and financial stability as a condition to achieve it.
- ***Insufficiently recognizes the contribution of all policies to economic outcomes.*** In Article IV, Section 1, as further clarified by the 2007 Decision, "exchange rate

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[7] The proposal for a decision on multilateral surveillance in 2010 did not gain sufficient support. See *Review of the Fund's Mandate—Follow-Up on Modernizing Surveillance*.

policies" are understood to directly affect external stability, while "domestic policies" only do so indirectly through the promotion of domestic stability. In reality, all policies contribute to a country's internal and external balances and may ultimately impact global stability. Ultimately, what matters is the policy mix.

- ***Imposes serious limitations on the coverage of policy spillovers.*** Given that the purpose of bilateral surveillance is to assess a member's compliance with its obligations under Article IV, Section 1, it follows that, in the context of bilateral surveillance, the Fund should only discuss with a member issues that are relevant for those obligations. As such, where the member is implementing its policies in a manner that promotes its own domestic stability, the spillover effects from those policies may not be a primary focus of bilateral surveillance.
- ***Is subject to the perception of discrimination among members.*** By establishing a stricter regime for exchange rate policies, Article IV creates the perception that bilateral surveillance discriminates against members that implement exchange rate policies and is in favor of members that maintain floating exchange rates. This perception has a bearing on the traction of surveillance with some members.

13. **Limitations in bilateral surveillance imposed by Article IV have been compounded by additional constraints in the 2007 Decision**. Under the latter, bilateral surveillance permits the Fund to examine outward spillovers only when they are transmitted through the balance of payments.[8] In reality, however, other transmission channels may be equally important. For instance, recent systemic crises demonstrate that the impact of a country's policy decisions can transmit widely and rapidly through incipient asset price changes, as asset and liabilities management strategies of financial institutions outside a country's borders adjust, without necessarily affecting the balance of payments of the originating country. Another example is the reassessment of risks that may be triggered by a specific event and lead to herd behavior, contagion, and the freezing up of markets.[9]

14. **The principal problem with multilateral surveillance is that the governing framework is only partly developed.** The absence of a comprehensive Board decision laying out the modalities for multilateral surveillance has precluded the Fund from using multilateral surveillance as effectively as it could. For example, there is no framework in place for the conduct of multilateral consultations. While it is possible for the Fund (as in 2006) to conduct such consultations on an ad hoc basis, the lack of a comprehensive framework hinders their use on a more systematic basis to bring together members to take collective action to solve common problems.

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[8] For a more complete discussion of the legal framework governing the coverage of spillovers under bilateral surveillance, see *The Fund's Mandate—The Legal Framework*, page 8.

[9] See *Analytics of Systemic Crises and the Role of Global Financial Safety Nets*.

15. **Amending the Articles would help address most of these problems at their root, but this option lacks support.** The most effective way to address the above problems would be to amend the Articles to change the scope of members' policy obligations under Article IV, Section 1. This could be done, for example, by eliminating the distinction between domestic and exchange rate policies, and requiring members to take into account the spillover effects of all their policies. Moreover, the amended Articles could eliminate the distinction between bilateral and multilateral surveillance and replace the two functions with a single exercise. However, it was clear in the Board discussion of the TSR that there is insufficient support within the Fund's membership for this approach at this stage.

16. **Nonetheless, a number of issues can be addressed through the adoption of Board decisions under the existing Articles**. In particular:

- ***There is scope for multilateral surveillance to fill gaps left by bilateral surveillance.*** In contrast to bilateral surveillance, members are not subject to any substantive policy obligations in the context of multilateral surveillance: they are only subject to a procedural obligation to consult with the Fund whenever the Fund considers such consultations necessary to oversee the IMS. However, the scope of potential policy discussions under multilateral surveillance is broader than under bilateral surveillance: in the context of multilateral surveillance, the Fund may examine any issue that is relevant for the effective operation of the IMS, which includes any issue relevant for global economic and financial stability including related policy spillovers. Thus, in terms of the range of issues that the Fund may discuss with a member—and the member will have to discuss with the Fund—multilateral surveillance supplements bilateral surveillance where needed.
- ***There is also scope to use multilateral surveillance to facilitate discussions of policy externalities or other issues where collective action is needed to enhance global economic and financial stability***. Using multilateral surveillance as a legal basis, the Fund could adopt a Board decision that would establish a comprehensive framework for facilitating discussions of policy externalities bilaterally or multilaterally.
- ***For the purposes of bilateral surveillance, the Board may adopt guidance on domestic policies, thereby helping address the problem of asymmetric treatment of policies.*** Article IV, Section 3 requires the Fund to adopt principles for the guidance of members in the conduct of their exchange rate policies, which it did in the 2007 Decision. However, there is nothing that prevents the Fund from adopting corresponding principles for the guidance of members in the conduct of their domestic policies.

17. **An ISD would be the most effective way to crystallize all the desired changes.** This approach, which has commanded broad support from the Executive Board, is further discussed in the next section.

C. General Approach

18. **An ISD would effectively help the Fund fill the gaps in bilateral surveillance by relying on multilateral surveillance and bridging the two activities**. Under this approach, the Fund would, for the purposes of Article IV discussions with individual members, rely not only on its legal authority under bilateral surveillance but also on its authority under multilateral surveillance. While the two legal mandates would continue to co-exist, surveillance operations would have greater scope for adopting an integrated approach in fulfilling these mandates.

19. **An ISD could bring about immediate benefits.** In particular, an ISD would clarify the importance of global economic and financial stability in achieving the objectives of multilateral surveillance. It would establish the *conceptual* link between the multilateral and bilateral mandates and bridge the two activities at the *operational* level. The most significant changes would be as follows:

- ***Article IV consultations would become a vehicle for both bilateral and multilateral surveillance, allowing the Fund to discuss with a member the full range of spillovers arising from its policies***. While Article IV consultations are currently a vehicle for bilateral surveillance, there is nothing that would legally preclude the Fund from also using them for multilateral surveillance. In discussing outward spillovers, the Fund would no longer be constrained by the limitations of bilateral surveillance. To the extent that Article IV consultations would cover spillovers falling under the Fund's multilateral surveillance mandate, members would be obligated to discuss them with the Fund. Accordingly, even if domestic polices do not give rise to domestic instability (and therefore are not a primary focus of bilateral surveillance) the spillover effects of such policies may be scrutinized pursuant to the Fund's multilateral surveillance mandate.

- ***The ISD would fill in the missing framework for the discussion of issues requiring collective action***. It would set clear expectations for the role of members and the Fund in that respect, providing the basis for multilateral consultations.

- ***The ISD would provide guidance on the conduct of domestic policies***. The ISD would preserve the Principles for the guidance of members' exchange rate policies, but for the purposes of bilateral surveillance, would add guidance on domestic policies that are linked to domestic stability, thereby rebalancing the treatment of all policies and addressing the perception of a bias in the framework. The ISD would also encourage members to implement policies that are conducive to the effective operation of the international monetary system.

20. **The ISD would replace, but preserve key elements of, the 2007 Surveillance Decision.** Two important points should be noted:

- ***An ISD would not change the scope of members' obligations, which can only be done through an amendment of the Articles.*** An ISD would need to derive from the existing framework of the Articles of Agreement. As such, this approach would not change the circumstances in which the Fund could *require* a member to change its policies as a legal obligation. But it would enable the Fund to *discuss* on a more comprehensive basis the full range of a member's policies.
- ***Much of the existing 2007 Decision would be incorporated into the new ISD***. As such, an ISD would retain a strong focus on stability issues in individual members, and would ensure that the Fund continues to advise members on the appropriate policy mix to promote their own stability. Moreover, the ISD would preserve the emphasis on exchange rate policies. Such emphasis is both in keeping with the framework of the Articles and economically relevant. But an ISD would also elevate the focus on domestic policies, which is, from an economic point of view, equally important to the assessment of global and individual members' stability.

21. **Set out below is a discussion of the following key building blocks of an ISD. More specifically:**

i) The *scope* of surveillance.

ii) The *procedures* and *modalities* of all surveillance activities.

iii) *Guidance* to members with respect to the conduct of all of their economic and financial policies.

III. CLARIFYING THE SCOPE OF SURVEILLANCE

22. **An ISD would lay out the scope of surveillance and the range of issues it needs to cover.** In defining the scope of surveillance, the ISD would encompass both multilateral and bilateral surveillance and provide, at the conceptual level, a bridge between the two activities deriving from the two separate legal mandates. These issues are discussed in greater depth in Annex I of this paper.

23. **An ISD would clarify that the Fund, to fulfill its surveillance mandates, needs to focus on promoting global economic and financial stability**. More specifically, an ISD would establish the relationship between the objectives of surveillance as set in the Articles of Agreement, (i.e., the *stability of the system of exchange rates* for bilateral surveillance and the *effective operation of the IMS* for multilateral surveillance) and the manner in which these objectives are supported by—and supportive of—*global economic and financial stability* (Box 1). In that context, it would clarify that global economic and financial stability is a necessary condition for the effective operation of the IMS and therefore its promotion is a key focus of multilateral surveillance.

Box 1. The Underlying Concepts of Bilateral and Multilateral Surveillance

Three important concepts for the Fund's surveillance framework are: (i) the stable system of exchange rates which is the objective of bilateral surveillance; (ii) the effective operation of the IMS which is the objective of multilateral surveillance; and (iii) global economic and financial stability.

- **The *stable system of exchange rates* is a system that allows for the necessary adjustments in response to changes in economic fundamentals.** In other words, the stable system of exchange rates should not be understood as meaning unchanging exchange rates: a country should not resist an adjustment in its exchange rate if needed in response to underlying conditions. Rather, the objective is to achieve the stability of the *system,* which is achieved when exchange rates are permitted to fluctuate in response to underlying conditions in situations where economic and financial policies are themselves geared toward the promotion of sound fundamentals.
- **The *effective operation of the international monetary system* is observed when the elements it governs do not exhibit symptoms of malfunction.** The IMS comprises official arrangements that directly control the balance of payments of members (both official and private flows). It consists of four elements: (i) the rules governing exchange arrangements between countries and the rates at which foreign exchange is purchased and sold; (ii) the rules governing the making of payments and transfers for current international transactions between countries; (iii) the rules governing the regulation of international capital movements; and (iv) the arrangements under which international reserves are held, including official arrangements through which countries have access to liquidity through purchases from the Fund or under official currency swap arrangements. As such, the IMS encompasses, but is broader than, the system of exchange rates. It can be regarded as operating effectively when the areas its four elements govern do not exhibit symptoms of malfunction. Such symptoms may include for instance (but are not limited to): an unstable system of exchange rates, persistent current account imbalances, volatile capital flows, or very large build up of international reserves.
- ***Global economic and financial stability* is a broader concept than the effective operation of the IMS, best understood through examples of instability.** Such examples include all the symptoms of malfunction of the IMS as defined above, but go beyond them, to include, for instance, situations such as global recessions and global financial crises. Global economic and financial instability may arise due to factors that could be: (i) related to the elements within the IMS (e.g., disorderly exchange rate adjustments, excessively volatile capital flows, etc.); (ii) other economic and financial factors outside the IMS (e.g., regulatory changes in a globally systemic financial center, commodity price shocks, interest rate shocks, sovereign debt defaults, collapse of a global systemically-important financial institution); and (iii) non economic or financial factors (e.g., war, natural disasters).

24. **An ISD would make clear what, legally, falls within the scope of bilateral surveillance and multilateral surveillance**. It would note that bilateral surveillance focuses on issues that are relevant for a member's compliance with its obligations under Article IV, Section 1 while multilateral surveillance examines issues that may affect the effective operation of the IMS, including through their impact on global economic and financial stability. It would clarify that spillovers from members' polices, including those that are not captured by bilateral surveillance, fall within multilateral surveillance to the extent that they may affect the effective operation of the international monetary system. Making this distinction clear is important, since issues outside the scope of bilateral surveillance cannot form the basis for the Fund to require a member to change its economic or financial policies.

25. **The ISD would clarify that, taken together, bilateral and multilateral surveillance potentially may cover all relevant policy spillovers.** The ISD would recognize that all types of economic and financial policies of a member (including exchange rate, but also fiscal, monetary, financial, capital flow management, and structural policies) may have an impact on global stability. It would also recognize that such spillovers may transmit though a variety of possible channels (including through or outside members' balance of payments) and that, in addition to direct spillovers, global stability may also be negatively impacted by policy *interactions* or inconsistencies. An ISD would also acknowledge that the impact of individual countries' policies may be magnified by the interconnectedness across countries, so size is not the only factor that matters. Even problems in seemingly small sectors (e.g., US subprime real estate market) or economies (e.g., Greece's) can end up having global consequences, either through chain reactions or by aggregation.

26. **In sum, an ISD would clarify that the scope of surveillance, as a whole, cuts across various levels of stability, policies and transmission channels.** As a whole, surveillance would focus on assessing the impact of a country's external and domestic policies on country level stability, regional or group-wide stability of countries that are closely linked, and global economic and financial stability. It would cover all spillovers that influence global economic and financial stability, and would identify situations where policy interactions across countries produce outcomes that are globally suboptimal. But it would also recognize that the assessment of members' policies needs to reflect the exact nature of their obligations, as further discussed below.

27. **An ISD would also help address weaknesses in the surveillance of currency unions identified in the TSR.** The integration of bilateral and multilateral surveillance into an Article IV consultation would help integrate country-level and union-wide surveillance, a concern raised in the TSR study of surveillance in the euro area. In particular, the ISD would foster a better coverage of individual members' policy spillovers within the union and how problems in one country may add up to problems in the union as a whole by aggregation or domino effect.

Box 2 provides an illustrative example of a possible section on the scope of surveillance in an ISD.

Box 2. Illustrative Section on the Scope of Surveillance

Article IV requires the Fund to conduct both bilateral and multilateral surveillance. While legally distinct, the Fund's bilateral and multilateral surveillance are mutually supportive and reinforcing.

Bilateral Surveillance

The scope of bilateral surveillance is determined by members' obligations under Article IV, Section 1. Members undertake under Article IV, Section 1 to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates (hereinafter "systemic stability"). Systemic stability is most effectively achieved by each member adopting policies that promote its own "external stability"—that is, policies that are consistent with members' obligations under Article IV, Section 1 and, in particular, the specific obligations set forth in Article IV, Section 1, (i) through (iv). "External stability" refers to a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements. Except as provided in paragraph [ ] below, external stability is assessed at the level of each member.

In its bilateral surveillance, the Fund will focus on those policies of members that can significantly influence present or prospective external stability. The Fund will assess whether these policies are promoting external stability and advise the member on policy adjustments necessary for this purpose. Accordingly, exchange rate policies will always be the subject of the Fund's bilateral surveillance with respect to each member, as will monetary, fiscal, financial sector policies and capital flow management (both their macroeconomic and macroeconomically relevant structural aspects). Other policies will be examined in the context of surveillance only to the extent that they significantly influence present or prospective external stability.

In the conduct of their domestic economic and financial policies, members are considered by the Fund to be promoting external stability when they are promoting domestic stability—that is, when they: (i) endeavor to direct their domestic economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to their circumstances; and (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. The Fund in its surveillance will assess whether a member's domestic policies are directed toward the promotion of domestic stability. While the Fund will always examine whether a member's domestic policies are directed toward keeping the member's economy operating broadly at capacity, the Fund will examine whether domestic policies are directed toward fostering a high rate of potential growth only in those cases where such high potential growth significantly influences prospects for domestic, and thereby external, stability.

Multilateral Surveillance

The scope of multilateral surveillance is determined in Article IV Section 3 (a) which requires the Fund to oversee the international monetary system in order to ensure its effective operation. The international monetary system consists of: (a) the rules governing exchange arrangements between countries and the rates at which foreign exchange is purchased and sold; (b) the rules governing the making of payments and transfers for current international transactions between countries; (c) the rules governing the regulation of international capital movements; and (d) the arrangements under which international reserves are held, including official arrangements through which countries have access to liquidity through purchases from the Fund or under official currency swap arrangements.

The international monetary system is considered to be operating effectively when the areas its four elements govern do not exhibit symptoms of malfunction such as persistent current account imbalances, foreign exchange rate misalignment, volatile capital flows, or the excessive build up of reserves. It is recognized that, typically, the international monetary system may only operate effectively in an environment of global economic and

Box 2. Illustrative Section on the Scope of Surveillance (concluded)

financial stability (hereinafter referred to as "global stability"), and that its effective operation contributes to such stability. Both global stability and the effective operation of the international monetary system may be affected by, among other factors, members' own external stability, economic and financial interconnections among members' economies and potential spillovers from members' economic and financial policies through balance of payments and other channels.

Therefore, in its multilateral surveillance, the Fund will focus on issues that may affect the effective operation of the international monetary system, including (a) global economic and financial developments and the outlook for the global economy, including risks to global stability, and (b) the spillovers arising from policies of individual members that may significantly influence the effective operation of the international monetary system, for example by undermining global stability. The policies of members that may be relevant for this purpose include exchange rate, monetary, fiscal, and financial sector policies and policies respecting capital flows.

IV. Surveillance Procedures and Modalities

28. **An ISD would lay out the main procedures for surveillance.** The ISD would clarify what is expected from the Fund and its members for both bilateral and multilateral surveillance. In the context of a re-designed Article IV consultation process, it would be clarified that a member is under an obligation to discuss with the Fund any issue that falls within the scope of bilateral or multilateral surveillance. An ISD would also lay out the modalities and clarify expectations for other multilateral surveillance activities, including the monitoring of global economic and financial developments, and multilateral consultations.

A. Article IV Consultations

29. **An ISD would make Article IV consultations a vehicle for the Fund to fulfill not only its bilateral surveillance mandate but its multilateral surveillance mandate as well.** The scope of bilateral surveillance would remain unchanged: the Fund would continue to examine whether a member is conducting its policies in a manner that promotes its own external stability and, with respect to its domestic policies, its own domestic stability. But, in addition, outward spillovers from an individual member's policies that fall outside of bilateral surveillance, irrespective of their source and transmission channels, would also potentially become the subject of Article IV consultations as part of multilateral surveillance.[10] The ISD would provide guidance on the circumstances under which such spillovers would need to be discussed, i.e., when they may significantly affect the effective operation of the international monetary system, for example when they may in themselves or in combination with other factors undermine global stability. Such an approach would go a long way to better integrate bilateral and multilateral surveillance by bringing a more

[10] To the extent the Fund considers it necessary to discuss those spillovers, a member would have to engage in such discussions.

systemic perspective into policy discussions between the Fund and members. Combining the bilateral and multilateral discussions could also help minimize the logistical burden and time demand for policy makers in relevant members.

30. **An ISD would clarify that, in the context of multilateral surveillance, the Fund may offer policy options to better promote global stability, but may not legally require members to change their policies.** As noted above, to the extent that such spillovers fall outside of the scope of bilateral surveillance (e.g., because they do not create domestic instability) but within multilateral surveillance, the Fund could not legally *require* a member to change those policies but it could *discuss* potential policy changes with the member. The ISD would provide that the Fund may suggest, where relevant, policy alternatives to better promote the effective operation of the IMS and global stability. But it would make clear that members would *not* be required to change their policies to the extent that they satisfy their obligations under Article IV, Section 1. Of course, in practice, surveillance is always based on dialogue and persuasion rather than on strict enforcement mechanisms of policy recommendations. However, a key legal and operational issue that the ISD would clarify is that, to the extent that there is a conflict between the domestic policies needed to promote a member's own stability and those to minimize adverse systemic effects, the member's own stability would be given precedence.

31. **The ISD would retain flexibility in the specific procedures for Article IV consultations.** While laying out the basic framework for Article IV consultations, an ISD would preserve flexibility in adapting them to changing circumstances. For instance, as argued in the 2011 TSR, Article IV consultations of several members that are closely interconnected (e.g., with financial links) or face similar challenges, could be discussed by the Board on the basis of a consolidated report.[11] Similarly, there would appear to be no reason to significantly modify the provision governing ad hoc Article IV consultations, so the current paragraph 20 of the 2007 Decision would remain largely intact.

32. **The ISD would preserve the key modalities for surveillance as laid out in the 2007 Decision, extending them to apply also to multilateral surveillance.** The 2007 Decision stresses the importance of dialogue and persuasion, clarity and candor, fostering an environment of frank and open dialogue and mutual trust, and evenhandedness. It provides that the Fund's advice on a member's policies will pay due regard to the member's circumstances, including its implementation capacity. Moreover, it provides that, in advising members on how to promote their stability, the Fund should, to the extent permitted under Article IV, take into account their other policy objectives and place its advice in a medium-term perspective. An ISD would clarify that all of these qualities would equally apply to multilateral surveillance.

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[11] See *2011 Triennial Surveillance Review—Overview Paper*. Note that this could already be done under the current legal framework.

Box 3. Illustrative Section on Bilateral Article IV Consultations

Members shall consult with the Fund regularly under Article IV to enable the Fund to oversee the international monetary system to ensure its effective operation, and to assess members' compliance with their obligations under Article IV, Section 1 and, in particular, exercise firm surveillance over their exchange rate policies. 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 observance by members of the principles set forth above as well as of a member's obligations under Article IV, Section 1. In addition, they shall include a discussion of the spillover effects of a member's economic and financial policies that may significantly affect the effective operation of the international monetary system for example by undermining global stability.

It is expected that no later than sixty-five days after the termination of discussions between the member and the staff, the Executive Board will reach conclusions and thereby complete the consultation under Article IV, except in the case of consultations with members eligible for financing under the Poverty Reduction and Growth Trust established by Decision No. 8759- (87/176), ESAF, as amended, where it is expected that the Executive Board will reach conclusions no later than three months from the termination of discussions between the member and the staff.

B. Other Multilateral Surveillance Activities

33. In addition to the Article IV consultation process, the ISD would set out the framework for other vehicles for multilateral surveillance.

Global Monitoring

34. **An ISD would include a provision for the Fund's monitoring of global developments and assessments of outlook and risks.** It would clarify that such modalities may take the form of the preparation by staff, for discussion by the Board, of regular or ad hoc reports tackling issues relevant for global stability. Examples of such reports include the WEO, GFSR, Fiscal Monitor, and Consolidated Multilateral Surveillance Report, as well as the External Sector Report under preparation. However, the ISD would not prescribe any specific outputs to preserve flexibility to adapt them as circumstances require. The ISD would clarify that, in its surveillance of the global economy, the Fund may collaborate with other international bodies as necessary.

Box 4. Illustrative Section on the Global Economy

The Fund will assess issues relevant for global stability, including broad developments in exchange rates which will be reviewed periodically. These assessments may take the form of periodic or ad hoc reports produced by staff for discussion by the Executive Board, such as the World Economic Outlook, the Global Financial Stability Report, the Fiscal Monitor, and others. In order to inform the Fund's oversight of the operation of the international monetary system, the Managing Director may collaborate with other international bodies in conducting assessments of relevant issues.

Multilateral Consultations

35. **An ISD would provide a framework for the multilateral discussion of global issues requiring collective action.** In case a systemic policy issue required close collaboration among a group of members for an effective solution, a multilateral consultation could facilitate reaching agreement on collaborative action. The Fund has the power under Article IV, Section 3 (a) to hold such consultations.[12] In 2006-07, the Fund did conduct such a multilateral consultation on global imbalances, with the voluntary participation of five members. One lesson from this experience is that it would be helpful to have already in place an agreed framework for holding such consultations, including the expected roles of the Fund and members and other procedural issues, so as to focus on the substance of the issue at hand, as opposed to having each time to agree on the modalities of the consultation in an ad hoc manner.[13]

36. **The ISD would clarify that the Fund would act as a *facilitator* as opposed to trying to broker a particular solution.** The Fund's role in trying to foster agreement on collective action would be to facilitate discussions among members by providing analytical input and identifying policy options. However, the discussion on how best to share the policy adjustments among members would be led by participating members. As argued in previous papers, when a global problem requires adjustments by several countries, there is typically more than one option for burden sharing to achieve the desired global adjustment. The framework for multilateral consultations would recognize that reality.

37. **An ISD would spell out procedures for multilateral consultations.** First, it would allow the Fund to initiate a multilateral consultation on an "as needed" and a "mutual understanding" basis. Specifically, whenever the Managing Director formed the view that there is a need for a multilateral consultation, she/he would seek to reach understandings with the relevant members on the recommended scope and modalities of the possible multilateral consultation and would report to the Board. The Board could then decide to initiate the consultation taking into account the Managing Director's recommendation. Duplication with ongoing processes in other fora such as the G-20 MAP would be avoided: a multilateral consultation would take place only when the collaboration to solve the issue was not already taking place in another context. Finally, as discussed above, while the Fund would serve as a facilitator for discussions, agreement on specific policy actions would be left to relevant members. These delineations in the ISD could help enhance ownership of the process and increase the chances of success.

38. **An ISD would clarify members' procedural obligations under the Articles and the Board's involvement in a multilateral consultation.** As noted above, members are

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[12] See *The Fund's Mandate—The Legal Framework*.

[13] See Appendix I of *Modernizing the Surveillance Mandate and Modalities*.

under a procedural obligation to consult with the Fund for the purposes of multilateral surveillance. Hence, the relevant members would be required to do so in accordance with the Board decision to initiate the multilateral consultation.[14] However, given the cooperative nature of the Fund, it is expected that the Board decision would reflect understandings reached by the Managing Director with the relevant members. For the purposes of the multilateral consultation, participating members would provide the information required for the Fund to undertake its analysis and participate in meetings convened by the Fund with relevant officials. The consultation discussions, including any resulting agreement between participants regarding policy adjustments, would be reflected in a staff report discussed by the Board and then published.

Box 5. Illustrative Section on Multilateral Consultations

Whenever the Managing Director considers that an issue has arisen in a policy area or a member country that may affect the effective operation of the international monetary system, and that requires collaboration among members that is not already taking place in another forum in which the Fund is a party, the Managing Director shall informally and confidentially discuss the issue with the relevant members. Where the Managing Director forms the view that a multilateral consultation is necessary, the Managing Director shall seek to reach understandings with relevant members on the scope and modalities of such consultation and shall report to the Executive Board.

After consideration of the Managing Director's report, the Executive Board may decide that a multilateral consultation will be held. Taking into account any understandings reached by the Managing Director and the relevant members, the decision to initiate a multilateral consultation will set out: (i) the scope of the consultation; (ii) the participating members; (iii) the specific modalities for the consultation; and (iv) the date by which the consultation is expected to be completed. The relevant members shall consult with the Fund in accordance with the decision.

A multilateral consultation will consist of discussions between Fund staff and management and officials of relevant member countries, which may take place on a bilateral or multilateral basis. The Fund will facilitate discussion among participating members and encourage them to agree on policy adjustments that will promote the effective operation of the IMS. In these discussions, the Fund will provide analysis and propose policy options that participating members may adopt, and may advise on the effect of different combinations of policy adjustments.

After the conclusion of these discussions, the Managing Director will report to the Executive Board on the discussions, any agreed policy adjustments and their impact on the participating members and the operation of the IMS. The Executive Board will conclude the multilateral consultation with the consideration of this report and its conclusions will be set out in a summing up of the Chairman.

[14] See *The Fund's Mandate—The Legal Framework* and *Review of the Fund's Mandate—Follow-up on Modernizing Surveillance*.

C. Data Provision Requirements

39. **An ISD could provide a platform to encourage members to enter into voluntary agreements with the Fund to provide key financial sector data.** To map global financial networks, the Fund will need access to both aggregate data on the operation of the networks and those on key systemic institutions.[15] As discussed in the Board papers on modernizing surveillance, under Article VIII, Section 5, the Fund may require a member to report any information it deems necessary for its activities, including surveillance. However, Article VIII, Section 5 (b) makes it clear that members are under no obligation to furnish information in such detail as to disclose the affairs of individuals or corporations. Nonetheless, Article VIII Section 5 (c) clarifies that the Fund may obtain key financial sector information through voluntary agreements with members. To promote better financial sector surveillance, and in particular the monitoring of risks building up in individual financial institutions and discussion of these vulnerabilities with relevant authorities, the ISD could include a provision to encourage members to voluntarily share data on individual institutions, where relevant for the conduct of surveillance.

Box 6. Illustrative Section on Data Provision

The Fund may, under Article VIII, Section 5, require members to provide the Fund with information it deems necessary for the conduct of bilateral and multilateral surveillance. Members shall be under no obligation to furnish information that discloses the affairs of individuals or corporations. However, the Fund may obtain such information by agreement with members with due regard to the confidentiality of such data. The Fund shall collaborate with other international bodies, if relevant, in trying to obtain such information.

V. Providing Guidance to Members

A. Principles for the Guidance of Members in the Conduct of their Policies

40. **An ISD could also elaborate on the "principles" set out in the 2007 Decision to help rebalance the treatment of exchange rate and domestic policies.** The current principles comprise Principles A-D in the 2007 Surveillance Decision. As noted earlier, the fact that the 2007 Decision provides guidance to members only with respect to the conduct of their exchange rate policies has contributed to fuelling a perception of uneven treatment among members. While the Fund is required to adopt principles on exchange rate policies, nothing precludes it from also adopting principles on domestic policies. This could be done as part of bilateral surveillance as it relates to the obligation of members to promote their own domestic stability. With respect to the impact of domestic policies on global stability, guidance could be included under multilateral surveillance.

41. **While the principles in the 2007 Decision guide members on how to comply with their obligations on exchange rate policies, compliance with the principles themselves is**

[15] See *Financial Sector Surveillance and the Mandate of the Fund*.

not, in all cases, obligatory for members. Of the four existing principles, only Principle A on exchange rate manipulation is an obligation as its language simply repeats language of the corresponding obligation set out in Article IV, Section 1 (iii) of the Fund's Articles. In contrast, the other principles (i.e., the current Principles B-D) are "recommendations" that provide guidance to members on how to comply with their obligations. While a member that conducted its policies in a manner consistent with the exchange rate principles would be deemed to comply with its exchange rate obligations, the failure of the member to observe these principles would not necessarily mean that a member would be found in breach of its obligations. Thus, compliance with the current principles creates a presumption of compliance with obligations under Article IV, Section 1, (iii) and (iv), constituting an effective "safe harbor" for members.

42. **Although Principles B-D are currently recommendations rather than obligations, the Fund may adopt a decision transforming them into obligations.** As was explained in the Board papers that led to the 2007 Surveillance Decision, the chapeau sentence of Article IV gives the Fund the legal authority to *require* members to pursue—or refrain from pursuing—specified policies pursuant to their general obligation to collaborate to promote a stable system of exchange rates. Accordingly, the Fund could adopt a decision specifying conduct that members must adhere to in order to be in compliance with their general obligation to collaborate.[16] In practice, the Fund has never taken this step.

43. **In assessing members' observance of the exchange rate principles, the Fund has put in place safeguards for the interest of members.** Article IV, Section 3 (b) provides that any exchange rate principle adopted by the Fund shall "respect the domestic social and political policies of members" and, in adopting these principles, the Fund "shall pay due regard to the circumstances of members". Moreover, the 2007 Decision provides that members are presumed to be implementing policies consistent with the principles and, whenever a question of observance arises, the Fund is to give the member the "benefit of any reasonable doubt". It also provides that the Fund, in informing a member of policy adjustments that need to be made to comply with the principles, "will take into consideration the disruptive impact that excessively rapid adjustment would have on the member's economy." Furthermore, the guidance on the implementation of the 2007 Decision has recognized that, due to methodological uncertainties and the difficulty in attributing economic outcomes to one particular policy, the circumstances under which a member would be found in non observance of Principle D are likely to be very rare.[17]

44. **To rebalance the treatment of all policies in the legal framework for surveillance, it is proposed that an ISD include a new principle E on domestic policies.**

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[16] See *Review of the 1977 Decision on Surveillance over Exchange Rate Policies – Further Considerations*, page 22.

[17] *The 2007 Surveillance Decision—Revised Operational Guidance*.

As the purpose of such a principle would be to provide guidance to members on the observance of their domestic policy obligations under Article IV, Section 1, the scope of any such principle would need to reflect those obligations. As such, it would focus on the promotion of the member's own domestic stability, regardless of the spillover effects arising from such policies. Under the 2007 Decision, a member, in the conduct of its domestic economic and financial policies, promotes external stability by promoting its own domestic stability. Against this background, it is proposed that the new principle focus on monetary, fiscal and financial sector policies that lead to external instability.

45. **Such a principle would help address the perception of a framework that discriminates among members depending on whether or not they are implementing exchange rate policies, without adding to members' obligations.** It would consequently help improve the traction of Fund advice where the perceived exchange rate bias is undermining the Fund's legitimacy. A new principle on domestic policies would not result in any new obligations for members.

46. **The new Principle would be subject to the same safeguards applying to existing ones**. Similar to the current Principles B-D, the new provision would be a recommendation rather than an obligation. Moreover, it would be subject to the same safeguards that apply to the Fund's assessment of members' observance of the exchange rate principles, as explained above. In particular, the recognized methodological uncertainties and difficulty in attributing economic outcomes to one particular policy would also apply to the new Principle.

Box 7. A Possible New Principle E

E. A member should seek to avoid domestic economic and financial policies that result in external instability.

B. Indicators

47. **In the 2007 Decision, indicators are provided to guide the assessment of members' observance of the principles for the conduct of exchange rate policies.** These indicators serve to signal whether or not a thorough review is necessary in the context of an Article IV consultation. The purpose of these indicators is to provide more operational clarity to aide in the assessment of whether or not a member is complying with its obligations under Article IV. These indicators are only the starting point for further dialogue with members, and would not be considered sufficient by themselves in gauging whether members are in observance of the principles.

48. **On balance, staff does not see a case for revising the current list of indicators.** While the addition of the new principle on domestic policies could justify adding indicators to provide more specific guidance on the monitoring of members' domestic policies, staff, overall, sees no compelling reason for revising the existing list of indicators. The ultimate

purpose of the indicators is to provide guidance on whether or not a member is in breach of its obligations under Article IV; these obligations will not change with the introduction of an ISD. Moreover, the list of indicators is already fairly broad, and includes variables, such as the exchange rate and the current account, whose assessment methodology (e.g., in CGER and the upcoming external balance assessment) involves looking at a number of domestic policy variables (e.g., public debt). Furthermore, a list of indicators relating to the contribution of domestic policies to domestic and external stability is potentially very long (e.g., financial sector indicators, output gaps, price developments, etc.) and includes areas where data gaps are significant, for instance on flow of funds or balance sheet vulnerabilities and would therefore be difficult to apply uniformly. Ultimately, what is required is for surveillance to conduct a comprehensive health check of the economy, based on all relevant and available economic data and techniques.

C. Promoting Global Stability

49. **An ISD could also provide guidance for the promotion of global stability by encouraging members to take into account the global effect of their policies, either in themselves or in combination with the policies of other members.** Such encouragement would be fundamentally different from the principles adopted for the purposes of bilateral surveillance. It would not relate specifically to members' compliance with their obligations. Rather, it would only form the basis for policy discussions in the context of multilateral surveillance on issues that go beyond members' policy obligations under Article IV, Section 1.

Box 8. Illustrative Language on Promoting Global Stability

Beyond members' obligations under Article IV Section 1, and recognizing that a member's policies may have a significant impact on other members and on global economic and financial stability, members are encouraged to implement domestic and external economic and financial policies that, in themselves or in combination with the policies of other members, are conducive to the effective operation of the international monetary system.

Annex I. Multilateral and Bilateral Surveillance—Some Conceptual Considerations

1. **This annex lays out some conceptual issues relevant for the definition of the scope of surveillance in an ISD.** In defining the scope of surveillance, the ISD would encompass both multilateral and bilateral surveillance and provide, at the conceptual level, a bridge between the two activities deriving from the two separate legal mandates. Importantly, it would also clarify that the Fund, in order to fulfill its surveillance mandates, needs to focus on promoting economic and financial stability not only at the individual but also at the global level—a key objective of the modernization of the legal framework, as noted earlier. In turn, an ISD would clarify that all economic and financial policies may have an impact on individual countries' stability, as well as on global stability, through a variety of possible transmission channels, and that therefore all spillovers may potentially fall within the scope of surveillance. This annex discusses these issues in greater detail.

A. Understanding and Mapping the Concepts at Hand

2. **To build the bridge between multilateral and bilateral surveillance, it is important to understand how their respective objectives relate to each other**. In thinking through how to lay out the scope of surveillance in an ISD, one needs to understand the relationship between the objectives of surveillance as set in the Articles of Agreement, i.e., the *stability of the system of exchange rates* for bilateral surveillance and the *effective operation of the IMS*, which is the objective of multilateral surveillance and the manner in which these objectives are supported by—and supportive of—*global economic and financial stability*. In that context, defining and mapping these concepts is useful.

- ***The stable system of exchange rates* is a system that allows for the necessary adjustments in response to changes in economic fundamentals.**[1] In other words, the stable system of exchange rates should not be understood as meaning unchanging exchange rates: a country should not resist an adjustment in its exchange rate if needed in response to underlying conditions. Rather, the objective is to achieve the stability of the *system,* which is achieved when exchange rates are permitted to fluctuate in response to underlying conditions in situations where economic and financial policies are themselves geared toward the promotion of sound fundamentals.
- ***The effective operation of the IMS* is observed when the elements it governs do not exhibit symptoms of malfunction.** As explained in previous Board papers, the IMS comprises official arrangements that directly control the balance of payments of members (both official and private flows).[2] It consists of four elements: (i) the rules governing exchange arrangements between countries and the rates at which foreign exchange is purchased and sold; (ii) the rules governing the making of payments and

[1] See *Article IV of the Fund's Articles of Agreement—An Overview of the Legal Framework*.
[2] See *The Fund's Mandate—The Legal Framework*.

transfers for current international transactions between countries; (iii) the rules governing the regulation of international capital movements; and (iv) the arrangements under which international reserves are held, including official arrangements through which countries have access to liquidity through purchases from the Fund or under official currency swap arrangements. As such, the IMS encompasses, but is broader than, the system of exchange rates. It can be regarded as operating effectively when the areas its four elements govern do not exhibit symptoms of malfunction. Such symptoms may include for instance (but are not limited to): an unstable system of exchange rates (see above), persistent current account imbalances, volatile capital flows, or very large build up of international reserves.[3]

- ***Global economic and financial stability* is a broader concept than the effective operation of the IMS, best understood through examples of instability.** Such examples include all the symptoms of malfunction of the IMS as defined above, but go beyond them, to include, for instance, situations such as global recessions and global financial crises. Global economic and financial instability may arise due to factors that could be: (i) related to the elements within the IMS (e.g., disorderly exchange rate adjustments, excessively volatile capital flows, etc.); (ii) other economic and financial factors outside the IMS (e.g., regulatory changes in a globally systemic financial center, commodity price shocks, interest rate shocks, sovereign debt defaults, collapse of a global systemically-important financial institution); and (iii) non economic or financial factors (e.g., war, natural disasters).

3. **Global economic and financial instability typically results in the IMS not operating effectively.** The effective operation of the IMS and global economic and financial stability are intrinsically linked. First, as just noted, the effective operation of the IMS is part of, and thus a condition for, global economic and financial stability. But conversely, global economic and financial instability, even when not originating within the IMS, will typically result in the IMS not operating effectively. In other words, it will always pose a *threat* to the effective operation of the IMS, including the stability of the system of exchange rates. This, de facto, makes global economic and financial stability a necessary condition for the effective operation of the IMS. The history of systemic crises shows that symptoms of malfunction of the IMS and other manifestations of global economic and financial stability are so closely related that the causality is bidirectional (Figure 1).[4] Empirical evidence

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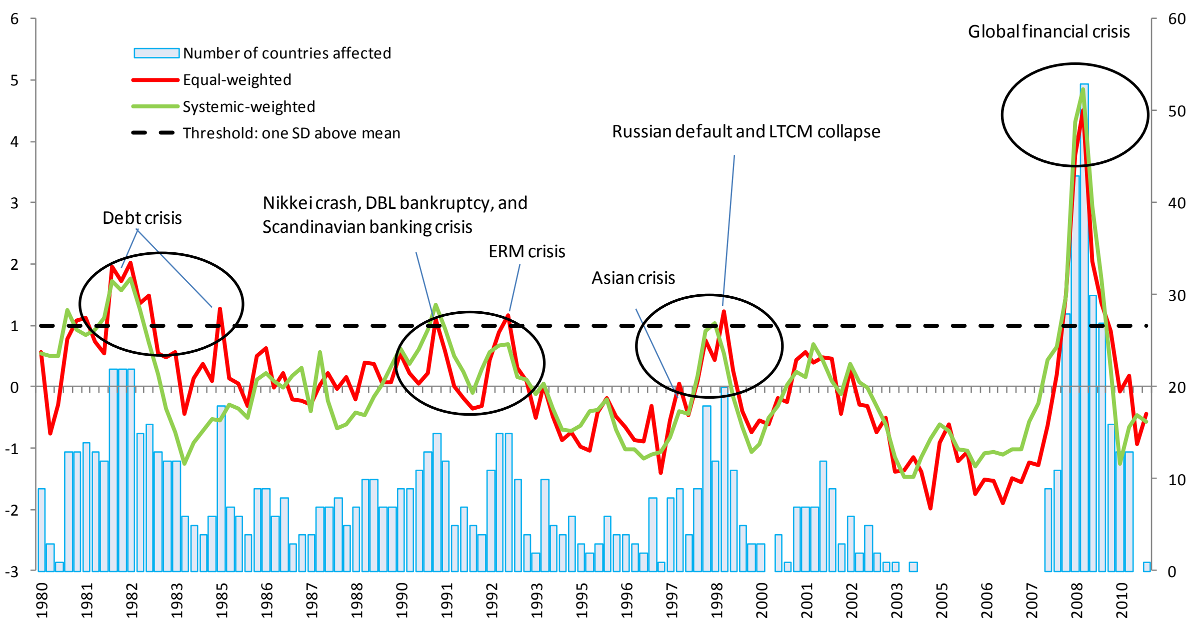
[3] See *Strengthening the International Monetary System: Taking Stock and Looking Ahead*.

[4] See for example *Analytics of Systemic Crises and the Role of Global Financial Safety Nets*; *This Time Is Different, A Panoramic View of Eight Centuries of Financial Crises*, Carmen Reinhart and Kenneth Rogoff, NBER Working Paper 13882; *Banking Crises: An Equal Opportunity Menace*, Carmen Reinhart and Kenneth Rogoff, December 17, 2008.

illustrates these links.[5] For example, various emerging market crises in the 1990s (e.g., Asian crisis, Mexican crisis) involved major disruptive exchange rate adjustments and led countries to self insure against future crisis by ramping up their international reserves to unprecedented levels. There is some evidence that countries have used reserve buffers to help ease the impact of crises on their domestic economies.[6] However, excessive reserve build up that are concentrated in a few reserve currencies could contribute to global imbalances.[7] Another example is that periods of high international capital mobility have been closely associated with crisis episodes.[8]

Figure 1. Systemic-weighted and Equal-weighted Global Systemic Crisis Indicators



Source: WEO database and IMF staff calculations.
1/ A country is considered "affected" if its country-level crisis indicator (a simple average of FSI/EMPI and real GDP growth, both normalized) is above one standard deviation from its mean. Global systemic crisis indicators are constructed as a simple average of normalized global real and financial stress indices, which aggregate country-level indicators using either "systemic importance" as weights (systemic-weighted) or equal weights. Both global crisis indicators are normalized for easy presentation and comparison.

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[5] See *Strengthening the International Monetary System: Taking Stock and Looking Ahead*, and *The Multilateral Aspects of Policies Affecting Capital Flows*.
[6] See *Assessing Reserve Adequacy*.
[7] See *The Fund's Mandate—Future Financing Role*.
[8] See *This Time Is Different, A Panoramic View of Eight Centuries of Financial Crises*, Carmen Reinhart and Kenneth Rogoff, NBER Working Paper 13882 and *Banking Crises: An Equal Opportunity Menace*, Carmen Reinhart and Kenneth Rogoff, December 17, 2008.

4. **Therefore, the promotion of global economic and financial stability is essential for the Fund to fulfill its surveillance mandate.** Figure 2 illustrates the links between the stability of the system of exchange rates, the effective operation of the IMS and global economic and financial stability. While global economic and financial stability is a broader concept than the effective operation of the IMS, the fact that the former is also a necessary condition for the latter (the arrow going downward in the diagram below) implies that in order to discharge of its responsibility to ensure the effective operation of the IMS, the Fund needs to promote global economic and financial stability.

Figure 2. Mapping the Different Concepts of Stability

B. The Contribution of Members' Policies

5. **The spillover effects of a member's policies can have particularly important implications for global economic and financial stability.** To promote global economic and financial stability, there is a need to promote, as a first order, individual economies' domestic and external stability. But independently of whether or not this is the case, the spillovers of members' policies (including domestic policies) may have important systemic impact. For example,

- *Monetary* easing, particularly of systemically-important countries, could lead to massive capital inflows into other countries that complicate macroeconomic policy making, and could reverse if monetary tightening in the source country takes place, causing disruptive movements in exchange rates.
- Loose and unsustainable *fiscal* policies of even small countries that are part of a currency union could cause global financial markets to react negatively, affecting private investment decisions and portfolio allocations.
- Lax *financial* regulation coupled with loose monetary policy in a systemically important country could fuel localized real estate bubbles the bursting of which could have massive ripple effects across the globe.

- *Capital flow management* measures (CFM) implemented by a country to control potentially destabilizing capital inflows could trigger retaliatory measures by other countries, and a proliferation of such measures could have significant global implications.[9]
- *Structural* issues depressing domestic demand (e.g., weak social safety net) in large surplus economies could contribute to exacerbating global imbalances.

6. **Such spillovers can have a significant impact on global economic and financial stability regardless of whether they are transmitted through the balance of payments or through other channels.** As demonstrated by recent crises, factors such as contagion or swings in market sentiments in reaction to policy announcements can transmit shocks across borders through asset prices without necessarily going through the balance of payments.[10]

7. **Beyond direct spillovers from individual countries' policies, global stability may be negatively impacted by policy *interactions* or inconsistencies.**[11] Intensified interconnection may exacerbate tension between individual stability and systemic stability through policy interactions. An illustrative example could be if, say, country A –with a floating exchange rate--attempts to reduce its current account deficit without sacrificing its domestic demand by loosening monetary policies. This might increase capital flows to fast-growing country B, which may impose capital inflow restrictions to stabilize its own economy. However, these stabilizing measures by countries A and B may cause massive capital flows to other fast-growing countries and lead to volatile capital flows and abrupt exchange rate adjustments.

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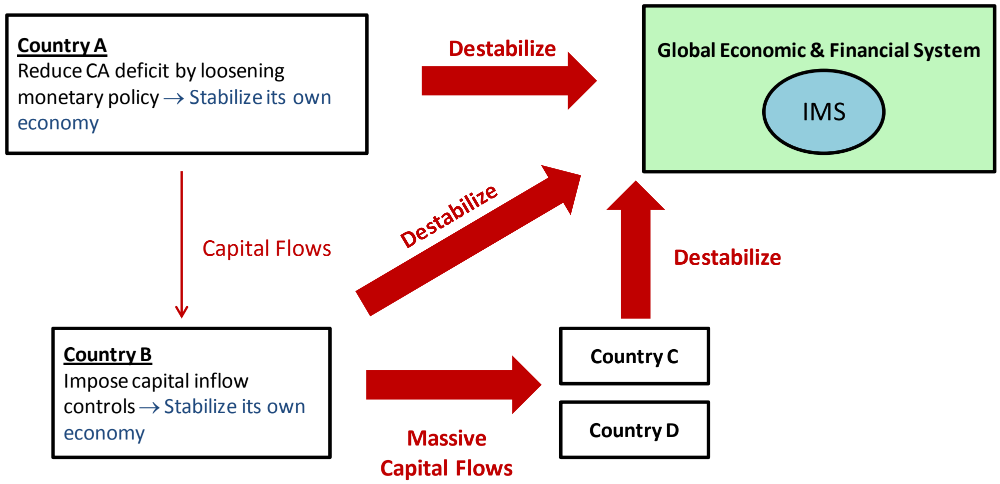
[9] See *The Multilateral Aspects of Policies Affecting Capital Flows*.

[10] See *Understanding Financial Interconnectedness*, *The Multilateral Aspects of Policies Affecting Capital Flows—Background Paper*, *Unforeseen Events Wait Lurking, Estimating Policy Spillovers from U.S. to Foreign Asset Prices* (IMF Working Paper 11/183).

[11] See *Strengthening the International Monetary System: Taking Stock and Looking Ahead* and *The Multilateral Aspects of Policies Affecting Capital Flows*.



8. **The potential impact of individual countries' policies is magnified by the degree of interconnectedness across countries, so size is not the only criteria that matters.** Studies have shown that interconnectedness of countries through both trade and financial channels have increased exponentially over the past years.[12] This combined with rapid financial globalization that has taken place as demonstrated by a six-fold increase in the external assets and liabilities of countries in percent of GDP, as well as the proliferation of global systemically-important financial institutions have contributed significantly to the transmission channels of shocks.[13] As a result, problems in seemingly small sectors (e.g., US subprime real estate market) or relatively small economies (e.g., Greece's) can end up having global consequences. This global impact may be the result of a chain reaction (through the impact on other economies) or by aggregation of a large number of small problems.

C. Implications for the Scope of Surveillance

9. **What is the implication of the above discussion for the scope of surveillance in an integrated surveillance decision?** The following figures summarize the discussion so far.

- The ***current legal framework*** clearly separates bilateral from multilateral surveillance, with bilateral surveillance artificially distinguishing between the role of external and domestic policies, and not effectively capturing spillovers arising from domestic policies:

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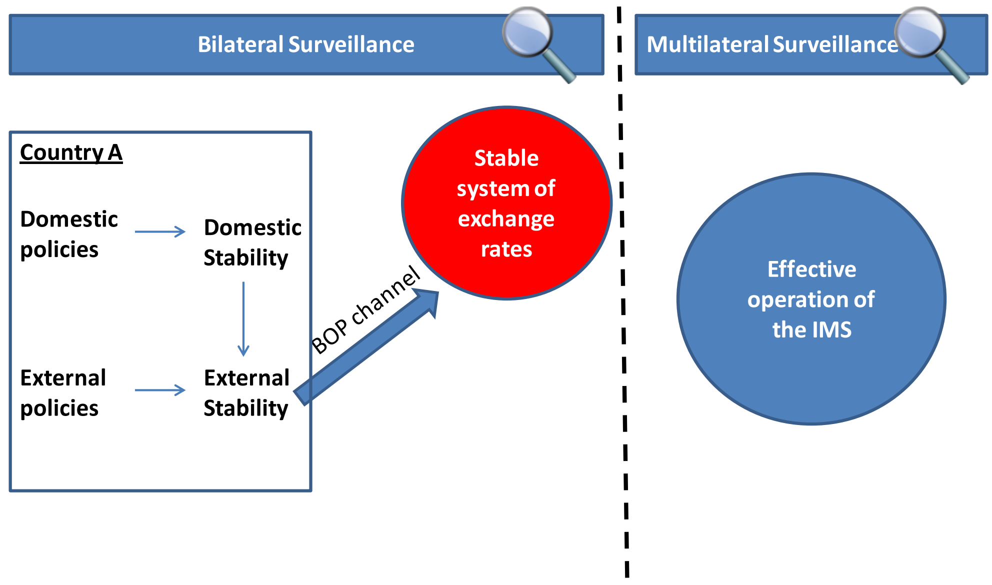
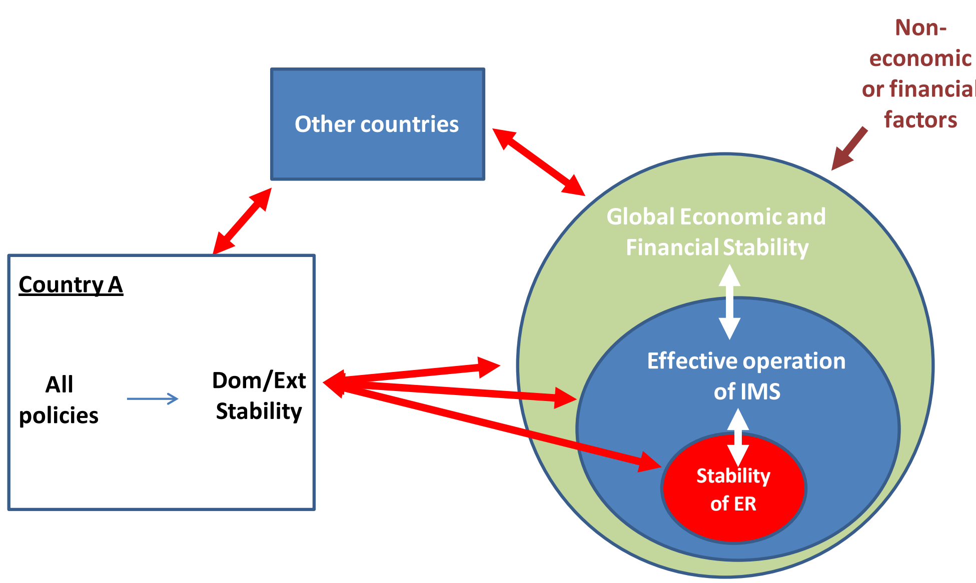
[12] See *Multilateral Aspects of Policies Affecting Capital Flows*.

[13] See *The External Wealth of Nations Mark II*, Philip Lane and Gian Maria Milesi-Ferretti, Journal of International Economics, 73(2), November 2007; and *Understanding Financial Interconnectedness*.

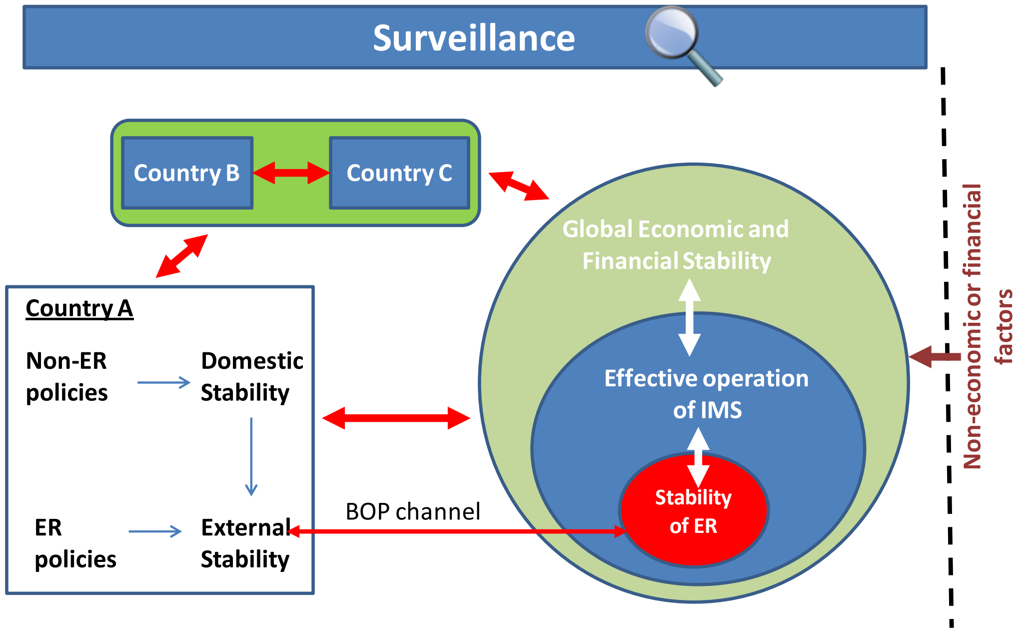


- In ***economic reality***, the combination of all policies affect the balance of an economy and may impact on the effective operation of the IMS, transmission channels from individual policies to the system are many and complex, and the stability of the system of exchange rates, the IMS and global economic and financial stability are closely intertwined.



10. **A new framework would need to address this economic reality, within the constraints of the Articles**. The framework for bilateral surveillance would be preserved, but it would be complemented by a more comprehensive framework for multilateral surveillance that would allow the Fund to discuss, including in an Article IV consultation,

with an individual country, the issues that fall outside of the scope of bilateral surveillance–in particular, spillovers relevant for global stability that arise from a member's domestic policies or that are transmitted through channels other than the balance of payments.



11. **In sum, an ISD would clarify that the scope of surveillance, as a whole, cuts across various levels of stability, policies and transmission channels.** Surveillance as a whole should focus on country level stability, regional or group-wide stability of countries that are closely linked, and global economic and financial stability. It needs to look at both external and domestic policies (including exchange rate, monetary, fiscal, financial, capital flow management, and structural policies), and assess the impact of these policies on a country's own stability, and also assess potential adverse spillovers from these policies on global stability. It should cover all potential channels of transmission of spillovers, and would identify situations where policy interactions across countries produce outcomes that are globally suboptimal.