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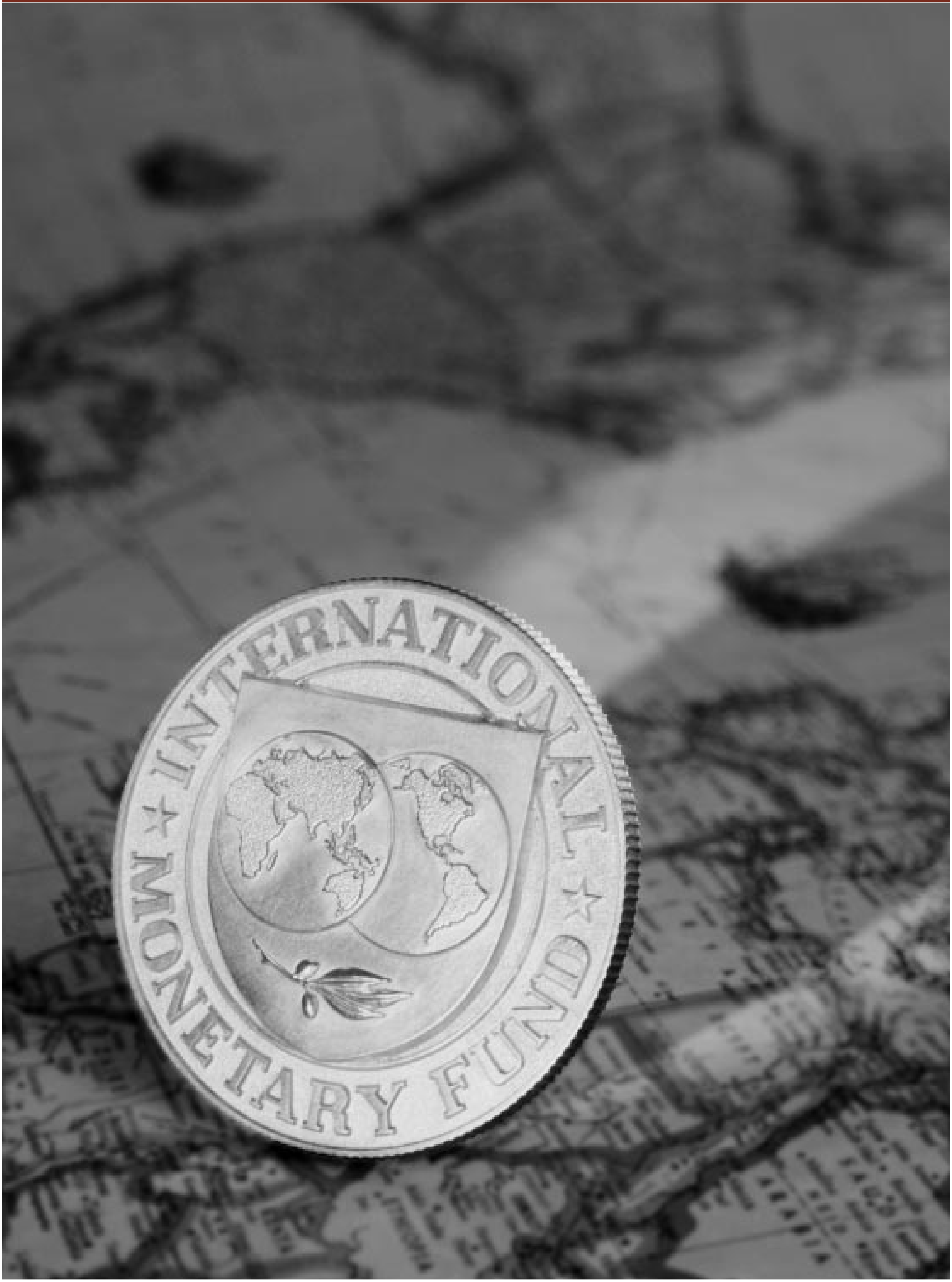

CHAPTER 4

Issues in Fund Surveillance

The Fund has the mandate under its Articles to exercise firm surveillance over the exchange rate policies of members in order to oversee the international monetary system and ensure its effective operation. To this end, the Fund assesses the appropriateness of each member's economic and financial policies in achieving the objectives of orderly economic growth with reasonable price stability, promoting stable underlying economic and financial conditions and a monetary system that does not produce erratic disruptions, and following exchange rate policies compatible with these undertakings. Surveillance thus combines the analysis of individual country policies with an examination of the consequences of these policies for the global economic system.

The two principal means of surveillance are annual consultations, known as Article IV consultations, with each member country and the twice-yearly World Economic Outlook discussions, which consider issues and policies from a global perspective. These are supplemented by other discussions, such as those on international capital market developments, and regular Board deliberations on important issues in selected countries and on world economic and market developments. The Board's work is supported by the Managing Director's participation in other forums, such as in the policy discussions of the Group of Seven industrial countries in which he presents the Fund's views on the global implications of these countries' policies.

Surveillance through Article IV consultations is the primary channel for collaboration between the Fund and members (see Chapter 5). For members facing balance of payments difficulties, formal financial arrangements for the immediate use of Fund resources provide a framework for more intensive collaboration (see Chapter 9). In addition, some members have found it useful to collaborate closely with the Fund and the staff in a number of other ways. These other types of collaboration include precautionary financial arrangements, informal staff-monitored programs, and enhanced surveillance. In some cases, such intensified monitoring has been a prelude to a Fund-supported program, especially by documenting the establishment or reestablishment of a track record of policy implementation. In other cases, monitoring provides the authorities with a framework to reassure interested third parties, such as donors, creditors, or financial markets.

- Under precautionary arrangements, members reach agreement with the Fund on a Stand-By Arrangement or an Extended Arrangement but do not use resources committed under these arrangements. Precautionary arrangements are useful for the member in providing a framework for financial policy, as well as highlighting the Fund's endorsement of a member's policies and boosting confidence in these policies.
- Informal staff-monitored programs provide a member with more intensive dialogue than provided by the annual Article IV consultation but do not imply formal Fund endorsement of the member's policies.
- In enhanced surveillance, which also does not constitute formal Fund endorsement, the emphasis is on close and formal monitoring of a member's economic program by the Fund. This procedure was established in 1985 to facilitate debt-rescheduling arrangements with commercial banks, but it has been used occasionally in other situations.

Review of Current Practices

In 1996/97, the Board reviewed both the policy strategy of the Fund's membership to sustain global growth and the progress made in recent years in strengthening Fund surveillance.

Members' Policies in the Context of Surveillance

Interim Committee Declaration

At its meeting in Madrid in October 1994, the Interim Committee issued a *Declaration on Cooperation to Strengthen the Global Expansion* (*Annual Report, 1995*, pp. 207–208). This declaration, while welcoming the improved prospects for world economic growth, cautioned that serious policy challenges remained: these were to sustain economic growth, reduce unemployment, and prevent a resurgence of inflation in the industrial countries; to maintain and extend growth through strong programs of adjustment and structural reform in developing countries; and to integrate the economies in transition into the world economy and to set them firmly on the path of sustainable growth. To meet these challenges, the declaration outlined a common strategy agreed by the Committee. The strategy emphasized the importance of sound domestic policies, international cooperation, and global integration.

Subsequently, in its communiqué following its meeting in April 1996, the Committee requested the Board to review progress toward the goal set in the declaration and to update it and refine it if necessary. The Board conducted the review in September 1996 and agreed that the cooperative medium-term global strategy to sustain and extend economic growth remained valid. It noted that the favorable performance of many industrial, developing, and transition economies owed much to the implementation of policies that were consistent with the strategy. In light of the changing global environment, however, the Board recommended that the Interim Committee update and broaden the Madrid Declaration, and strengthen its implementation in a renewed spirit of partnership.

At its September 1996 meeting, the Interim Committee took account of the outcome of the Board's deliberations and adopted a *Declaration on Partnership for Sustainable Global Growth* (Box 3). Following its subsequent meeting in April 1997, the Committee reaffirmed that the implementation by all members of the guidelines set out in this new declaration would be essential to ensure that all shared in an increasingly prosperous world economy. It stressed in particular the importance of sound macroeconomic policies, market-oriented reforms, sound banking systems, trade and investment liberalization, and good governance. (See Appendix VI.)

Six-Monthly Review by Board

In the wake of the Madrid Declaration of October 1994, since 1995 the Board has also been conducting six-monthly reviews of members' policies in the context of surveillance. These reviews were initially conceived as a review of the implementation of members' policies under the Madrid Declaration but later were broadened to include a review of policy performance under Article IV. They are held in the spring and in the fall prior to the meeting of the Interim Committee and provide an opportunity for the Board to review those issues that have been prominent in the Article IV dialogue with members. A report based on the Board's discussions is transmitted by the Managing Director to the Interim Committee for its consideration, thereby providing a bridge between the Board's bilateral surveillance activities and the broader issues addressed by the Interim Committee.

The latest in the series of six-monthly reviews of members' policies in the context of surveillance took place in September 1996. (The six-monthly review did not take place in April 1997 in view of the biennial review of surveillance that was held at that time—see below.) In the September 1996 discussion, the Board focused on three issues that had surfaced with some frequency in country surveillance discussions: the composition of fiscal adjustment, disinflation in countries with persistent inflation at moderately high levels, and trade policy in transition economies. A report based on the Board's discussion was transmitted to the Interim Committee for consideration at its meeting in September 1996.

In their discussion, Directors stressed that fiscal adjustment was the most pressing policy objective for many members, noting that from a global viewpoint it yielded systemic benefits by raising world saving and contributing to stability in increasingly integrated financial markets. The composition of that adjustment, however, was also important, since it affected the quality and sustainability of fiscal consolidation. Directors emphasized that Fund advice should be tailored to take account of country-specific circumstances and the often limited options available. In this context, the size of the public sector was seen by Directors as an important factor in shaping the Fund's fiscal adjustment recommendations. In many industrial countries with large public sectors, fiscal consolidation inevitably should put greater weight on expenditure reductions than on revenue increases. In some other countries, particularly developing countries with a great need of public goods, such as health, education, and infrastructure, as well as those industrial countries with relatively low revenue-to-GDP ratios, it was felt that medium-term fiscal consolidation could rely somewhat more on efforts to raise additional revenues.

Noting the inevitable trade-offs between short-run stabilization and medium-term structural improvements in public finances, some Directors considered that when imbalances were large, priority should be given to reducing them rapidly, even if measures had to be unwound later; in their view, the greatest risk was fiscal inaction. Others emphasized the need for a credible medium-term path for fiscal consolidation if it were to be sustainable. The Board agreed that the Fund should encourage reforms to spending programs that would lead to a durable restructuring of the public sector in the medium term, and that it should pay due regard to equity and efficiency considerations in recommending specific revenue measures.

Box 3

Interim Committee Declaration on Partnership for Sustainable Global Growth

The following Declaration on Partnership for Sustainable Global Growth *was adopted at the conclusion of the forty-seventh meeting of the Interim Committee of the Board of Governors of the Fund, September 29, 1996.*

The Interim Committee has reviewed the *Declaration on Cooperation to Strengthen the Global Expansion*, which it adopted two years ago in Madrid. It notes that the strategy set out in the Declaration, which emphasized sound domestic policies, international cooperation, and global integration, remains valid. It reiterates the objective of promoting full participation of all economies, including the low-income countries, in the global economy. Favorable developments in, and prospects for, many industrial, developing, and transition economies owe much to the implementation of sound policies consistent with the common medium-term strategy.

The Interim Committee sees a need to update and broaden the Declaration, in light of the new challenges of a changing global environment, and to strengthen its implementation, in a renewed spirit of partnership. It attaches particular importance to the following:

- Stressing that sound monetary, fiscal, and structural policies are complementary and mutually reinforcing: steady application of consistent policies over the medium term is required to establish the conditions for sustained noninflationary growth and job creation, which are essential for social cohesion.
- Implementing sound macroeconomic policies and avoiding large imbalances are essential to promote financial and exchange rate stability and avoid significant misalignments among currencies.
- Creating a favorable environment for private savings.
- Consolidating the success in bringing inflation down and building on the hard-won credibility of monetary policy.
- Maintaining the impetus of trade liberalization, resisting protectionist pressures, and upholding the multilateral trading system.
- Encouraging current account convertibility and careful progress toward increased freedom of capital movements through efforts to promote stability and financial soundness.
- Achieving budget balance and strengthened fiscal discipline in a multi-year framework. Continued fiscal imbalances and excessive public indebtedness, and the upward pressures they put on global real interest rates, are threats to financial stability and durable growth. It is essential to enhance the transparency of fiscal policy by persevering with efforts to reduce off-budget transactions and quasi-fiscal deficits.
- Improving the quality and composition of fiscal adjustment, by reducing unproductive spending while ensuring adequate basic investment in infrastructure. Because the sustainability of economic growth depends on development of human resources, it is essential to improve education and training; to reform public pension and health systems to ensure their long-term viability and enable the provision of effective health care; and to alleviate poverty and provide well-targeted and affordable social safety nets.
- Tackling structural reforms more boldly, including through labor and product market reforms, with a view to increasing employment and reducing other distortions that impede the efficient allocation of resources, so as to make our economies more dynamic and resilient to adverse developments.
- Promoting good governance in all its aspects, including by ensuring the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption, as essential elements of a framework within which economies can prosper.
- Ensuring the soundness of banking systems through strong prudential regulation and supervision, improved coordination, better assessment of credit risk, stringent capital requirements, timely disclosure of banks' financial conditions, action to prevent money laundering, and improved management of banks.

The Committee encourages the Fund to continue to cooperate with other international organizations in all relevant areas. It welcomes the recent strengthening of Fund surveillance of member countries' policies, which is an integral part of the strategy. It reaffirmed its commitment to strengthen the Fund's capacity to fulfill its mandate. It will keep members' efforts at achieving the common objectives of this strategy under review.

On the issue of inflation, the Board observed that price stability was a principal macroeconomic policy objective and that the reduction of even moderate rates of inflation was a key task for many members. Some Directors noted that, in a number of emerging market economies, growth had been high despite moderate inflation. This suggested that some circumstances, such as the rapid structural changes taking place in some transition countries, might warrant a more gradual pace of disinflation. Most Directors, however, were of the opinion that inflation inertia could undermine the foundation for sustained growth.

Finally, in the area of trade reforms, Directors noted that many transition countries had made important progress in recent years. Most Directors concurred that Fund policy advice and financial support should emphasize minimizing backward steps, pursuing further trade reform, and adopting tariff-based import regimes. They also agreed that it was preferable not to utilize trade measures to supplement insufficient fiscal revenues; the authorities should instead focus on improving the efficiency of tax administration. The complementarities between trade liberalization and other structural reforms were noted by Directors; thus, increased competition would accelerate enterprise restructuring and create a more level playing field for private enterprise.

Biennial Review of Surveillance

The principles and procedures of surveillance are described in a 1977 document "Surveillance Over Exchange Rate Policies." The principles pertain to the conduct of members' exchange rate policies, as well as to the Fund's surveillance over those policies. The Board is required to review these principles normally every two years to see if any modifications might be needed to take account of changing economic circumstances. The Board conducted the most recent review during March–April 1997.

In the course of the review, Directors made a number of observations on the principles and procedures of surveillance.

- They noted that numerous initiatives had been taken in the wake of the Mexican financial crisis to increase the effectiveness of Fund surveillance. Directors agreed that steady progress had been made, particularly with regard to detecting emerging financial tensions at an early stage, and they emphasized the need for continued cooperative efforts on the part of the Fund and its membership to meet the challenges that lay ahead.
- Directors welcomed the increased focus on data issues, such as the efforts to ensure the regular and timely reporting of economic data to the Fund and the introduction of the Special Data Dissemination Standard (SDDS) to make data available to the public (see the section on Data Dissemination, below).
- They agreed that the continuity of surveillance had improved, as evidenced by the increased country coverage of Article IV consultations, the intensification of contacts between Fund staff and country authorities between Article IV consultations, the greater use of follow-up procedures, and the periodic Board discussions on country matters and world economic and market developments.
- They welcomed the fact that, in general, delays in holding consultations had been reduced in 1995–96. Several Directors, however, regretted that, for some members, Article IV consultations had been delayed considerably and that in several countries the economic situation had deteriorated in the period between consultations. These Directors, emphasizing that Article IV consultations should not be postponed because of protracted program negotiations, advocated earlier Board involvement in such cases.
- Directors stressed that the principle of annual consultations with members represented a cornerstone in ensuring the continuity of surveillance. At the same time, they recognized that the procedures needed to be flexible to ensure an effective focus of Fund surveillance, particularly in the context of limited resources. Directors therefore agreed to make greater use of longer consultation cycles to redirect resources according to priorities. Decisions to lengthen cycles in each case would be made with the consent of the Executive Directors and the authorities and, more generally, with input from the Board.
- Directors considered as largely appropriate the priorities and focus of Fund surveillance over the two preceding years. In this connection, the increased attention accorded to capital account and financial and banking sector issues was welcomed by Directors, given the global trend of financial integration and the Fund's role as the central international monetary institution.
- They agreed that programs monitored by Fund staff provided the requisite flexibility to respond to a demand for closer relations with the Fund without the use of Fund financial resources. A few Directors suggested that the development of Board-approved guidelines on staff-monitored programs could be useful. Most Directors supported staff monitoring only if the country's policy program was consistent with the program's stated objectives and with the thrust of Fund advice provided in the context of Article IV consultations. Noting that staff-monitored programs did not constitute Fund endorsement of a member's policies—which can be provided only by the Board—a number of Directors voiced concern about possible misinterpretation by the public and whether such misinterpretation might make investors less cautious. These Directors observed that in cases requiring closer monitoring and policy advice, and in the absence of an immediate balance of payments need, members should be encouraged to make use of precautionary Fund arrangements, which provided a clear Board assessment and Fund endorsement of members' policies.
- Directors supported the increased focus on regional surveillance, in view of the growing importance of policy formulation at the regional level. In addition to the increased focus on Europe related to EMU, some Directors suggested that additional attention be given to regional integration in other parts of the world and that staff contacts also be strengthened with regional economic institutions and monetary unions such as the CFA franc zone and the Eastern Caribbean Currency Union.

The review of surveillance also provided an occasion for a comprehensive debate on the virtues of further openness in the Article IV process. Most Directors emphasized the importance of the confidentiality of the dialogue between the Fund and its members. Care needed to be taken not to jeopardize the candor of discussions between the staff and the authorities, the reports prepared for the Executive Board, and Board deliberations. Some Directors felt, however, that greater transparency in the dissemination of Fund views would enhance the effectiveness of surveillance.

Against this background, the Board agreed in April 1997 to the issuance, on a voluntary basis, of Press Information Notices, following the conclusion of members' Article IV consultations by the Board, for those members seeking to make the Fund's views known to the public. Press Information Notices would normally be three to four pages in length and would consist of a background section with factual information on the economy of a member, including a table of economic indicators, and a section on the Fund's assessment of the member's prospects and policies, as reflected in the Chairman's summing up of the Board's discussion of the Article IV consultation. A Press Information Notice would normally be released about five to ten working days after the relevant Board meeting. (See Appendix V.)

The conclusions of the Board's biennial review were conveyed in a report to the Interim Committee, which welcomed the strengthening of Fund surveillance to meet the new challenges of globalization and the Board's decision on the release of Press Information Notices, which was seen as further improving the transparency of surveillance.

Progress in Providing Information to the Fund

The quality of Fund surveillance depends critically on the timely provision by members of comprehensive and reliable data. Over the past few years, along with encouraging members to improve the dissemination of data to the public (see the section on Data Dissemination, below), the Fund has reviewed regularly the quality and timeliness of data provided to it by members. In November 1996, in examining progress by members in data provision, Directors welcomed the comprehensive and candid assessments of data issues in the context of Article IV consultations. They suggested that future consultation reports should not only identify data deficiencies but also address the reasons for the deficiencies and outline the steps needed to overcome them. They also suggested that the implementation by countries of the recommendations of technical assistance should be monitored closely and that shortcomings should be noted in staff reports.

The Board observed that the timeliness of data provision had improved modestly, but it expressed concern that, while the provision of data was satisfactory for most members, in certain cases data issues remained a significant problem. Some Directors were concerned about the effect that the nonprovision of data might have on the continuity of surveillance and urged members to improve the timeliness and frequency of their reporting.

Besides timeliness of reporting, the quality and integrity of data were viewed as having a major bearing on the Fund's ability to conduct effective surveillance. Directors therefore urged greater emphasis on these aspects in future reviews. They noted that as members improved their statistics to meet the requirements of the data dissemination standards, the provision of data to the Fund would improve as well. In this connection, many Directors stressed that the Fund's need for data for surveillance was no less than that of the markets.

Evolving Issues in Fund Surveillance

During 1996/97, as part of its surveillance mandate, the Fund gave intensified consideration to a number of new issues that had come to the fore in an increasingly globalized world economy. Foremost among these issues were the importance of banking system soundness in member countries and how this might best be promoted; the design of currency board arrangements and their implications for the Fund's work; the encouragement of capital account convertibility, including a possible amendment of the Fund's Articles; the development of standards to guide members in providing economic and financial statistics to the public; and the Fund's role in promoting good governance in member countries.

Banking Soundness

Directors met twice during the financial year to discuss issues related to the soundness of banking systems in member countries, including the relationship between systemic bank restructuring and macroeconomic policy, and the development of a framework for banking soundness.

Systemic Bank Restructuring and Macroeconomic Policy

Meeting in February 1997, Directors welcomed the opportunity to consider the relationship between systemic bank restructuring and macroeconomic policy, which they viewed as an increasingly important issue. They noted that a wide range of member countries had undertaken systemic bank restructuring programs in response to banking or financial sector distress. Because the costs of widespread banking problems could be very high, Directors underlined the need for effective resolution strategies. Recognizing the importance for the Fund of linkages between systemic bank restructuring and macroeconomic policy, as well as the potential for spillover effects in an environment of globalized financial markets, Directors considered that there was a need for the Fund to devote more attention to those issues and to carry out further work in this area, especially with respect to the implications for its own operations.

Directors generally agreed that the Fund was uniquely placed, through its activities related to surveillance, program design, and technical assistance, to play an important role in alerting members to weaknesses in their banking systems and legal and regulatory regimes, and in encouraging and monitoring adherence to international supervisory and prudential guidelines. They emphasized that responsibility for monitoring and implementing banking standards and bank restructuring rested with national authorities, while the Fund should focus on the macroeconomic implications of systemic bank-restructuring strategies and exercise caution in assessing members' banking systems so as not to take on the role of a "rating agency." They also stressed that the Fund should avoid duplicating the work of the World Bank and other international and regional organizations; most Directors believed that the World Bank and other multilateral financial organizations should take the lead in the microeconomic and operational aspects of bank restructuring.

Directors agreed on the importance of early detection of systemic banking problems and prompt implementation of comprehensive policies to address them. Such policies, besides dealing with macroeconomic issues, should address both financial and operational restructuring of banks. To succeed, they would require strong political support, a clear institutional framework, and thorough diagnosis.

Directors observed that instruments selected for implementing bank restructuring should ideally be cost effective, simple to implement, and consistent with sound macroeconomic management; distribute losses equitably while minimizing the public sector burden; avoid generating moral hazard problems; and promote good governance. Directors also agreed on the importance of designating an agency with lead responsibility for restructuring banks, monitoring the process, applying firm exit policies, and putting in place appropriate asset management and loan-recovery policies. They emphasized the need to correct weaknesses in the legal and institutional framework, including banking supervision, and to have in place suitable tax treatment of loan losses and provisioning.

Directors noted the importance of building sound banking systems by promoting an open and competitive environment with a level playing field. In that context, some on the Board felt that special attention should be given to privatizing state-owned banks, while some called for more liberal entry of foreign banks to enhance competition.

Directors emphasized the need for an assessment of the macroeconomic implications of bank restructuring programs as well as their medium-term implications for debt sustainability. Ensuring consistency with macroeconomic stability, many Directors noted, often required substantial fiscal adjustment. Moreover, any public sector financial assistance should be provided to banks only in conjunction with a comprehensive and credible restructuring program. Directors generally agreed that, for countries with significant bank assistance operations, the proposed "augmented" fiscal balance, which incorporated the major quantifiable costs of bank assistance operations, would usefully complement standard fiscal measurements and facilitate comprehensive, transparent, and consistent recording of such operations, but they cautioned that the "augmented" balance should not be used as a performance target. The design of bank-restructuring programs should also take into account the impact of such programs on nonbank financial institutions so as to ensure macroeconomic stability.

Directors observed that systemic bank restructuring complicated the conduct of monetary policy because the effectiveness of particular monetary instruments could be reduced, and the information content of monetary and credit aggregates could become distorted. They also noted that the central bank should not provide solvency support or long-term financing of bank-restructuring operations, although it might need to extend substantial liquidity support to viable banks.

Some Directors felt that if the pursuit of tight macroeconomic policies exacerbated solvency problems and raised the overall cost of bank restructuring, the possibility of lengthening the timetable for achieving certain macroeconomic objectives should be considered. A number of other Directors, however, suggested that such a trade-off might not be necessary unless liquidity were scarce or the capacity for fiscal adjustment limited. They argued that bank restructuring was best undertaken in the context of a monetary policy geared to price stability, and that a tight policy stance, through its positive effect on confidence and interest rates, could lead to higher growth and better conditions for the banking sector.

Toward a Framework for Sound Banking

In March 1997, Directors held a preliminary discussion on the broad principles and characteristics of stable and sound financial systems. The health and stability of financial systems have clear implications for macroeconomic performance, the conduct of macroeconomic policies, and the functioning of global capital markets—matters at the core of the Fund's work. Directors agreed that the Fund, with its near universal membership and responsibility for surveillance, had an important role to play in international efforts to promote sound banking principles and practices worldwide.

The Fund's focus, Directors believed, should be twofold: on assisting member countries to identify vulnerabilities in their financial and supervisory systems with the potential for significant macroeconomic consequences and to formulate corrective policies; and on encouraging members to adopt guidelines and standards developed by the supervisory community and monitoring their progress to that end. In view of its constrained resources, the Fund would need to be selective in its approach. Directors called for close collaboration in these efforts with other international organizations and groups, including the World Bank and the Basle Committee on Banking Supervision, to ensure that each focused on areas where it had a comparative advantage and to avoid the possibility of developing conflicting standards. While recognizing that the framework for sound banking developed by Fund staff was intended for staff use in macroeconomic surveillance and therefore covered a broader range of issues than prudential standards, several Directors believed that the Fund's work should draw more heavily on the set of core principles for effective bank supervision being developed by the Basle Committee, and that the Fund should not get in front of those efforts. Nevertheless, it was also recognized that the Fund had played a catalytic role in pointing out the need for such efforts.

Directors agreed that the development of a framework of broad principles and characteristics of stable and sound financial systems would be useful to Fund staff in surveillance work, in particular by providing staff with guidance for the evaluation of banking sector issues and by identifying measures that could be taken to strengthen banking regulation and supervision. Directors broadly supported the five objectives of the proposed framework—increasing the transparency of banking, limiting public sector distortions, controlling risk through regulatory and supervisory oversight, strengthening the broader structural framework, and fostering national and international supervisory coordination. Some Directors felt that the framework would need to be revised periodically in light of changing circumstances and new insights.

Directors agreed that effective regulation and supervision were necessary to limit the official safety net's adverse impact on risk taking and that supervisors needed sufficient autonomy, authority, and capacity to carry out their responsibilities. Directors thought that the increasing sophistication of financial instruments and techniques as well as the growth of cross-border banking were making it difficult for national supervisors to promote sound banking by enforcing strict adherence to quantitative prudential regulations. Greater emphasis on good internal governance—including adequate risk management—and market discipline was required. In that regard, the education and training of financial professionals—supervisors as well as bank managers—were important. Directors also stressed the need to improve the quality and transparency of banking data.

Although most Directors agreed that the elements of the general framework were relevant and appropriate for the analysis of banking sector soundness, they saw the implementation of the proposed set of "best practices" as an ambitious endeavor. These best practices covered the following areas: accounting, supervisory reporting, and public disclosure; official safety net and exit; prudential regulation and supervision; cross-border supervision; and banking infrastructure. Some Directors cautioned against excessive rigidity in applying or recommending the proposed framework. Directors believed that the Fund should not become involved with detailed issues relating to individual financial institutions and that the staff would need to be sensitive to the priorities of individual member countries in achieving best practices in light of their different traditions, existing structures, and resource constraints. It was particularly important to recognize the difficulties faced by supervisors in many developing countries with inadequate legal and judicial structures, the absence of a credit culture, and inadequate supervisory resources. Directors felt it would be inappropriate for the Fund to use the set of best practices proposed by the staff as a checklist to "rate" banking systems. They asked that the Board be informed of macroeconomic issues arising from developments in a member's banking system in reports on Article IV consultations and, when urgent and serious, in informal sessions or other appropriate forums.

Some Directors noted that the lines between the banking sector and other parts of the financial system were becoming increasingly blurred in many countries and that the Fund might therefore need to extend its analysis and surveillance to other parts of the financial system where problems had clear macroeconomic consequences.

Directors recognized that Fund staff would need time to develop the expertise and knowledge necessary for the assessment of banking and financial sector issues with significant macroeconomic relevance. The Fund should focus initially on countries in which banking sector issues with macroeconomic effects were likely to have systemic implications for the international financial system.

The Interim Committee at its April 1997 meeting supported the Fund's increasing attention to banking and financial sector problems that could have significant macroeconomic implications. In this context, it emphasized the importance of close collaboration with the World Bank and other international organizations and groups.

Currency Board Arrangements

In January 1997, Directors discussed currency board arrangements and their implications for the work of the Fund. They observed that, although such arrangements had both advantages and disadvantages, they could be useful in certain situations. For example, they could bolster the credibility of stabilization programs in countries emerging from high inflation that needed to show a break with earlier policies or where the authorities had not had enough time to establish a strong policy record; in newly independent or postconflict countries, they could be adopted during a transition period while the expertise needed to operate a conventional central bank was being developed; and, in small, open economies, they could facilitate integration with a broader currency or trade area. Directors noted that, even in cases where currency boards are intended to be temporary, it is difficult to establish a termination date a priori.

Directors emphasized the ability of currency board arrangements, as rules-based arrangements, to enhance transparency and encourage financial discipline, key elements of an institutional framework for good policy management. At the same time, they stressed that, to be credible, arrangements had to be backed by strong macroeconomic and structural policies and the will and ability to minimize deviations from stated policy objectives. Directors noted that the drawbacks of such arrangements were due largely to their rigidity, which may make it difficult to correct any exchange rate misalignments that might develop. It was also observed that currency board arrangements limited the range of tools available to central banks for dealing with shocks and financial fragility. Directors agreed, however, that other regimes also face constraints and noted that mechanisms could be designed within the context of a currency board to manage adequately those problems. Some Directors felt that currency board arrangements were less well-suited for coping with a global environment of increasing capital flows and modern and dynamic financial markets.

Directors emphasized the importance of weighing all policy options before entering into a currency board arrangement. In particular, an arrangement should be introduced in the context of a comprehensive package of macroeconomic and structural reforms and where there was the political will and public support for such policy adjustments to succeed. Directors noted that strong fiscal policy, flexibility in labor and goods markets, and a sound banking system helped to reduce the likelihood of exchange rate misalignment or of a banking crisis that could jeopardize an arrangement's credibility.

Although some Directors favored a "pure currency board arrangement" limited solely to an exchange rate function, many Directors believed that allowing limited central bank functions with appropriate safeguards would, in many cases, make arrangements more resilient and therefore more credible and viable. A restrained role for monetary operations could be justified to avoid excessive interest rate volatility. Given the fragility of the banking systems in many countries, Directors also thought it would be useful to have a limited lender-of-last-resort facility, partly to accommodate interbank settlement needs, thereby checking potential systemic liquidity crises. With respect to the possible reactions of a currency board arrangement to systemic banking distress, Directors mentioned the successful actions of the Argentine authorities in protecting their arrangement in the aftermath of the Mexican crisis in 1995, including setting up specific funds outside the central bank for restructuring the banking system while preserving price stability. Directors stressed the importance of such actions to safeguard the soundness of the banking sector and preserve the currency board arrangement's credibility.

To preserve the credibility of currency board arrangements, any built-in flexibility to carry out central bank functions should be transparent and carefully designed, and only reserves in excess of the currency backing should be used. In particular, such functions should be limited and accompanied by explicit financial arrangements, such as a buffer of international reserves or contingent credit arrangements. Such separate financial facilities would give markets confidence in the authorities' ability to undertake required operations without infringing upon the legal constraints imposed by the arrangement.

Directors generally considered that, in most cases, currency board arrangements should be regarded as transitional. Thus, it would be important to consider orderly exit strategies. Directors noted that it would clearly be better for a country to exit from an arrangement from a position of strength. Directors stressed that attempts to exit an arrangement under conditions of currency weakness could engender an adverse market response, leading to capital outflows, downward pressure on the exchange rate, and reversal of many of the gains achieved under the arrangement. If an arrangement appeared to be excessively constraining, it could indicate that the underpinning policies had not been sufficient and should be strengthened, rather than that the arrangement should be abandoned.

Directors believed that the Fund should provide technical and financial assistance to member countries that had, or wished to establish, currency board arrangements on the same basis as that for member countries with other monetary–exchange rate arrangements. The Fund should not, however, provide incentives to adopt any particular monetary–exchange rate arrangement. Directors generally considered existing facilities and policies on the use of Fund resources to support programs anchored by currency board arrangements to be adequate.

Capital Account Convertibility and the Role of the Fund

In light of the very rapid growth and increased integration of international capital markets—and mindful of the need to ensure that the Fund was able to discharge effectively its mandate of overseeing an international monetary system increasingly dominated by capital flows—the Board took up the issue of capital account convertibility in February and in April 1997. In their discussions, Directors agreed that an open and liberal system of capital movements fostered economic growth and prosperity by contributing to an efficient allocation of world saving and investment. Directors also recognized that capital account liberalization should be an orderly and sustainable process and part of a broad and well-sequenced reform effort involving sound macroeconomic policies and strong financial systems. They expressed the view that the Fund, given its mandate and its universal membership, should play a central role in promoting capital account liberalization and fostering the smooth operation of international capital markets. The Fund should also be prepared to advise its members in determining how the removal of restrictions should be sequenced with supporting structural and macroeconomic reforms. Likewise, the Fund was well placed to assess whether temporary imposition of controls was appropriate to address surges in capital inflows and outflows.

Although the absence of a formal mandate to foster capital account liberalization had not prevented the Fund from playing an important role in encouraging and supporting members' efforts toward liberalization and in monitoring international capital markets, Directors noted that global integration was no longer limited to goods and services and now encompassed capital flows. Most Directors, therefore, supported an amendment of the Fund's Articles to include the liberalization of capital movements in the Fund's mandate. They also agreed that an extension of the Fund's jurisdiction to capital movements should allow for flexibility in implementation through transitional provisions and approval policies. In addition, they underscored the importance of ensuring adequate coordination with other international organizations.

With respect to the scope of jurisdiction, many Directors favored extending the Fund's jurisdiction to capital movements in a comprehensive manner covering capital transactions and payments in both inward and outward directions. At the same time, Directors preferred to exclude inward direct investment transactions from the Fund's jurisdiction, since such transactions are normally restricted for reasons other than macroeconomic and balance of payments management. Several Directors also pointed to the need to define clearly the scope of the Fund's jurisdiction on capital movements with respect to other international organizations and agreements.

The Board recognized that an extension of the Fund's jurisdiction to include capital movements would require approval policies that would enable members to impose temporary restrictions on both capital inflows and outflows to address emergency situations. In light of the potential volatility and size of capital movements, Directors generally supported greater flexibility in approving temporary restrictions than under the policy presently applied to payments and transfers for current international transactions. Directors also agreed that there would be a need for nontemporary approvals of restrictions or exclusions imposed for national security and prudential reasons.

Directors agreed that an extension of jurisdiction over capital movements would need to provide for appropriate transitional arrangements to ensure that liberalization was sequenced with structural measures, particularly in the monetary and financial sectors, and that the pace of liberalization took account of the distinct circumstances of individual countries. It was also recognized that members should not use such transitional measures to delay capital account liberalization unnecessarily. Directors noted that the Fund's established mechanisms of annual consultations, surveillance, and technical assistance would be the primary means of ensuring that capital liberalization was neither premature nor unduly delayed.

In their discussions, the Board considered the likely effect of capital account liberalization on the demand for Fund financing. Some Directors were of the view that, because of countries' access to capital markets, capital account liberalization would be likely to reduce such demand, while others expressed concern that the size and volatility of capital flows could increase the need for the Fund's financing in individual cases. It was agreed to return to this issue at a later stage.

In a significant development, the Interim Committee at its April 1997 meeting endorsed the concept of an amendment to the Articles to make the promotion of capital account liberalization a specific purpose of the Fund and to give the Fund appropriate jurisdiction over capital movements. The Committee asked the Board to continue its work with a view to making specific recommendations on key elements of an amendment by the time of the Committee's next meeting in September 1997. The scope of this jurisdiction would need to be carefully defined, the Committee observed, and sufficient flexibility should be allowed through transitional provisions and approval policies.

Data Dissemination

The discussions in the Board on a set of standards to guide Fund members in providing economic and financial statistics to the public began in response to a request by the Interim Committee in April 1995 and continued in 1995 and early 1996. The endorsed standards were to consist of two tiers: a General Data Dissemination System (GDDS), which provides guidance to all member countries, and a Special Data Dissemina-

Box 4

Dissemination Standards Bulletin Board on the Internet

The Fund's electronic bulletin board for the Special Data Dissemination Standard on the Internet provides public access to information about the data dissemination practices of subscribing member countries or territorial entities. These subscribers undertake to follow sound practices regarding (1) the coverage, periodicity, and timeliness of the data; (2) access by the public; (3) the integrity of the data; and (4) the quality of the disseminated data. The bulletin board posts information on the practices of subscribers in each of these areas—the so-called metadata.

Countries and entities that had subscribed to the Special Standard by the end of April 1997 are listed below, and subscribers for which metadata had been posted are indicated with an asterisk:

Argentina*	Australia	Austria
Belgium	Canada*	Chile*
Colombia*	Croatia*	Denmark*
Finland*	France*	Germany
Hong Kong, China*	Hungary*	Iceland
India	Indonesia	Ireland*
Israel*	Italy*	Japan*
Korea	Latvia	Lithuania*
Malaysia*	Mexico*	Netherlands*
Norway*	Peru*	Philippines*
Poland*	Singapore*	Slovak Republic
Slovenia*	South Africa*	Spain
Sweden*	Switzerland*	Thailand*
Turkey*	United Kingdom*	United States*

Electronic links (hyperlinks) between the bulletin board and actual data on national data sites were also established by the end of April 1997. These hyperlinks allow data users to move quickly between the bulletin board, which describes the statistical practices of subscribers, to their actual data. At the end of the financial year, such links were in place for Canada; Hong Kong, China; Israel; Mexico; Singapore; South Africa; and Switzerland. The existence of such links is not intended to signal Fund endorsement of the data. Data users can access the DSBB at the Internet address (http://dsbb.imf.org) or through the Fund's public Internet site (http://www.imf.org). (See also Box 11 in Appendix IV.)

tion Standard (SDDS), which is targeted at countries participating in international financial markets or aspiring to do so. In April 1996, the Board approved the SDDS, to which Fund members could subscribe on a voluntary basis (*Annual Report, 1996*, pages 48–51). The process reached an important new stage in September 1996, when the Fund opened an electronic bulletin board for the SDDS that the public could access on the Internet.

Special Data Dissemination Standard

At the end of April 1997, 42 countries or territorial entities had subscribed to the SDDS (Box 4). In subscribing to the SDDS, countries are expected to follow the best practices incorporated in the standard regarding the coverage, periodicity, and timeliness of data; ready and equal access by the public; and assisting users in assessing the integrity and the quality of data. It is expected that most subscribing countries will need to adapt their dissemination practices to meet the standards of best practices incorporated in the SDDS. To meet the standard fully, a transition period through the end of 1998 is provided during which subscribing countries need to make the necessary adjustments in their practices. During this transition period, the Fund, in cooperation with member countries, will continue to elaborate certain aspects of the SDDS and to undertake reviews of its operation in light of experience.

In a September 1996 discussion, Directors observed that member countries may require considerable technical assistance to comply fully with the needs stemming from the data standards initiative. These needs would add to the requests for technical assistance already in the pipeline and would have to be considered in formulating the Fund's budget and in establishing Fund technical assistance priorities. Some speakers proposed that, where feasible, member countries participating in the SDDS should meet some of the costs of technical assistance themselves, while others thought that the work on the SDDS should not have a negative impact on the availability of other technical assistance for countries that were not in a position to participate. To support the technical assistance effort, coordination with other multilateral and bilateral organizations was also needed. Directors encouraged the staff to pursue opportunities for additional financing and asked the staff to look into the potential for cost recovery from users of the Dissemination Standards Bulletin Board (DSBB).

Directors agreed that it would be useful to establish a hyperlink facility for the DSBB that would enable users to move directly from a country's so-called metadata (that is, information about its data, such as measurement characteristics and calendars for the release of the data) on the DSBB to actual country economic and financial data on the Internet. They agreed with the staff proposal to introduce hyperlinks from the DSBB to country data sites on the Internet for countries wishing to have such links, while taking into consideration country-specific circumstances in setting a date for the provision of such links. The first links were opened in April 1997, and many more subscribers are expected to open links in the future.

General Data Dissemination System

In March 1997, the Board reviewed and welcomed the progress toward a framework for the GDDS, the primary focus of which is to encourage members generally to improve data quality and systems for the production and dissemination of statistics. Directors considered it appropriate for the GDDS to provide a broad framework to guide members in the development of their systems and observed that improvements in statistical infrastructure for data compilation and dissemination could be far-reaching and could take considerable time to implement.

Directors agreed with the pragmatic and flexible approach of the GDDS, which allows for the diverse characteristics and capabilities of potential GDDS countries and for voluntary participation. Directors considered it appropriate that the specifications for coverage, periodicity, and timeliness of data for the GDDS should be less prescriptive than for the SDDS and that the General System, while distinguishing between improvements in broad statistical frameworks on the one hand and indicators on the other, should emphasize efforts to improve data quality. Many Directors agreed to the inclusion of social and demographic data in the General System, but several Directors pointed out that other international institutions had expertise in these areas. The Board stressed the importance of coordination with other international and regional organizations in assisting members to improve their statistical systems. Some Directors remarked on the importance of setting up a legislative framework to underpin the establishment of an effective statistical structure, and they emphasized the need to encourage countries participating in the GDDS to move toward internationally accepted methodologies in economic and financial data development. In this connection, Directors stressed the role that technical assistance from the Fund and other agencies could play.

Referring to the encouraging experience with the SDDS and its associated DSBB, most Directors agreed that an electronic bulletin board could be considered for the General System. To avoid a perception by the public that participation in the GDDS implied a Fund seal of approval of a member's statistics or statistical practices, several Directors noted that the Fund should clarify the differences between the GDDS and the SDDS. Further, some Directors thought that the Fund should disseminate information about a country's statistical practices only after sufficient improvements had been made in the country's practices.

Many Directors expressed concern regarding the possible budgetary burden that could arise both for the Fund and for member countries, while recognizing that resource implications would depend on the speed with which members signed on to the GDDS. On balance, Directors agreed that the pace of implementation envisaged seemed realistic in light of the absorptive capacity of many of the potential GDDS countries.

The conclusions of the Board were transmitted in a report to the Interim Committee, which at its April 1997 meeting welcomed the large number of subscriptions to the SDDS and looked forward to the establishment of the GDDS.

Role of the Fund in Governance Issues

Recognizing that good governance in member countries is closely linked to many issues of central concern to the Fund, the Board held a preliminary discussion in January 1997 of the role of the Fund in this area.

Directors noted that their discussion had been prompted by a growing emphasis that good economic performance depended on using public resources efficiently, creating an environment conducive to private sector activity, and bolstering public support for economic reforms. All of these issues were aspects of good governance. It was also clear, Directors agreed, that greater transparency in formulating and carrying out macroeconomic policy could build private sector confidence in government policies and that external financing—both official and private—was tied closely to issues of governance.

The Board also noted that country authorities were increasingly looking to the Fund for assistance to support their efforts to improve governance through strengthening both their institutional structures and their administrative procedures. Other international institutions and bilateral agencies had also been increasing their efforts to strengthen the capacity of countries to implement reforms and to secure public support for these reforms. In this connection, the Board noted that the Interim Committee's September 1996 declaration (see Box 3) had fostered a heightened awareness of good governance.

Directors endorsed the Fund's involvement in governance through surveillance, the use of Fund resources, and the provision of technical assistance to its member countries. In this context, Directors noted that the Fund had traditionally contributed to promoting good governance through reducing the scope for generalized rent seeking, discretionary and ad hoc decision making and preferential treatment on taxes and subsidies, and enhancing capacity to design and implement economic policies and improve public sector accountability. Efforts were also noted in promoting transparency in financial transactions, such as the inclusion of extrabudgetary transactions and implicit subsidies in the budget, and improvements in central bank accounts.

There was some disagreement on the Board, however, concerning the Fund's future role in governance issues. While some Directors considered that the Fund could be more active in fostering good governance, others were concerned that if the Fund were to expand its involvement it might go beyond its mandate or overstretch its resources in areas in which it lacked a comparative advantage. At the same time, many Directors observed that a single comprehensive definition of governance was likely to remain elusive. Directors acknowledged that it was often difficult to separate economic aspects of governance from political aspects, and that it was therefore important to focus the Fund's efforts in this regard on areas of governance with potentially significant macroeconomic consequences. They also asked for more information on Fund involvement in dealing with cases of corruption and stressed that there should be uniformity of treatment in issues related to governance.

On the basis of the Board's discussion—and given the wide recognition of the importance of good governance in facilitating sustainable growth—it was agreed to return to the matter early in the next financial year with a view to clarifying the Fund's role. Such clarification should aim, inter alia, to

- ensure that the Fund's policy advice gives due consideration to governance issues that are within its mandate and expertise;
- provide for the Fund's approach to governance issues to be evenhanded among member countries; and
- enhance collaboration in this area with other multilateral institutions and bilateral donors and official creditors.