External Evaluation of IMF Surveillance

Report by a Group of Independent Experts

International Monetary Fund

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Contents

The following symbols have been used throughout this book:

. . . to indicate that data are not available;

— to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;

– between years or months (e.g., 1996–97 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years (e.g., 1996/97) to indicate a crop or fiscal (financial) year.

"Billion" means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

The term "country," as used in this book, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

Glossary of Abbreviations

APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of South East Asian Nations
BIS	Bank for International Settlements
CCL	Contingent Credit Line
CGER	Coordinating Group on Exchange Rates
CIS	Commonwealth of Independent States
ECB	European Central Bank
ECOFIN	European Council of Finance Ministers
ED	Executive Director
EMU	Economic and Monetary Union
ERM	exchange rate mechanism
EU	European Union
EWS	early warning system
FSSA	Financial Sector Stability Assessment
G-7	Group of Seven
G-22	Group of 22
GCC	Gulf Cooperation Council
ICMR	International Capital Markets report
IIF	Institute of International Finance
ILO	International Labor Organization
IOSCO	International Organization of Securities Commissions
MAE	Monetary and Exchange Affairs Department
NGO	nongovernmental organization
OECD	Organization for Economic Cooperation and Development
PDR	Policy Development and Review Department
PIN	Press/Public Information Notice
RED	Recent Economic Developments report
RES	Research Department
WEMD	World Economic and Market Developments
WEO	World Economic Outlook

Part I

Statement by Thomas Bernes, Chairman of the Evaluation Group of Executive Directors, on the Report of the External Evaluation of Surveillance

Summing Up by the Chairman of the Executive Board of Executive Board Meeting 99/100, on the External Evaluation of Fund Surveillance

Statement by Thomas Bernes, Chairman of the Evaluation Group of Executive Directors, on the Report of the External Evaluation of Surveillance

August 27, 1999

It is to be expected that any comprehensive evaluation of the Fund's surveillance activities will touch upon an impressive range of issues. In this regard, the report of the external evaluators does not disappoint. On behalf of the Evaluation Committee, I would therefore like to express my sincere appreciation to Messrs. Arriazu, Crow, and Thygesen for an outstanding effort that has resulted in the production of a well-written, insightful, and thought-provoking document. It is the mark of a good evaluation that questions about the prevailing wisdom are raised and the status quo challenged. Indeed, were the evaluators to have concluded that all was well and good at the Fund, I would have had reservations as to whether or not our money had been well spent. This is clearly not the case here. That is not to say that the institution could—or should—adopt all recommended changes, but that we should seize on the opportunity provided by the evaluators' report to reassess long-standing practices and the adequacy of institutional and procedural reforms presently under way.

It is worth noting that—with a topic as broad as that addressed by the evaluators—there will inevitably be exceptions to the conclusions drawn, even while the broad thrust of generalized observations remains valid. This suggests that the relevance of particular recommendations will vary by country, within the Fund's institutional structure, and across staff. Therefore, to make the most constructive use of this evaluation, we need to approach its observations with a considerable degree of honesty and openness to criticism, drawing on the insights where appropriate. The flip side of this is that we need to avoid excessive fixation on individual instances where the criticisms may not be as directly relevant.

In terms of next steps, and consistent with existing precedents, it would seem appropriate that the text of the report should be published along with the staff's response and the summing up from this discussion.

In the period after the Annual Meetings, and in light of both the report and the Board discussion, I would suggest that management prepare an "action plan" for consideration by Directors on proposals to respond to the report. A date within 12 months of the approval of this plan should be set for a "stocktaking" of our response. As with the external evaluation of ESAF, I believe it is critical to provide some formalization of the follow-up process to our evaluations.

More generally, we will then need to turn our attention—before the end of the year—to launching a review of our experience with independent evaluation. The terms of reference and modalities for such a review should be discussed shortly after the Annual Meetings. At the same time, I believe it would be appropriate to undertake a further external evaluation—perhaps more modest in scope than the surveillance evaluation—since it would not be appropriate or desirable for this institution to cease the conduct of independent evaluations while we assess our experience to date.

Summing Up by the Chairman of the Executive Board of Executive Board Meeting 99/100, on the External Evaluation of Fund Surveillance

September 8, 1999

Executive Directors welcomed the Report of External Evaluators on Fund Surveillance. They expressed their deep appreciation for the careful work and considered judgments of the panel. Directors considered that the issues raised in the report would serve to stimulate debate within and outside the institution, and to motivate further discussion of a number of topics of importance to the work of the Fund.

Directors welcomed the comprehensive evaluation of the Fund's surveillance work and the high consideration in which the *World Economic Outlook* (WEO) and the *International Capital Markets* reports (ICMR) are held. They noted the value that members place on the Fund's surveillance of their own economies. In this regard, the evaluators' observation that Fund surveillance should be viewed as an "input" to a country's policies—that could on occasion be significant—underscored the importance of the Fund's analysis being first rate and of remaining focused on issues of serious and immediate concern.

Directors underlined the substantial common ground between the evaluators' report and the Fund's own internal evaluations. They noted, in particular, the need to (i) revisit the definition of the core areas; (ii) give more explicit attention to international aspects of a country's macroeconomic policies and spillover issues; (iii) focus more on cross-country comparisons and regional developments; (iv) devote substantially more attention to vulnerability analysis; and (v) give more emphasis to financial sector and capital account issues.

On the focus of surveillance, Directors acknowledged that the issue remains a challenge for the organization in light of the forces driving an expanding agenda. In this regard, they acknowledged that issues identified in Fund surveillance as core had changed over time, moving from a narrow focus on exchange rate policy and the balance of payments and attendant monetary and fiscal policies to greater emphasis on capital account, financial sector, and nonfinancial structural issues. Some Directors stressed that the report was written at a time when the focus of surveillance was undergoing major changes within the Fund, largely as a result of the crises of the last five years. Thus, as noted in the evaluation, some of the recommendations on the focus of surveillance, including those relating to enhancing surveillance of the financial sector, capital account issues, and policy interdependence and contagion, are in the process of being implemented.

Nevertheless, Directors expressed a range of views on which issues should be considered generally as noncore issues in the context of Fund surveillance. Most Directors thought that one of the main recommendations of the report—that surveillance should focus only on the core areas of exchange rate policy and directly associated macroeconomic policies—ran counter to the demands of the membership and the international community for increasing emphasis on the interactions between macroeconomic, structural, and social policies. They viewed the broader focus of surveillance as appropriate in light of global developments and the need for a surveillance process that remains relevant to the policy challenges faced by Fund members. Nevertheless, a number of these Directors saw scope for sharpening the focus of surveillance in the context of a country-by-country approach: coverage of issues could differ depending on the circumstances of a particular country, but the staff would be expected to present a clear case for the consideration of any particular set of noncore issues as relevant to the core concerns of the Fund. Other Directors, however, felt that Fund surveillance had moved inappropriately beyond the original core issues, including into areas such as labor markets, pension reform, social policy, and governance. Nevertheless, most Directors agreed that, to the extent possible, the Fund should make use of outside expertise in areas beyond its conventional mandate and when it had little in-house expertise. In this regard, Directors stressed the importance of close cooperation with other international institutions, taking due account of comparative advantage and expertise, and avoiding duplication of effort. Directors agreed to return to the issue of the focus of surveillance more systematically in the context of the internal review of Fund surveillance later in the year.

Directors supported increased attention to the international and regional aspects of surveillance. They saw the need for increased cross-country comparisons—in which the Fund has a unique advantage—in the context of greater emphasis on regional and international developments. They also endorsed the recommendation to heighten the interaction between bilateral and multilateral surveillance, and looked forward to a better integration of the ICMR and WEO analysis with bilateral surveillance. However, Directors agreed that, while the Article IV process should be enriched through the integration of global and regional dimensions, it should remain clearly focused on a country's own policies.

Directors emphasized their support for more explicit attention to vulnerability issues in Fund surveillance: this would entail enhanced analysis of the capital account, the financial sector, and the treatment of contagion. They agreed that, in an environment of increased financial and trade flows between countries, Fund surveillance at the country level should pay greater attention to the sequencing and the pace of moves toward capital account liberalization. Directors observed that the stepped-up level of staff work on financial sector issues in collaboration with the World Bank (including through the Financial Sector Assessments Program), the Bank for International Settlements, and other international organizations was being reflected in more comprehensive coverage of vulnerabilities in this area. Directors agreed that surveillance should pay greater attention to policy interdependence and the risks of contagion, and they noted in this regard that multilateral surveillance has an important role to play in identifying potential spillover effects.

On surveillance procedures, Directors observed that the strength of the Fund as an institution derives from the symmetry with which countries are treated in the surveillance process. Many Directors saw annual consultations as a cornerstone in ensuring the continuity of Fund surveillance. At the same time, Directors recognized the need for some flexibility in Fund procedures given the institution's strained resources. Against this backdrop, Directors agreed that, for most industrial economies, in light of their systemic impact, annual consultations remain appropriate. Most Directors thought that surveillance of these countries should continue to focus on their domestic policies while also bringing to the table the international implications of those policies.

To ensure resource-efficient surveillance that, at the same time, could be more continuous, some Directors thought it should be possible in some cases to have shorter annual consultation visits supplemented with interim electronic communications. However, other Directors thought it important that this not lead to any diminution of the attention paid by national authorities to the formal consultation discussion. Directors asked the staff to come forward with proposals in this area.

Most Directors viewed annual consultations with smaller industrial countries—particularly those that are members of the euro area—as providing a number of critical advantages that could be lost with less frequent consultations, although a few Directors saw potential advantages in reducing consultation frequency. Several Directors also pointed out that, in the case of the euro area countries, fiscal policy remained a national prerogative and many other policies continued to be conducted at the national level; it would thus be impossible to cover these areas adequately in consultation with the European Central Bank or European Union institutions. While several Directors considered that there might be scope to reduce the size and duration of missions to these countries as European integration proceeds, other Directors were not in favor of diminished attention to the euro area.

Directors were also not in favor of shifting sole responsibility for the WEO projections to the Research Department. They felt that the area departments provided critical input to these projections and that the projections should remain a joint product of the staff. They noted that the current practice of six-monthly WEO reports, with special issues when warranted by circumstances, had worked well and should continue.

On organization, Directors considered with interest the proposal that all Article IV staff reports be discussed in the first instance in a committee rather than by the full Board, but they thought this likely to result in an increased work load for the organization as a whole. In this regard, most Directors thought it desirable to continue with the lead speaker experiment recently undertaken as a step toward more efficient and focused Board coverage of surveillance. Directors welcomed the observations of the evaluators on the internal review process. They urged management and staff to pursue greater efficiencies in this area, while preserving the valuable contribution of the process to the high quality of analysis.

Directors noted that the transparency of the Fund had increased considerably in recent years and that a pilot project for the voluntary release of staff reports had been launched. They agreed that the review of the pilot project would inform the development of a general publication policy for Article IV staff reports.

Looking ahead, Directors stressed that the strengthening of Fund surveillance has been, and is, an ongoing process. In this regard, the report of the evaluators provides an informed outside perspective that should serve as an important input in deliberations on enhancing surveillance. Directors looked forward in the period ahead to further consideration of many of the issues addressed in the evaluators' report. Directors considered that the key issues to return to later this year could include the focus of surveillance; the increased attention to international, regional, and cross-country issues; vulnerability analysis and early warning systems; and the coverage of financial sector and capital account issues.

Management intends to come back to the Board after the Annual Meetings with precise suggestions on a program to deal with the issues raised by the External Evaluation Report. These issues will also be followed up in more detail in the Biennial Review of Surveillance scheduled for end-1999.

Part 2

External Evaluation of Surveillance Report

Members of the Evaluation Team:

John Crow (Chairman)
Ricardo Arriazu
Niels Thygesen

Secretary to the Team: Jonathan Portes

Contents

Preface

This evaluation of IMF surveillance over members' policies under Article IV of the Articles of Agreement was commissioned by the Executive Board in June 1998. Our terms of reference are in Appendix I.

The evaluation was conducted by John Crow (formerly Governor of the Bank of Canada), who served as Chairman; Ricardo Arriazu (Bansud, Buenos Aires, and formerly Alternate Executive Director at the Fund), and Niels Thygesen (Danske Bank Professor of International Economics at the University of Copenhagen). Jonathan Portes (formerly United Kingdom Treasury) served as Secretary to the team.

In July 1998, the group held a seminar with the Executive Board, where we set out our general approach and presented our list of sample countries pursuant to the terms of reference: Brazil, Chile, China, the Czech Republic, India, Japan, Korea, Saudi Arabia, South Africa, Sweden, Thailand, and the United States. We should note that, in accordance with our terms of reference, our examination of surveillance was confined to periods when these countries made no, or at most sporadic, use of IMF resources.

Over the next months, we made country visits as well as taking advantage of the 1998 Annual Meetings to meet with a number of country officials, IMF Executive Directors, IMF staff, and visitors. Our preparatory work included, in addition to these interviews, reviewing the Article IV staff reports for these countries covering the period from 1990 to the present, as well as a considerable amount of relevant internal Fund documentation, including the mission briefings, back-to-office reports, and interdepartmental memoranda. We also met with a group of representatives of small states. In February 1999, we met in Washington to discuss our approach to drafting the report, and to conduct a number of further meetings. Between February and June, we met again in Washington a number of times to prepare and finalize the report, and to take account of comments on the draft from Fund staff.

While the main focus of our research was our sample countries, the subject matter of the report is Fund surveillance as a whole, and the conclusions and recommendations are intended to be of general applicability. The report is therefore organized thematically, rather than in the form of country case studies. In Chapter I, we give some historical and institutional background. Chapters II–IV describe the results of our interviews and research, grouped under the three headings: conduct and method, substance, and impact. We should note that this material, while descriptive of the views we heard, does not necessarily represent our own views; in particular, specific quotes are included only when they are of use in elucidating a particular point. We then set out our own analysis, conclusions, and recommendations in Chapter V.

We would like to express our gratitude to all those who assisted us in various ways. Most of all, we would like to thank all those who met with us to discuss our work—country officials, Fund staff and former staff, Executive Directors, academics, and private sector and nongovernmental organization (NGO) representatives. Without their time, trouble, and willingness to speak frankly, our task would have been impossible. A list of those we met is in Appendix III. We would also like to thank all those who assisted us in setting up our country visits, and the Director and staff of the Office of Internal Audit and Inspection, in particular, Elena Frolia and Cathy Song. Soren Baunsgaard provided valuable research assistance. We are also grateful to Marina Primorac for editorial assistance.

Executive Summary

This evaluation of Fund surveillance over members' policies under Article IV of the Articles of Agreement was commissioned by the Executive Board in June 1998. Our terms of reference are in Appendix I.

Much of our research centered on the Fund's surveillance over the past decade of a sample of 12 countries: Brazil, Chile, China, the Czech Republic, India, Japan, Korea, Saudi Arabia, South Africa, Sweden, Thailand, and the United States. We reviewed documentation prepared by the Fund, we discussed the issues with the relevant Fund staff, and we visited the countries, where we met present and former government officials and others who had come into contact with the Fund. We also met numerous other present and former Fund staff, a number of Executive Directors, officials of other national governments, other international institutions where we could, academics, private sector, and NGO representatives.

The report comprises five chapters. The first describes the historical and institutional background to surveillance. The next three describe the results of our interviews and research, grouped into the three headings of conduct and method, substance, and impact. The concluding chapter sets out our own conclusions and recommendations.

Our main findings in our discussions were the following.

- In bilateral surveillance, the quality of Fund analysis and advice in the Fund's traditional areas of core expertise—exchange rate policies and the associated macroeconomic framework—is generally rated highly. The quality of multilateral surveillance is also generally seen as good. The most important reservation was in the area of the Fund's analysis of capital account issues.
- The scope and coverage of bilateral surveillance has expanded significantly, especially in the past few years, into structural issues of a nonfinancial nature. This expansion is questioned. Doubts were raised as to the Fund's capacity to deal adequately with such issues. Furthermore, there were concerns that this expansion of coverage in fact detracted from the effectiveness of surveillance overall.
- There was considerable critical comment on the fact that bilateral surveillance concentrates almost exclusively on the country's own situation, and rarely focuses on the various international dimensions of a country's macroeconomic and financial situation.
- While in their own cases member country authorities did not generally regard the Fund's bilateral surveillance advice as insufficiently frank and direct, this concern persists among other observers.
- Member country authorities were generally content with the broad process of bilateral consultation. However, there was also an interest in shortening Article IV consultation missions and in making more use of telecommunications as a way of keeping on top of developments in addition to visits.
- Among many close observers of the institution, knowledge transfer across departments is seen as deficient. In the surveillance context, this manifests itself in an inadequate cross-fertilization between multilateral and bilateral surveillance, and in insufficient use of what is learned in different countries.
- The interdepartmental review process for surveillance documents, while necessary, has become excessively formalized and time-consuming, adding to an already significant problem of overwork for many staff involved in surveillance. Beyond this, the Fund faces a number of other internal organizational, management, and staffing challenges that have an impact on surveillance.
- The Executive Board spends a great deal of time on surveillance matters, especially in the concluding discussions of Article IV consultations. However, all agree that these discussions are not well focused. And despite the important peer review role that the Board has in principle, it has little ownership of surveillance priorities.

- While surveillance is generally seen as constructive by officials, its impact on country policies is bound to be secondary to domestic forces, and less than many outside observers believe. In the case of four countries that went into crisis, we judged that the single most important factor limiting Fund impact was a difficult internal political situation.
- Internal reviews have identified reasonably well the key areas in which surveillance should be improved. However, progress has been slow in translating the general principles set out in the reviews into actual change.
- The introduction of Public Information Notices (PINs) is generally regarded as a success. However, views on the desirability of publishing Article IV staff reports remain divided. At the same time, we noted that in practice these reports already receive a relatively wide, if unofficial, circulation, and, furthermore, what is put in those reports is filtered in response to this reality.

Based on these findings, our key recommendation is that bilateral surveillance should focus as much as possible on the core issues of exchange rate policy and directly associated macroeconomic policies (including financial sector and capital account issues). Furthermore, the international implications of such policies should be given significantly greater attention. In regard to the latter point, there are three distinct areas where the Fund has a clear comparative, and as yet underexploited, advantage:

- in relating the country's position to the international economic situation and prospects;
- in analyzing the experiences of other countries confronting similar policy problems; and
- in discussing the likelihood of, and possible responses to, significant negative external shocks, whether originating from direct effects through trade flows or interest rates or from more general contagion.

Bringing the Fund's expertise to bear on surveillance more effectively in this way will require some reallocation of resources. Accordingly,

- We recommend a significant shift in surveillance work toward the areas described above. We cannot rule out the possibility that this may mean some increase in resources for functional departments, but principally it involves reallocation and refocusing within area departments as a group.
- We recommend that the Fund curtail the expansion of the scope of surveillance into nonfinancial structural areas, with consequent savings in resources. Analysis outside the areas of core expertise—exchange rate policies, the associated macroeconomic framework, and financial sector and capital account issues—should only be undertaken if directly relevant to a particular case.
- We recommend that there should be a greater emphasis on more continuous surveillance, through shorter, leaner, more focused visits, and more regular long-distance communication and exchange.
- We recommend a reduction in the resources devoted to the surveillance of small and medium-sized industrial countries (and, more generally, participants in the euro area). This scaling back would essentially be achieved through the prioritization described above, and through longer intervals between Article IV consultations, in part replaced by more continuous surveillance.
- We recommend that surveillance of the largest industrial countries—the United States, Japan, and the euro area (which should be viewed as a whole)—focus more on the international aspects of policy.
- We recommend that surveillance devote substantially more attention to identifying vulnerabilities. A point should be made of presenting this analysis to national authorities for their consideration.
- We recommend quarterly publication of the World Economic Outlook forecasts, with ultimate responsibility given to the Research Department for forecasts and analysis.

We also make a number of suggestions of a more organizational nature:

- We recommend some internal measures to better attune the skills mix of staff involved in surveillance to new demands, and to improve the accountability and the incentives for staff. We also make a suggestion for a broader, deeper, review of such matters.
- We are concerned about the extent and consequences of overwork among staff engaged in surveillance and have aimed at making recommendations that, besides enabling a reallocation of resources, also make possible some reduction in the overall volume of surveillance work relative to the number of staff engaged in it.
- We recommend significant changes in the way in which the Executive Board discharges its statutory role in the surveillance process by proposing extensive use of committee work; all Article IV reports should initially be discussed in a Board committee.

On some issues—transparency, international standards, and contingent credit facilities—the practice of surveillance was changing as we prepared this report.

- The introduction of PINs and the recent decision to experiment with the voluntary publication of some Article IV reports are welcome. However, we do not believe this goes far enough. We recommend full publication of all such reports, while defining also an area for confidential exchange between staff and national authorities.

- We recommend that—outside the Fund's core areas—monitoring international standards should to the maximum extent possible be delegated to other international institutions or associations with the necessary expertise, with the Fund, because of its existing surveillance role, acting as a clearinghouse for information.

- We believe that the recent introduction of the Contingent Credit Line could increase the impact of surveillance by raising the demand for high-quality assessments and by adding financial clout. But we underline that this will reinforce the need to implement a number of the changes that we recommend.

For reference purposes, a complete list of recommendations is attached in Appendix IV.

I Introduction

Objectives of Surveillance

Objectives

1. How is Fund surveillance defined? Our terms of reference requested us to examine "all channels and instruments of Fund surveillance, including bilateral surveillance, regional surveillance, multilateral surveillance and the content and format of the World Economic Outlook, and surveillance of international capital markets and financial systems and of the provision by member countries of economic and financial data to the IMF and the public." We take surveillance as referring to all aspects of the Fund's analysis of, scrutiny over, and advice concerning, member countries' economic situations, policies, and prospects. Surveillance is conducted for the benefit both of the international community as a whole and of individual member states.

2. While the Fund regards the surveillance it undertakes on behalf of the international community as one function and our remit treats it as such, in practice it is clear that Fund surveillance is far from being one unified concept. In fact, as currently practiced, surveillance reflects a number of overlapping but conceptually distinct purposes. We have identified six such purposes.

- Policy advice. The Fund offers advice and proposals on the main economic policy dilemmas facing a member country. It also provides a sounding board for discussion.
- Policy coordination and cooperation.[1] The Fund cannot, at least through the surveillance function, force cooperation. However, by providing what might be seen as neutral and reliable data, forecasts, and analysis, it provides machinery through which policy coordination can take place if countries so wish.
- Information gathering and dissemination. The Fund gathers both statistics and other information about the direction of policy. In this, it provides a service to member countries, who can rely on the Fund's reports rather than having to maintain their own economic information-gathering networks. To the extent that the Fund then disseminates this information publicly, this service also benefits private markets and the general public.[2]
- Technical assistance and aid. In many countries, surveillance is essentially technical assistance; that is, it supplies expertise in macroeconomic policymaking that is scarce in the country. Not surprisingly, this is especially true of smaller and poorer countries, but it is also a role in some medium-sized and larger ones.
- Identification of vulnerabilities. This is an extension of the informational role and policy advice role that is particularly relevant when a country's policies are likely to be unsustainable. It is also a role that has become much more prominent in the past five years. If the government is warned of such problems by an outside, objective source, it may be able to take the necessary policy measures. It is also suggested—although the Fund has yet to take such action—that by providing warnings to financial markets and the public, the incentives for policymakers to take measures in a timely fashion would be substantially increased.
- "Delivering the message." This is an extension of the advice role. The Fund provides countries with policy prescriptions on numerous topics, from the advantages of moving toward a system of indirect instruments of monetary control to the need to liberalize labor markets. By doing so, the Fund provides a way by which the prevailing consensus of the econo-

[1]In what follows, we do not make the distinction sometimes made in the academic literature between "coordination" and "cooperation."

[2]It is notable that the informational function of the Fund has only recently come to the fore; many authorities do not mention it at all. For example, see Manuel Guitián, *The Unique Nature of the Responsibilities of the International Monetary Fund*, IMF Pamphlet Series No. 46 (Washington: International Monetary Fund, 1992), which does not mention the provision of information as one of the Fund's "key institutional functions" (p. 8).

ics profession is disseminated to government and policymakers throughout the world.

Underpinnings

3. Why might Fund surveillance be necessary? When government, or another public authority like the Fund, produces goods or services, it is standard practice for economists to demand a justification. What is the market failure that prevents the good or service from being produced by the private sector? In the case of Fund surveillance, it is necessary to ask not only why the private sector does not do it, but also why national governments cannot. As the discussion of objectives above makes clear, Fund surveillance may be held to provide three types of services to members and the general public: information, policy advice, and policy coordination.

4. Information, including economic data and information about government economic policies, clearly has many of the characteristics of a public good. It is very difficult for a private supplier of information to capture all the returns to that information; in other words, the social return to the provision of information is likely to exceed the private return. As a result, less information may be supplied than is socially efficient. This is perhaps less true than it used to be; the private return to high-quality information in financial markets is quite high, and as a result there are a great many private sector providers of such information, especially in developed financial markets. However, even in industrialized countries, the private sector provides little information about economic data and policies that is not directly relevant to financial markets, and even less in developing countries. Moreover, private sector providers are likely to make the information they collect available primarily to paying clients; and in the case of some (e.g., investment banks), conflicts of interest may arise.

5. But all this does not in itself explain why the Fund, rather than national governments, should provide the information. Why have an international institution writing reports on each country rather than each country simply submitting an annual economic report? Surely the latter would be more efficient. The answer here is that such an arrangement would clearly create a conflict of interest; countries would have an incentive to be too optimistic, for both political and economic reasons. This would be true even if the analysis were merely for the use of other governments; it is even more so if the analysis is to form the basis for decision making in the private sector.

6. It should be noted here that the provision of information does not always unequivocally improve matters. In particular, while complete information is first-best, more information is not always better than less. This is a point that has recently been made in the context of the disclosure of countries' reserve positions. Some finance ministries and central banks have argued that as long as supposedly important private sector players—such as hedge funds—face little or no obligation to disclose their positions, it is not clear that forcing countries to disclose theirs increases either economic efficiency or social welfare.

7. It is also far from clear that the Fund is any better positioned than the private sector to play the role of identifying vulnerabilities to private markets. Its opinion on the sustainability of a country's policies is presumably valuable to private markets because the Fund has access to information that enables it to produce a better analysis than private sector agents can; that is, it has a comparative advantage. However, if countries know that the Fund will "blow the whistle" in certain circumstances, they are unlikely to provide it with such information, so the Fund will lose its comparative advantage. These are clearly complex issues.

8. Turning to policy advice, why should an international organization provide it? As noted above, in some cases governments may simply not have sufficient capacity to do as much or as good policy analysis as they would like. In this case, surveillance, like other Fund technical assistance, is essentially a form of development aid, provided and financed by the international community. More problematic are the circumstances under which the country itself has ample capacity within government to formulate economic policy. In this case, the justification for Fund surveillance must be that the Fund can provide some forms of advice more efficiently than the government can do itself; in other words, that it has a comparative advantage. In particular, it could be argued that the Fund might have a comparative advantage in the provision of advice on the international macroeconomic environment, on the policies adopted by other countries, or in specific areas where it has developed a particular expertise (hypothetically, for example, the identification of financial sector vulnerabilities).

9. The presumed objectivity of the Fund may also be an advantage in the provision of advice, even if its basic analysis is no better than that of the government or of private sector agencies. This is particularly relevant when there are internal disagreements within the government: the Fund may be able to say things that certain branches of government cannot, or to strengthen the position of those within government arguing for appropriate policies; or even to serve as the scapegoat for the implementation of unpopular policies (although this is probably more relevant in the context of an IMF-supported program).

10. Finally, the economic literature on international policy coordination describes the circumstances in which countries might benefit from coordination. For example, in the classic "Prisoners' Dilemma"

example, two agents, or countries, that set policy noncooperatively both end up with outcomes that are inferior to those attainable under coordination. In the international macroeconomic policy arena, this might be thought to apply to fiscal expansion, competitive devaluation, trade barriers, etc. It might be thought that the Fund would have a role in enabling countries to coordinate to achieve the best outcome for all. In the macroeconomic policy area, the Fund is clearly a plausible candidate for such a role.

11. That role could in principle range from the minimalist—providing reliable information and data, and perhaps some analysis—to a much more powerful one of setting and enforcing international coordination. In the extreme, the Fund could identify the set of policies that would produce the optimal outcome for the world as a whole, and even provide some sort of enforcement mechanism to ensure that countries adopted them. Of course, even if such an arrangement were desirable—and there are a number of arguments, both theoretical and practical, why it might not be—it is clearly highly implausible at present. The Fund's current role is much closer to the minimalist end of the spectrum.

12. It should also be noted that the nature of this role varies along a second dimension, depending on whether international policy coordination is based on discretionary action or on rules and standards.[3] Under the Bretton Woods regime, there were major elements of a rules-based system; countries were supposed to conduct domestic policies in a manner consistent with their chosen exchange rate. Since 1973, policy cooperation has been largely discretionary in nature. But recent initiatives to place more emphasis on rules and standards—not through fixed exchange rates, but through codes of conduct and the like—may lead to the pendulum swinging back again, with important implications for surveillance, as discussed in Chapter V.

13. This discussion suggests that Fund surveillance will be most useful and efficient when the service provided is a public good, that is, undersupplied by the private sector; and where the Fund, as a particular type of international organization, has a comparative advantage in providing such a service, either by virtue of its resources or its "objectivity." In all three areas—information, policy advice, and policy coordination—there are tasks the Fund may undertake that meet these criteria. However, that does not mean that it is sensible for the Fund to undertake every conceivable task in these areas. There are many areas of policy advice, for example, where it may not command the best expertise available.

Origins and Development of Fund Surveillance[4]

Origins and Legal Basis

14. Scrutiny of members' economic policies—even outside the context of Fund programs or of a prospective change in the exchange rate regime—has always been one of the functions of the Fund. Indeed, the concept of a degree of oversight of the international monetary system, undertaken by an international organization and based on some common framework of norms for the economic policies of individual countries, originated with the League of Nations, although the League was a political rather than economic organization.[5] Many authorities see this as the underlying principle on which the Fund is based: "There is a well-defined thread that binds together all the activities of the IMF: the promotion and safeguarding of an international code of economic conduct."[6]

15. In the immediate postwar period, the Fund's main task, in addition to the oversight of the Bretton Woods par value system, was to encourage members to move toward current account convertibility. In this context, the Fund examined the economic circumstances of individual members under Article XIV of the Fund's Articles of Agreement.[7] This authorized members to maintain certain exchange restrictions, provided that they held regular consultations with the Fund "as to their further retention."

16. Between 1958 and 1961, most European industrialized countries moved to convertibility; that is, acceptance of Article VIII of the Fund's Articles of

[3]See, for example, Ralph C. Bryant, *International Coordination of National Stabilization Policies* (Washington: Brookings Institution, 1995), for a helpful exposition of the two dimensions of international policy coordination (minimalist to maximalist, and rules versus discretion).

[4]This section draws heavily on James M. Boughton, *Silent Revolution: The International Monetary Fund, 1979–1989* (Washington: International Monetary Fund, forthcoming). See also Louis W. Pauly, *Who Elected the Bankers?* (Ithaca, New York: Cornell University Press, 1997), for a description of the origins of economic surveillance.

[5]See Pauly (1997), chapters 3–5. Pauly views the surveillance function as inherent in the design of the Fund, which in turn was a product of the experience of the interwar years. "The surveillance function of the Fund has existed in embryonic form ever since the organization was established. . . . In a very basic sense, the acceptance of these obligations, implicitly in 1945 and explicitly three decades later, was a response to the depression studies of the League of Nations." However, Jacques Polak suggests Pauly "paints a picture of more continuity—and that means less progress—than the facts warrant." (Jacques Polak, "Comments on Louis Pauly," unpublished mimeo, 1998, p. 1.)

[6]Guitián (1992).

[7]In the early postwar period, surveillance of Western European economies took place primarily through other institutions, notably the Organization for European Economic Cooperation and the European Payments Union.

Agreement. As a result, they would no longer have been subject to regular consultations. The United States, however, did not want the Fund to lose its capacity to provide information and analysis of European economies. The Europeans, for their part, wanted symmetry, so that the Fund should also be able to examine the United States (and Canada).[8] It was therefore agreed that the Fund should introduce voluntary consultations for all members, beginning in 1961 with the United Kingdom.

17. These consultations dealt with the general economic circumstances of the country, thus ranging wider than simply issues relating to exchange restrictions. However, they had no formal status. As a result, there was a limit to how meaningful they could be, particularly in the par value system established at Bretton Woods. In such a system, the real issue for a country with serious problems is whether to adjust the exchange rate. There was little prospect that countries would discuss such an option seriously in voluntary consultations.[9]

18. Multilateral surveillance would have been an obvious task for the Fund; under the Bretton Woods system there was a need, when imbalance became apparent, to determine who should adjust to whom. However, the Fund's work in the 1960s was almost exclusively based on country-by-country analysis, except for the evaluation of the need for international liquidity. It was left to the Organization for Economic Cooperation and Development (OECD) to initiate multilateral surveillance, through its Working Party 3 and through work on systematic comparisons of national policy experience in various policy areas.[10]

19. In August 1971, the United States closed the "gold window," effectively ending the par value system. However, it took several years before policymakers recognized that the system of fixed exchange rates could not be revived. So it was not until January 1976, at the Interim Committee meeting in Jamaica, that a framework for the new international monetary system was created. This new system accepted floating exchange rates, but foresaw a key role for the Fund in avoiding "excessive" fluctuations. In particular, under the new Article IV of the Articles of Agreement, the Fund: "shall exercise firm surveillance over the exchange rate policies of members and shall adopt specific principles for the guidance of all members with respect to those policies."[11]

20. The introduction of surveillance as an explicit part of the Fund's mandate therefore came as part of the Fund's adaptation to the post–Bretton Woods monetary system. In particular, the use of the phrase "firm surveillance over the exchange rate policies of members" was an attempt to ensure that the international community still exerted some discipline over exchange rates, even in a world of floating rates.[12] As such, it represented a compromise between those who believed that a substantial degree of international coordination was necessary to maintain exchange rate stability, pending—it was hoped—a return to a more managed system of exchange rates, and those who believed that such an objective was unrealistic (correctly, as it turned out) and probably undesirable.[13]

21. Surveillance also had an important role in the Fund's lending activities. The policy advice given by the Fund in the surveillance exercise was likely to provide the framework for the conditionality attached to any future Fund program.[14] It has often been argued that, as a consequence, surveillance is the one essential core of the Fund's activities.[15]

22. For operational purposes, the Fund's Executive Board set out five ways in which surveillance would occur.[16]

- Periodic (usually annual) consultations with individual members would take place;
- The Board was periodically to review "broad developments in exchange rates";
- The Managing Director was to maintain close contact with members regarding exchange rates;
- Members were to be required to notify the Fund of any changes in exchange rate policies; and

[8]See Pauly (1997).

[9]As illustrated by, for example, the U.K. experience in the 1960s.

[10]See OECD, *The Balance of Payments Adjustments Process* (Paris: OECD, 1966), and subsequent OECD studies of fiscal and monetary policy.

[11]The text of the relevant sections of Article IV and of Article I (which describes the general purposes of the Fund) is reproduced in Appendix II.

[12]Boughton (forthcoming) describes the phrase as a compromise between advocates of flexible and stable exchange rates: "Those who sought a flexible system in which exchange rates could adjust freely to market forces saw surveillance as a means of discouraging countries from manipulating exchange rates in opposition to market pressure. Those who sought greater stability in exchange rates saw it as a means of encouraging countries to adopt economic policies that would ensure such stability."

[13]See Harold James, "The Historical Development of the Principle of Surveillance," *Staff Papers*, International Monetary Fund, Vol. 42 (December 1995), pp. 771–72.

[14]The Contingent Credit Line, whereby the Fund agrees in advance to make funds available to a country if it were to require them, clearly blurs the line between surveillance and conditionality even further.

[15]See, for example, James (1995), p. 775: "The consultation exercise made the IMF aware of problems that might potentially require financial assistance. As a result, the IMF's financial programs, and the conditionality attached to them, could be regarded as nothing more than an extension of the surveillance procedure." This point was also made to us in conversation by the Managing Director and Jacques Polak.

[16]Executive Board Decision No. 5392, April 29, 1977.

- The Managing Director could initiate "special consultations" with members.

22. The third and fourth of these points had little substantive content, while the fifth (as described below in paragraph 30) has been invoked only very rarely. However, the first and second formed the basis for the Fund's bilateral and multilateral surveillance operations, respectively.

Scope

23. It was always recognized that "exchange rate policies" could not be viewed in a vacuum, and that the sustainability or otherwise of a country's exchange rate policy was likely to be determined by its compatibility with domestic macroeconomic policies. As the original Decision put it, the Fund's appraisal of exchange rate policies: "shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments."[17] Of course, virtually any domestic policy could be argued to affect, in some way, the external position. Therefore, as one practitioner put it: "the challenge is to identify the domestic policy areas that influence *primarily* the economy's external position, so as to provide the basis for a general consensus among the membership that they are of legitimate international concern and properly belong within the scope of surveillance."[18]

24. So Article IV consultations always focused on monetary and fiscal policy. However, there is clearly a difference between examining a country's macroeconomic policies solely with a view to determining whether they are consistent with its exchange rate policy and pronouncing more generally on the merit of those policies.[19] Even early on, the Fund generally took the broad approach. And over time, the scope of surveillance has steadily expanded into "structural" policies (e.g., market policy, privatization, industrial policy, and competition policy), into the financial sector (e.g., capital account issues, banking supervision, deposit insurance, and other financial sector regulation), and into a number of other areas (e.g., the environment, military spending, the "millennium bug").[20]

26. This expansion, which has been particularly rapid in recent years, has been driven by a number of factors.

- The need for the Fund to address the problems of formerly centrally planned economies. In these countries, structural questions—like public enterprise reform and privatization—clearly had major macroeconomic implications. While most of these countries had Fund-supported programs, the effects of this shift tended to permeate throughout the organization and hence into surveillance.
- Political pressures. As the Fund became more open, and as nongovernmental organizations focused more of their attention on international organizations like the Fund and the World Bank, there were pressures for the Fund to look wider than macroeconomic policy, conventionally defined, to the implications of issues like the environment and poverty reduction. In recent years, the U.S. Congress has exerted considerable indirect pressure on the Fund in this regard.
- A growing consensus in the economics profession that a number of important economic variables, including unemployment and growth rates, can in the short term be affected by demand management policies, but are primarily determined in the long term by supply-side factors, combined with a desire on the part of the Fund to be relevant to what was regarded as important.
- The Mexican crisis (see below) and other financial crises in developed and developing countries (from Sweden to Indonesia, but particularly the recent Asian crisis) focused attention on the potential for external crises to be precipitated not only by traditional macroeconomic policy failures (government fiscal or monetary laxity) but also by structural weaknesses in the financial sector.

27. Of course, these factors do not necessarily explain why the Fund is involved in all these issues. From an institutional perspective, the origin of this expansion is the fact that the Fund is the only organization that has a mandate to examine on a regular basis the economic circumstances of virtually every country in the world. So even though this mandate was originally intended to apply only to a strictly

[17]Executive Board Decision No. 5392, April 29, 1977.

[18]Guitián (1992), p. 12. It is notable, reading Guitián's description (pp. 12–14) of the proper coverage of surveillance, how much the scope of Fund surveillance has expanded in the last decade.

[19]One of the academics we spoke to described this as the difference between simply advising a country how to avoid a crisis, on the one hand, and trying to optimize the use of all policy instruments on the other.

[20]An interesting illustration of this expansion can be found in the terms of reference for this evaluation, which ask us to assess "the effectiveness of surveillance in identifying those macroeconomic, structural, and financial weaknesses and imbalances in member countries and the world economy that are an obstacle to achieving sustainable noninflationary economic growth and external viability." This clearly goes well beyond exchange rates.

limited set of macroeconomic questions, when the international community thinks that surveillance is required in other areas—even if those areas go somewhat beyond the Fund's original mandate—the Fund is the obvious institution to call upon. Policymakers frequently say that it is the only institution that actually has "troops on the ground." This has been particularly noticeable in the recent move toward giving the Fund the responsibility of monitoring international standards in areas like accounting, auditing, and corporate governance.[21]

28. Within the Fund, both the Executive Board and management have supported this expansion of the Fund's mandate. In the general context, the most recent guidance promulgated by the Board in the discussion of lessons from the Asian crisis in March 1998 stated that "the focus of surveillance needs to extend beyond the core short-term macroeconomic issues, while remaining selective." In relation to individual countries, when discussing staff reports, an Executive Director frequently asks why a particular issue, which he or she considers relevant to the economic circumstances of the country in question, has not been covered: this generates pressure for the staff to cover that issue in future reports on that country and others in similar circumstances. And, especially in recent years, Fund management has signaled a readiness to expand the mandate of the organization to issues like social policy.[22]

Problem Cases

29. A perennial issue in the operation of Fund surveillance has been the tension between "equal treatment" and "focus." On the one hand, on the principle that all Fund members, all sovereign states, are equal, many of them have argued for surveillance to be comprehensive and comparable among all members. Moreover, there is a natural tendency for a large bureaucracy with many functions to seek to organize its work around a predetermined and relatively fixed schedule. As the description of the current Article IV consultation process below shows, this is precisely what happens. On the other hand, some members are clearly more important to the world economy and their neighbors than others; some members are more vulnerable to the external environment and to external shocks; and some members have a less well developed capacity to formulate and implement sound economic policies. Given that Fund staff resources are, and should be, limited, some have argued that the Fund's attention should focus more closely on members falling into one or more of these categories. As indicated in the Executive Board discussion of the 1997 biennial review of surveillance:

> Directors emphasized that the principle of annual consultations represented a cornerstone in ensuring the continuity of Fund surveillance. At the same time, Directors recognized the need for flexibility in Fund procedures to ensure an effective focus of Fund surveillance, particularly in the context of the Fund's strained resources.

30. In general, the Fund has resolved this dilemma in the direction of equal treatment rather than selectivity. Furthermore, although the Fund has the power to initiate "special" or "supplemental" consultations with countries whose exchange rate policies are, in the view of the Managing Director, of particular concern, this procedure has only been invoked extremely rarely because of the perceived political implications.[23] When a member's economic situation gives rise to serious concern, the Fund's response has usually been informal and confidential, taking for instance the form of a letter or visit from management.[24]

31. One respect in which the focus of surveillance has changed is in the balance between the industrialized and developing countries. The surveillance mechanism, as described above, was part of a framework primarily aimed at securing exchange rate stability among the major industrialized countries. In the 1970s and early 1980s, much of the Fund's efforts and resources were concentrated in that area, albeit with mixed results. However, from 1982, the Fund became heavily involved in efforts to resolve the debt crisis. And, in the 1990s, with the growth of private capital flows to emerging market countries, surveillance has increasingly come to be seen—both inside and outside the Fund—as a way of helping these countries to attain or preserve domestic macro-

[21] As the Managing Director put it: "Countries need new laws, new institutions, and strong professionals to adopt and apply the new standards. And the international community needs mechanisms to make the standards operational and to monitor progress. The IMF, which has been given a universal mandate for surveillance, will have here a critical role—a daunting task indeed—for which it will need to avail itself of the support of the variety of other bodies with more practical experience in each of these specific areas." Michel Camdessus, Speech to the Foreign Policy Association, February 24, 1999.

[22] In particular, management has sought to define the ultimate goal of the Fund as "high-quality growth," meaning growth that is sustainable, equitable, and environmentally friendly. See, for example, Michel Camdessus, "Addressing Concerns for the Poor and Social Justice in Debt Relief and Adjustment Programs," speech by the Managing Director, October 22, 1998.

[23] Supplemental consultations were held with Sweden in 1982 and Korea in 1987. Neither appears to have had much effect on policy in the countries concerned, but the Swedish exercise may have helped to reduce the political and economic tensions arising between Sweden and its trading partners as a result of a devaluation viewed by many as excessive. See Boughton (forthcoming).

[24] As in the case of Thailand. See the discussion in Chapter IV.

economic stability, so as to allow them to preserve or expand their access to such capital flows. Meanwhile, the interest of the Group of Seven industrial countries (G-7) in international policy coordination has waxed and waned; it certainly has not shown much inclination to give the Fund any major role in exchange rate management. As a consequence, the focus of Fund surveillance—at least in the public mind—is increasingly on developing and emerging market countries, particularly those considered to be of systemic significance.

Multilateral Surveillance

32. Not surprisingly, the central problem of multilateral surveillance since the breakdown of Bretton Woods has been the exchange rate system.[25] The dilemma has always been that while a floating rate regime has frequently allowed the exchange rates of the major economic powers to diverge significantly from fundamentals, with consequent destabilizing effects on international trade and capital flows, no better system has been on offer. In particular, estimates of "fundamental equilibrium" exchange rates are fraught with uncertainty. Moreover, even if such consensus estimates existed, there would still be ample scope for dispute—both political and economic—over the appropriate policy instruments to be adopted to bring market rates into line. So, while the Fund has sought to make estimates of equilibrium exchange rates, if only for internal use, it has recently been rare for it to make significant policy recommendations to the major countries on this basis.

33. Multilateral surveillance has therefore tended to concentrate on forecasting and analysis rather than policy prescription. It has centered on the *World Economic Outlook* (WEO), produced at first annually and now semiannually. The WEO, with the forecasting and analytic apparatus that its production requires, provides a comprehensive set of economic forecasts for the world economy. This in turn provides a basis for discussion by countries in multilateral forums like the G-7. However, unlike the Article IV surveillance exercise, there is no attempt by the Fund itself to develop a comprehensive set of policy recommendations, although the published WEO contains some discussion of individual countries' policies.

Publicity

34. Initially, it was clear that surveillance was for the benefit of the Fund's member governments, not for private markets or the public at large. However, over time, the Fund has moved toward greater openness. To a large extent, this was the result of pressure from certain governments to make public some of the material produced in the surveillance process. In the 1980s, some countries began to release the Fund mission's "concluding statement." In the context of the 1980s debt crisis, the Fund agreed to allow a few countries making use of the "enhanced surveillance" procedure to make available the staff report itself to private sector creditors, on a confidential basis.

35. The first formal publication of Article IV material by the Fund came in 1989 when the "Recent Economic Developments" (RED) for Germany was published. Over time, the principle of routine publication of REDs (now "Selected Issues") was established. However, the RED/Selected Issues papers are usually either factual and statistical, or more like academic working papers, focusing on a medium- or long-term policy issue. As such, they are less sensitive than the staff report itself, which includes the more politically and market-sensitive discussion and recommendations on current macroeconomic policies and exchange rate issues.

36. In May 1997, the Fund introduced Press Information Notices (PINs, later Public Information Notices), described in more detail below. Although publication has remained voluntary, this initiative represented the first real recognition that the Article IV analysis of current macroeconomic developments and policies was of concern and interest, not only to the governments of members, but also to the general public and to financial market participants.

Resources

37. In terms of resources, surveillance is the Fund's most important activity. In 1999 surveillance is budgeted to account *directly* for 617 staff-years, 22 percent of the total. However, this is misleading, since considerable surveillance resources are attributed to central functions such as administration and external relations. Of the three principal "outputs" of the Fund—surveillance, "use of Fund resources" (programs), and technical assistance—surveillance accounts for about 42 percent. This proportion is forecast by the Fund to remain roughly constant in the next few years. Within the total resources devoted to surveillance, well over one-half was attributed to bilateral surveillance (Article IV consultations), with the remainder divided among multilateral surveillance, policy development, research, and evaluation.

[25] Peter B. Kenen, "What Role for IMF Surveillance?" *World Development*, Vol. 15 (December 1987), pp. 1445–56.

II Conduct and Methods

1. Under this heading the Executive Board asked us to address the following general question: how helpful are the procedures of surveillance, the resources and the staff skills employed, the means of interaction with member country authorities, and the dissemination methods of Executive Board surveillance conclusions? This general question was broken down into a number of more specific ones.[26]

(iii) Has Fund surveillance paid sufficient attention to regional surveillance, to interaction among countries, and to the external effects of policies in major countries?

(ix) Did the Fund balance openness and sensitivity appropriately from the authorities' perspective? How helpful were the documents that emerged from bilateral surveillance?

(xi) How do you assess the role of the Executive Board in surveillance?

2. This chapter begins with discussions of how bilateral (or Article IV), regional, and multilateral surveillance is conducted. We then discuss the internal procedures by which the Fund undertakes surveillance, and conclude with a discussion of the role of the Executive Board.

Bilateral Surveillance

3. We start with a description of the mechanics of the Article IV consultation.[27] (See Box 2.1 for the chronology of an Article IV consultation.) This is followed by a discussion of the views we received on the consultation process and on other elements of bilateral surveillance.

Mechanics

The Internal Process

4. Within the Fund, primary responsibility for the Article IV process lies with the relevant area department. The process begins with the drafting of a "mission brief" by that department. The brief is both descriptive and prescriptive: that is, it describes the economic situation of the country and sets out the staff's view of current policies and desirable changes. It therefore serves both as an agenda for the mission itself and as an outline of the major issues to be discussed in the staff report.

5. Before the mission brief is finalized, it is reviewed by other departments (and sometimes the World Bank). The Policy Development and Review Department (PDR) plays a particularly important role in this process; while other departments are invited to comment on the brief—comments that the area department may or may not choose to incorporate or address—PDR must "sign off," or approve it, before it is finalized. PDR's role is to ensure that the brief is consistent with general Fund policies, that it addresses all the topics that Article IV consultations are supposed to cover, and that it takes into account properly other departments' comments. The brief is then sent to management (the Managing Director or one of the Deputy Managing Directors) for final approval.

6. If there are significant disagreements between departments on an important issue in the brief, a covering memo will call this to the attention of management. If the issue is felt to be sufficiently important, or if management takes a particularly strong interest in a forthcoming consultation, there will be a meeting of the "Surveillance Committee"—chaired by management, with representatives of the interested departments—to review what the Fund's approach should be.[28] These internal mechanics are of interest because it is largely at this stage—the drafting of the mission brief, not the

[26]Numbers in parentheses indicate the number assigned to the question in the original Executive Board request. See the Terms of Reference in Appendix I.

[27]See Richard Harper, *Inside the IMF: An Ethnography of Documents, Technology, and Organizational Action* (San Diego: Academic Press, 1998), for an interesting discussion, from a rather different perspective, of the "career" of an Article IV staff report and of an Article IV mission (to "Arcadia").

[28]This committee is ad hoc (that is, it meets as required) and does not keep minutes.

Box 2.1. Chronology of an Article IV Consultation (Approximate)

Day 1	Mission brief draft circulated among departments
Day 8	Mission brief submitted to management
Days 15–28	Mission visits country
Day 32	Back-to-office report circulated to management and departments
Day 51	Draft staff report circulated to departments
Day 65	Staff report circulated to Board
Day 90	Board discussion

preparation of the staff report—that the Fund's "line" on the country's policies is thrashed out internally. It is also worth emphasizing that the mission brief is purely a staff document, not shown to the authorities of the country concerned or to the Executive Board.

The Mission

7. The next stage is the mission itself. A mission usually consists of a visit of about two weeks to the country by at least four or five staff members. The mission is headed by a relatively senior staff member from the area department—generally either the chief of the relevant division or someone more senior—and consists of other staff from the area department and, if required in a particular area of interest, possibly one or two staff from functional departments. The mission consists primarily of meetings with senior and midlevel officials from the finance ministry, central bank, and other government ministries involved in the formulation of economic policy.

These meetings have two distinct purposes:

- Information gathering. This varies from simply collecting and checking data and ensuring its consistency to ascertaining how government officials view the current state of the economy, and to getting more information about current and future policies.
- Policy discussion and advice. Here the Fund officials discuss with government officials what they consider to be the main policy problems or decisions facing the country, and make their own suggestions for how the government should proceed.

8. There may also be meetings with the private sector and representatives of "civil society"—in rough order of frequency: bankers, financial market participants, business associations, academics, trade unions, and NGOs.

9. At the end of the mission, there is often a formal concluding meeting with senior officials (including, in many countries, the finance minister and central bank governor). At this meeting the mission leader will sometimes read out a "concluding statement," which summarizes the staff's view of the economy, the current policy stance, and any recommendations for changes. As noted in Chapter I, in recent years, some countries have made the concluding statement available to the media.

10. Immediately after returning to headquarters, the mission leader will prepare a "back-to-office" report to management, summarizing the most important information about the visit. The mission staff will then prepare a staff report for the Executive Board. The staff report includes a comprehensive and reasonably detailed description of the macroeconomic environment, the main economic policy issues facing the country, the staff's forecast, and an account of the discussions between the staff and the authorities. However, the most important section is the "staff appraisal," which sets out the staff view of the soundness of the authorities' policies and what, if any, policy changes the staff recommend. The staff report will go through the same review process as described above, with comments from functional departments, and approval by first PDR and then management. It represents the formal, final view of Fund staff and management on the country.

The Executive Board

11. After approval by management, the staff report is submitted to the Fund's Executive Board. The Executive Board discusses most staff reports in some detail, with the discussion of even a middle-sized country occupying most of a morning.[29] Often

[29]The discussion of a *very* small country, however, can be relatively brief.

most or all Executive Directors (or their representatives) will speak. Directors may also use the discussion of the staff report as an opportunity to bring up other issues, either specific to the country or more general, that they wish to discuss.[30] At the end of the meeting, the Chair (the Managing Director or a Deputy Managing Director) will "sum up" the views of the Board. Usually, the summing up will begin with the phrase "The Board broadly agreed with the thrust of the staff appraisal," or similar. It will then summarize the views expressed by Executive Directors, including dissenting views (using phrases like "Most Directors felt . . . However, some Directors felt . . .").

12. Since it represents the official collective view of the Fund—not just the staff—and since it forms the basis for the PIN (which also contains a factual background section), it is worth examining in some detail how the summing up is prepared. A first draft is prepared before the Board meeting takes place. If Directors do not specifically dissent from the staff appraisal in a particular area, it is assumed that they endorse it. The draft is then modified during the meeting to take account of Directors' views, particularly in areas where they do not agree with the staff appraisal. The new draft summing up is then read out at the end of the meeting; this is the only chance most Directors have to challenge it. The summing up is then finalized by the Secretary's Department, in consultation with the area department, PDR, and the Director representing the country concerned.

13. The summing up is then transmitted to the country concerned. In cases where that country agrees, the summing up, together with a brief summary of the factual portion of the staff report, also forms the basis for the PIN. The draft PIN is submitted to the authorities by the Director, and only exclusion of highly market-sensitive material (and corrections of factual errors) is in principle allowed.

Views on Article IV Missions

Frequency and Intensity

14. For most countries, Article IV consultations are supposed to take place annually, although the process sometimes slips by a few months. There have been occasional attempts to reduce the frequency of consultations for smaller, "nonsystemic" countries, on a voluntary basis. However, in practice, countries have been reluctant to agree to move to biennial consultations; currently, only 23 of the Fund's members are on a biennial consultation cycle. In financial year 1998/99, the Fund completed 124 Article IV consultations, out of its total membership of 182.

15. Member states seem generally content with an annual consultation, although there are differences in how countries approach them. Small countries often regard the annual Article IV consultation as a valuable opportunity for bringing together the economic policy establishment of the country. For some, this may be the sole such occasion. Large and medium-sized member states felt that one annual visit (though not necessarily an Article IV mission) is about the minimum for maintaining the personal contact between Fund staff and national officials, and the "feel" of the former for the country's problems, which are essential ingredients in a constructive professional relationship.

16. However, differences of view were apparent over the desirable length and intensity of the main annual mission, its coordination with regional or multilateral efforts by the Fund, and the need for follow-up staff visits in between Article IVs.

17. A normal Article IV mission spans at least two working weeks. While recognizing the value to domestic officials of discussions with a well-prepared Fund team, most officials thought that the length of missions was excessive and could be shortened in the initial fact-exploring phases. Essentially, questions of fact (as distinct from interpretation) could and should in their view be settled in advance.

18. It is not uncommon for countries to receive follow-up visits from the staff once between the Article IV consultations. Some officials thought this was unnecessary, particularly since they also received visits from Fund staff responsible for the WEO and the *International Capital Markets* report (ICMR), as well as World Bank staff. Indeed, several country officials complained that they ended up answering the same questions repeatedly. The Annual Meetings (and in some cases the Interim Committee meetings) provide another opportunity for informal discussions. Quite a few thought that the Fund surveillance process was somewhat old-fashioned, with too much emphasis on large missions and not enough on more continuous surveillance based on watching the country data from Fund headquarters, as investment banks or rating agencies, for example, would tend to do.

19. In terms of resources, it is useful to separate the Fund's membership into three categories.

- Small states. Country surveillance seems particularly useful to, and appreciated by, small states; they strongly oppose any diminution in the resources devoted to them.
- Industrial countries. There was general agreement among officials of all countries, staff,

[30] See Harper (1998), p. 254.

and outsiders that because of the systemic implications the Fund needed to monitor closely the economies of the largest industrial countries. This view was perhaps strongest among officials of those countries that relied on the Fund for information about the largest countries. However, some felt that the resources dedicated to industrialized countries, especially the medium-sized and smaller ones, were too great.

- Emerging market countries. Many officials in both industrialized and emerging market countries thought that the Fund should give greater priority to emerging market countries, particularly those of systemic importance.

Contacts

20. The central bank is often the main contact, providing logistical support, and sometimes providing the venue for official meetings. Relations with central banks were generally good. Indeed, a concern voiced by some national officials was that the Fund ended up being too close to the central bank; in several of the countries we visited the Fund was seen by nonmonetary officials as insufficiently critical of the central bank's well-known views in the domestic policy debate.

21. The ministry of finance may also be the basic contact point, but in any case it is always a main stop for a mission. Although the line of the Fund is almost invariably that the budgetary position should be strengthened, hence tending to reinforce the position of the finance minister in conflicts with spending colleagues, the Fund appeared to get an approval rating in finance ministries that was not as high as that in central banks. Sometimes this attitude was based on the perception that the mission was insufficiently sensitive to domestic political problems in obtaining support for budgetary consolidation. Another contention was that the Fund was too dismissive of Keynesian views of the impact of changes in budgetary policies.

22. Missions do aim to see important economic actors in the government outside the central bank and the ministry of finance—for example, ministries of economic planning or of labor. However, coverage beyond this list varies. In countries where the legislature has a central role in economic policymaking, some officials suggested that it might be useful for an Article IV mission to have the opportunity to exchange views with selected members of the legislature. This occurs in some countries, but the practice does not appear to be widespread or systematic. In the United States, for example, the mission does not meet with legislators although Congress clearly exercises a major influence over U.S. budgetary policy. In Japan, even some officials from the central bank and the ministry of finance suggested that the shift of influence over economic policy and financial regulation from the Bank of Japan and the Ministry of Finance toward the Diet would justify a meeting with the mission. However, staff said that in some countries the Fund's traditional interlocutors prefer to keep missions more to themselves. Similar considerations apply to meetings with representatives of opposition parties; some missions have done this, but it is not standard practice.

23. In federal countries such as Brazil and India, where state or regional governments have substantial power over tax and expenditure policies, it may be useful for missions to meet when they can with regional or local representatives. Fund practice has moved in this direction. Here, central governments have generally been supportive. We were told in a couple of instances that this was because surveillance had in such cases a strong element of technical assistance to improve budgetary practice and/or debt management in a way that was also helpful to the central government.

24. Independent research institutions, financial sector representatives, other private sector organizations, and labor unions (in rough order of frequency) are also often included in the list of visits. However, the coverage of meetings with outside organizations appeared to vary substantially from country to country; it largely seemed to be determined at the discretion of the mission chief and the main government contact. We also noted that in a number of countries the central bank or finance ministry made it a rule to accompany Fund missions to all meetings, including those with nongovernmental organizations. Some outsiders said that this inhibited them from talking frankly to the Fund.

25. We found that Fund interlocutors in the private sector and in independent research institutions—and sometimes even within the government—were in one respect somewhat disappointed in the nature of their exchange of views with members of an Article IV mission. The Fund team asks good and searching questions to which those visited seek to reply to the best of their ability, but there is reportedly little give-and-take in the discussion and the team leaves few clues as to how the information provided is to be used in the staff report. Nor are the interlocutors given an opportunity to see the final product or simply the part of it to which they have contributed. Some said that missions would be better received if there could be more in the way of reciprocity. However, the scope for such reciprocity is of course limited when the staff consultations are supposed to be confidential.

Dissemination of Surveillance Results

26. We discussed the communication of Article IV consultations—be it through the PIN, the concluding statement, or the full report—in most of our interviews. We similarly reviewed dissemination and follow-up within government with officials. Since the choices made in these areas are up to the individual country, rather than to decisions in the Fund on the conduct and methods of surveillance, we postpone the discussion of these important questions to Chapter IV, on the impact of surveillance.

Other Bilateral Surveillance

27. Country surveillance through the Fund makes use of a number of other instruments in addition to the Article IV missions and the whole structure of intensive, but somewhat discontinuous, attention to a country to which the missions give rise.

Communications from Management

28. Management occasionally communicates in writing with the central bank governor, the finance minister, or even the prime minister, of a country where an Article IV report or some follow-up to it gives cause for concern. Such messages, obviously confidential, are typically much clearer and more pointed than staff reports, let alone the Fund's public statements. They no doubt serve to raise the attention level and the eyebrows of national authorities; as a consequence, they are regarded as a tool to be used sparingly. The Managing Director also visits countries for confidential discussions and/or public, national or regional, meetings; so does his First Deputy and, on rarer occasions, the two other Deputy Managing Directors. Furthermore, they consult with high national officials when the latter visit Washington to attend the Interim Committee or for other purposes. These are valuable occasions for focusing on one or two critical issues in relations with a country.

Informal Country Matters Sessions

29. Informal Country Matters sessions in the Executive Board have taken place for a number of years. They are designed to allow the Board to discuss the situation in countries whose economic situation gives cause for concern, in particular where a program may be in prospect. These sessions are held irregularly, on average monthly, with the list of cases mostly determined by the staff—most will be countries already in programs—but Executive Directors also have an opportunity to add to the list. The latter sometimes gets so long—15 or so countries—that there is not sufficient time for each case to be discussed in depth. Executive Directors said that they found these sessions helpful, but would like to be able to examine key cases in greater detail. Several also observed that the staff made no attempt to present a regional view at these sessions, although that had originally been stated as one of the objectives. One senior staff member also made the point that, from the point of view of the staff, it would be useful if Executive Directors would use these sessions to pass on any information they had from their capitals on the countries discussed. Apparently, this does not happen.

Resident Representatives

30. Although resident representatives are not formally part of the Article IV surveillance process, a number of officials expressed the view that they made a significant and distinct contribution. Countries generally welcomed proposals to appoint a resident representative, and regretted their withdrawal.

Technical Assistance

31. Technical assistance was generally considered helpful. This was particularly the case when it was well integrated with surveillance. For example, the Brazilian authorities were very complimentary about the technical assistance they had received from the Fund, especially on the fiscal side, and the way that it had complemented bilateral surveillance more generally. However, even though opinions on technical assistance were broadly favorable, successful integration with surveillance does not appear to have been very common elsewhere.

Regional Surveillance

32. Efforts at regional integration, particularly in Europe and to a lesser extent in Asia and in Latin America, have raised the issue of whether the Fund should engage itself more in surveillance of a regional nature. This question has become more topical following the experience of the past two years, when aspects of the international financial crisis have taken on a regional dimension.

The European Union and the Euro Area

33. When regional integration advances as far as has recently happened in the European Union (EU), the Fund has to make significant adjustments in its methods of surveillance. For a few years during the transition to Economic and Monetary Union (EMU), Fund missions regularly visited the precursor of the European Central Bank (ECB) and the European

Commission. We therefore visited the ECB and the Commission to discuss with leading officials how they saw the future evolution of surveillance of the euro area and its individual participants. We also sought the views of some national officials from EU countries inside or outside the euro area.

34. There are now plans to have a meeting at the ECB with a Fund mission twice a year to review the common monetary policy and its exchange rate implications, and the ECB has been given observer status at the Executive Board. However, country surveillance of the 11 participants in the euro area will continue on an annual basis (except for Luxembourg, which is on a two-year cycle). Officials of EU countries pointed to both formal and substantive arguments for continuing country surveillance of nonmonetary policies. From a legal point of view, the participants continue to be members of the Fund and are hence obligated to receive the Fund's Article IV missions. For euro area countries, only monetary policy has been centralized (trade policy, of course, has already been centralized for all members of the EU). Budgetary and structural policies continue to be a national responsibility, though the Pact for Stability and Growth subjects such policies to intensive monitoring by the Commission and by the Council of Finance Ministers (ECOFIN).

35. It is clearly in the interest of participants in the euro area, officials from those countries told us, to have the Fund apply the wide range of experience in its global membership to these policies. It may also be of interest to other Fund members to be kept informed about national policy developments in the euro area with respect to tax, expenditure, and labor market policies, not least because they are still far from uniform.

36. However, a number of interviewees (official and other) suggested that the resources devoted to such surveillance could now be considerably reduced. It was pointed out that with a centralized monetary policy there was no need to consult national central banks on this topic. Moreover, in areas other than monetary and exchange rate policy, EU states are already subject to monitoring both by the European Commission and by the OECD. In the view of these observers, it should be possible for Fund surveillance to rely largely on this work, albeit not in an uncritical way. Accordingly, it was also argued, the Fund should focus surveillance more on aggregate policies not only in the monetary but also in the fiscal area, since it is the policy mix of the euro area as a whole that is of concern to the world as a whole. Here the main input would be the Stability Programs submitted to the European institutions. They also suggested that just as Fund analysis of the United States and Japan has traditionally devoted considerable attention to the policy mix in these countries and its impact on other countries, this needs to be paralleled by a similar review for the euro area. We develop in Box 2.2 some ideas concerning the future subject material and organization of such surveillance.

Other Areas

37. In other areas of the world, regional integration is far less advanced than in Europe and will remain so for a long time. The focus on regional surveillance in other areas is therefore not as strong. However, member countries have taken a number of initiatives in recent years, and the Fund has been involved in several. We examined the Fund's role in regional surveillance in Southeast Asia and Latin America.[31] These revealed both the potential and limitations in such an approach.

38. In Southeast Asia, the Fund has been designated as the technical secretariat of the Manila Framework Group. The Fund is already engaged in preparing background documentation for meetings of the Finance Ministers of ASEAN, and the Managing Director has occasionally been invited to participate in and address the meeting. These contributions are recognized by country officials—and by the Fund staff—to be valuable, though the Managing Director's comments on impending crisis symptoms in the spring of 1997 were seen to have come too late to have any major impact. Similar remarks were made about Fund input into the deliberations of the Asia-Pacific Economic Cooperation (APEC) officials, meetings that now include participants from some 20 Fund members circling the Pacific.

39. The Fund's main contribution to such meetings is the preparation of background documentation. However, we were informed that this documentation focused not so much on regional interrelations and issues as on the individual country experiences—in other words, largely an updated replication of consultation material already available. In the view of several Asian officials, notably in Japan and Thailand, the Fund has been too ready to see difficulties in stronger regional cooperation, particularly in Asia. The Fund has traditionally been wary of mutual support facilities among central banks and/or governments at the regional level—on the legitimate grounds that such initiatives must not be allowed to erode the role and the discipline of the global system that the Fund is designed to monitor and reinforce. This concern also marked the Fund's attitude to a regional support mechanism in the earlier stages of Europe's monetary integration. But there might, in

[31] The Fund also has regular discussions with some other regional groupings, including regional monetary unions in Africa and the Caribbean. We did not examine these in detail.

Box 2.2. Surveillance of the Euro Area

European monetary unification poses special challenges for Fund surveillance, but also new opportunities. The Fund staff is recognized as objective and independent, and tougher in its analysis than European institutions. Unlike those institutions, it is not constrained to focus on precise numerical criteria. So we believe that Fund surveillance will continue to have an important role to play, provided it focuses on the area as a whole.

However, our suggestion that future surveillance of the euro area should focus on aggregate performance and policies meets with practical difficulties. Within the European Union the monitoring by ECOFIN, prepared by the Commission, of policies outside the area of monetary policy remains largely country based. This reflects the reality that budgetary and structural policies remain primarily a national responsibility. Monitoring of the aggregate performance of the euro area is not yet well developed outside the European Central Bank (ECB), which has to review its monetary stance on the basis of aggregate indicators. This asymmetry in the policy framework implies that it will initially be complex to focus Fund surveillance of the euro area on the aggregate performance and the policy mix, the core subjects for the Fund in conducting regional and multilateral surveillance. Furthermore, there is as yet no obvious authority to consult with outside the area of monetary policy.

This asymmetry in the policy framework is no accident. It reflects the view, still broadly shared in the euro area, that there is a much stronger economic case for centralizing monetary and exchange rate policies in a regional institution than for centralizing other macroeconomic or structural policies. The economic arguments are clear: (1) the introduction of the single currency implies that participants in the euro area require some fiscal flexibility, to allow their budgetary policies to absorb some of the residual divergence in national business cycles; and (2) it was hoped that problems of an inappropriate policy mix would not arise, because the combination of a monetary policy aiming at low and stable inflation and constrained national budgetary policies would prevent serious policy conflicts. There were also political arguments; the transfer of decision making on fiscal policy is a more sensitive issue than for monetary policy, where governments and parliaments have already delegated authority to national central banks; and concerns that the ECB would see its autonomy threatened by an ECOFIN with reinforced clout.

Fund surveillance may, however, gradually be facilitated by an evolution in the policy framework, which is already under way. Aggregate indicators of the performance of the euro area, notably the current account and the exchange rate of the euro, increasingly find a role in policy reviews by the Commission and in the debate in ECOFIN. Policy coordination—obviously so far on a voluntary basis, since the Treaty does not contemplate more mandatory forms—is moving onto the agenda. The purpose of coordination will be both to review the policy mix in the light of aggregate performance and to consider, in the light of that, the desirable speed of budgetary consolidation within the 3 percent limit to deficits. The recent debate over the level of the Italian deficit is a good example; in our view, illustrating that the broad stance of individual countries' fiscal policy will increasingly be influenced by what happens at the euro area level.

Fund regional surveillance should not only anticipate, but take advantage of, this evolution. As noted elsewhere, surveillance has relatively little impact on individual euro area countries. For the reasons stated above, the Fund is well placed to give advice on the overall stance of euro area policies, both monetary and fiscal. To do so, visits to the ECB, the Commission, and national authorities will not suffice. Fund consultations should be extended to ECOFIN and to the Economic and Financial Committee, as has already begun to occur.[1] The Managing Director might also usefully be invited to attend meetings of ECOFIN once or twice a year. In our view, given the increasing role of European institutions not only in monetary but in fiscal policy, Fund surveillance is more likely to have an impact at the euro area level than at the level of individual countries.[2] Consequently, Article IV missions to participants in the euro area should become less frequent, more focused, and leaner.

[1]We understand that such meetings took place in the June 1999 consultations with the authorities of the euro area, and the mission's concluding statement therefore referred, appropriately, to the "economic policies of the euro area."

[2]This point is underlined by the fact that, in recent discussions of staff reports on individual euro area countries, euro area Executive Directors have maintained positions collectively agreed at ECOFIN.

the view of several Asian officials, have been net benefits from encouraging a number of Asian countries to develop some degree of monetary cooperation. At a minimum, better information flows in the region might have reduced the risk of contagion, hence ultimately reducing the need for Fund resources.

40. In September 1998 the Fund convened a meeting in Washington of the finance ministers and central bank governors of the Americas to review the short-term prospects of the hemisphere—not least in the light of an impending crisis in Brazil. This meeting got mixed notices; the staff prepared relatively elaborate country notes for discussion, but felt that the

effort might not have been justified since the process of peer pressure did not visibly help to bring about any adjustments in Brazil's policies. Reluctance of neighboring countries to engage in frank exchange and criticism in such a forum was, we were told, characteristic of Asia also, and is apparently not unknown in European regional economic forums as well. Apparently, the Fund's bilateral "frankness" can stand out by comparison, and becomes rather salutary. This being said, some Latin American officials who had been present in Washington were more positive, pointing to the usefulness of at least sensitizing high U.S. officials to the problems of their southern neighbors.

Multilateral Surveillance

41. The principal vehicle for the Fund's multilateral surveillance is the WEO, produced twice a year (and sometimes more frequently). In addition, the ICMR has gained increasing attention in recent years. Both are produced by the Fund's Research Department. Conceptually, WEO has two main components: a description of the current state of the world economy, including forecasts of the main economic variables for the world as a whole and for large and medium-sized countries, and analytic chapters on a variety of topics. The forecast is prepared by a bottom-up rather than top-down procedure; that is, it is not produced by a single model of the world economy, but compiled from forecasts for individual countries by area departments. These individual country forecasts are scrutinized by the Research Department to ensure that they are both plausible and consistent, and if necessary changes are made after discussion between the Research Department and the area department. The ICMR is also produced by the Research Department, but with relatively little input from area departments or the Monetary and Exchange Affairs Department (MAE). Again, it has both descriptive and analytic sections.

42. As described in more detail in Chapter III, on substance, WEO and the ICMR are generally held in high regard among officials and others who monitor major international economic developments. We did not examine the process by which they are produced in as much detail as for bilateral surveillance. However, the following points did emerge in our discussions:

- Some of our interviewees, government officials as well as academics, suggested that quarterly publication of an updated and leaner version of WEO would be desirable, with maybe one of them as a larger annual overview. The Fund has moved in this direction by publishing toward the end of 1997 and 1998 an update of the assessment in the October WEO (and ICMR).
- A number of senior staff and some government officials raised the question of the interaction between multilateral and bilateral surveillance. It was suggested that the two processes tended to proceed on parallel, but largely separate, tracks, with area departments managing bilateral surveillance and the Research Department responsible for WEO and ICMR, and that a greater degree of integration would be desirable.

43. We heard favorable comments on the Occasional Paper series, which has been a useful vehicle for disseminating, for example, cross-country experience with different exchange rate regimes and capital account liberalization, two essential elements in the substance of Fund advice in country surveillance (see below).

44. Besides the publicly available information, multilateral surveillance also takes place inside the Fund; the chief vehicle here is the World Economic and Market Developments (WEMD) meetings, held approximately every six weeks, at which the Economic Counsellor presents his view of the world economy and of certain key countries (usually the major industrial countries and countries where the situation gives rise to particular concern). Finally, the Fund also has a role in the G-7 process. It provides a background note on the economic situation in the world and in each of the G-7 countries. At the meetings themselves, the Managing Director (and the Economic Counsellor at the G-7 Deputies meeting) gives a summary of the Fund's views on the situation. However, they are not present for all of the subsequent discussion and play no part in drafting the communiqué.

Fund Internal Organization and Procedures

45. A number of our interviewees, particularly—but by no means exclusively—present and former staff members, raised internal and organizational issues that affect surveillance. Most of these relate primarily to bilateral surveillance, although some raise wider issues that affect the effectiveness of the Fund overall.

Staff Continuity

46. Many, perhaps most, government officials observed that there was a lack of continuity in the personnel involved in bilateral surveillance. Staff, especially junior and midlevel staff, rotate frequently. While staff believe that this has important advan-

tages in career terms, it causes irritation among country officials, who sometimes feel they are answering the same questions on each mission. There is usually (but not always) more continuity at the head of mission level. The head typically participates in a minimum of two or three visits. It was also pointed out that sometimes the head of mission is not the division chief for the country concerned, but someone from the front office in the area department who will be more senior, but sometimes lacks familiarity with the country. However, staff pointed out that often such problems are at least in part the responsibility of the country, since some authorities consider it a slight if the mission head is not, in their view, sufficiently senior.[32]

The Skills Mix

47. The majority of Fund economists are recruited either more or less immediately after completing a Ph.D. (usually in macroeconomics with a specialization considered relevant by the Fund) or relatively early in their careers, with some previous experience, often in finance ministries, central banks, or research institutions. The quality of the intake is undoubtedly high, though a couple of leading academics we interviewed thought that the Fund had been less successful than a decade or two ago in attracting the very best graduates from the top universities. In any case, this recruitment policy has certainly produced a relatively homogeneous staff with high competence in the core areas of the Fund.

48. However, this situation also gave rise to some concerns among people we interviewed. These basically revolved around the question of whether country policy experience was particularly valuable in surveillance. The point was made to us by quite a few staff that because outside experience is, by definition, from the outside, and because the Fund has a strong culture regarding the way things should be done and the need to build up relevant Fund experience to do them properly, the value of significant outside policy experience (be it from a central bank, economics ministry, or a private financial institution) is undervalued. This was particularly the case for those recruited rather later in their career than the core group described above. On the other hand, in many of the countries we visited, officials were at pains to point out that they valued dealing with staff who had themselves been in a country policy position. They thought it added something to the quality of the policy dialogue.

49. Another, somewhat related, issue was the need to ensure adequate career opportunities for staff with different skills. Here it was felt that a large premium was placed on macroeconomic expertise relative to other areas, with the result that other skills were underappreciated, making it difficult to recruit and retain staff who possessed them. This gained added importance with the Fund's increased emphasis on financial sector matters, where macroeconomics is less central.

Interdepartmental Relations and the Review Process

50. There is a tradition of strong departmental identity and autonomy in the Fund. As a consequence, there is, as there should be, vigorous debate among departments on important issues. However, a number of staff members (present and former) expressed the view that interdepartmental relations were not as constructive as they could be and that this had an adverse impact on the effectiveness of surveillance. In some cases, the relationship was adversarial; in others, distant. This situation obviously does not prevail for all departments or at all times. However, a number of comments we received, including from very senior staff, indicated that the issue was of concern.

51. In terms of its direct effect on surveillance, the most striking example was the generally poor relationship (in the period we were studying, notably the run-up to the Asian financial crisis) between the Research Department, responsible for capital markets surveillance, and the area departments responsible for country surveillance, especially the Asia and Pacific Department. All sides must share responsibility for this. Disagreements between the two departments, and the consequent breakdown in communication, were at least in part responsible for the fact that concerns about the health of Korea's financial system were not properly reflected in surveillance nor communicated to the Executive Board (see also the discussion of Korea in Box 3.2). This situation may also have reduced the effectiveness of the Fund's surveillance of other Asian countries, such as Japan. Internal procedures in this area appear, if anything, to have deteriorated since; the confidential "Financial Sector Notes" circulated to management and other departments by the Capital Markets group of the Research Department were discontinued in late 1997.

52. More specifically, we also encountered a number of problems in the functioning of the interdepartmental review process. While, we should emphasize, there is no suggestion on our part or on that of others that the review process should be discarded, there was a general concern that the process was becom-

[32] We learned from the staff that the mission head's seniority had been an issue for one of our sample countries (Korea) in the period leading up to a crisis. This had delayed the consultation and had, in the staff's opinion, reduced the effectiveness of surveillance in this instance.

ing very time consuming and inadequately focused. Concerns were expressed from the sides of both area departments (for example, too many comments that were more form or detail than substance) and functional departments, where there was an impression that area departments did not take their comments seriously enough.[33] Some further stated that the situation had worsened in recent years, as the Fund, and the coverage of staff reports, had expanded and more departments had therefore been drawn into the process. However, departments did not feel constrained to limit their comments to their areas of professional expertise—again adding to the workload all around for no particularly beneficial result.

53. While the review process does of course seek to ensure that the Fund's views or "line" are properly reflected in the brief,[34] concerns were also expressed to us that the process hinders innovation and flexibility; departments are inhibited from trying to do things differently. Some interviewees suggested that this tendency may also lead to insularity—one of the most common external criticisms of the Fund, both among our interviewees and in general—because staff are preoccupied with getting their analysis agreed and accepted internally rather than listening or learning from outside.

Other Organizational Issues

54. Here, brief mention is made of a number of other organizational challenges for the Fund. Their effect on surveillance is indirect, but they were raised frequently in our interviews within the institution.

- Hierarchy and accountability. A number of concerns were raised here—notably a tendency to centralize decision making and a reluctance to delegate. This tendency, we were also told, leads to a general lack of individual accountability and responsibility. Several of our interviewees, inside and outside the Fund, felt that it was notable that no one had been held accountable for what they saw as the failures of Fund surveillance in Asia.
- The number of senior staff in area department front offices. While the numbers of front office staff look large by outside standards, and quite a few staff raised doubts about the necessity of offices of this size, we were told by senior staff that the workload, given the sheer number of countries in each department and the needs of Fund-wide coordination, justified these numbers. And in any event, we were told, some nominally front office members were in effect operating as division chiefs. In any case, it was apparent that not all front offices were able to provide what one senior staff member, rightly, believed were their central functions: first, to provide an overview of the department's work across countries; and second, to bring a perspective on what was going on in other departments and outside the Fund that would be useful to the department.
- Finally, the team was struck by the burden of overwork that prevails among staff involved in the surveillance process: this has been a longstanding issue, but it seems to have worsened in recent years. Above and beyond the consequences for personnel, it surely detracts from the quality of surveillance overall.

Role of the Executive Board

55. The role of the Executive Board in the conduct of surveillance is, in principle, paramount. It is the Board's discussion, and the summing up thereof, that completes the consultation process with a country or that authorizes the release of publishable work by the staff. We sought comments from a number of Executive Directors (EDs), from senior staff and management, and from national officials with personal experience of participation in the Board.

56. Views in general, both among current EDs and others, were negative both about the process and the results. The following points in particular were raised.

- The size of the Board, although understandable from the viewpoint of membership representation, makes a free-flowing or well-focused discussion very difficult. On important countries or issues, most or all EDs will speak, often from prepared statements. (Indeed, silence is officially consent: if a Board member does not specifically dissent from the staff view, he or she is normally recorded as endorsing that view.) This can lead to sterile discussions, where one Director after another opines on each element in the staff report: monetary policy, fiscal policy, exchange rate policy, etc. As can be imagined, this is neither enjoyable for the participants nor useful for the country.[35]

[33]This latter point does not apply to PDR, which has to sign off on every brief.

[34]At the same time, it was also suggested to us that in terms of the PDR involvement in the review process, there was now less of a "line" to be adhered to than earlier.

[35]While no one suggested that the problem did not still exist, some thought that it had lessened somewhat recently, especially with the increased use of preliminary statements ("greys") distributed in advance of the meeting.

- The workload is huge. The Fund has 182 members, most of them on an annual consultations cycle. So bilateral surveillance alone generates more than 150 substantive agenda items annually, and there are also numerous multilateral surveillance items. Program countries, of course, generate even more work than surveillance-only countries, not to mention discussion of general issues, administration, and the like.
- Staff members observed that EDs tended to be defensive about the countries they represent, and that other EDs deferred to this, partly because they expected the same deference in return in due course. As the internal review of the Mexican experience put it, peer pressure can become peer protection.
- Some staff and EDs felt that EDs rotated too rapidly, so that they could not develop the institutional knowledge to contribute to the Board. In part, this is a consequence of the multicountry constituency system, when EDs from different countries rotate every two years or so.
- The Board is chaired by management. Some EDs regarded this as anomalous, potentially putting management in a difficult position if a staff paper is strongly criticized.
- The Fund staff and management attach considerable importance to presenting a unified view in Board discussions. Internal disagreements are generally not divulged to the Board. Some Directors thought it could be healthy for this to happen more frequently.

Directors noted that efforts to address the first two problems by introducing a committee structure had not made much progress. Even when committees were set up—as for some administrative matters—they were open, that is, any ED could attend (or send a representative) and speak. In the event, little real streamlining was accomplished. Some EDs thought that their colleagues would insist on making use of such an open access provision to a committee that discussed Article IV reports.

Some EDs complained that they had relatively little influence on the policy positions taken by staff. Others, however, pointed to one or two occasions when advice had been modified by the Board. (Interestingly, these were cases in which the staff had recommended devaluation to countries with pegged exchange rates.) We did examine the mechanism by which the views of the Board were transmitted back to staff at the working level. In the surveillance context, the primary formal mechanism by which this happens is the summing up; the staff report always begins by reviewing what the Board said in the previous year. So, to the extent that the Board views are still relevant, the staff will try to incorporate them into the report. Staff we spoke to said that they did try to do this; they did not want to be embarrassed by having the Board ask the same question, or repeat the same criticism, two years in a row. However, the process was less systematic for cross-country issues. Some Board members suggested that if they could see the mission briefs in advance of Article IV missions, this would enable the Board to have more input into the conduct of surveillance than it does now, when it only sees the final staff report. (Indeed, as noted earlier, the mission brief—which sets the agenda—is arguably more important than the final report.) However, some staff and national officials said that such access would, among other things, raise confidentiality concerns.

This brings us, finally, to the delicate issue of equality among the EDs. The resources they can devote to the monitoring and anticipation of papers and initiatives by staff and management clearly vary. Some EDs also have substantial resources to back them up with analytical and policy efforts in their respective capitals. It is no surprise, therefore, that the perception of many EDs is that information on important aspects of surveillance, on policy initiatives developing in the Fund, and particularly, on the preparation of programs, is not equally accessible to all shareholders. In particular, there is a firm impression among developing countries that the G-7 countries have disproportionate access, information, and influence; and a perception among many countries—including some industrialized countries—that this is doubly the case for the United States.

There is no doubt that the U.S. Executive Director's office and to a lesser extent those of some other G-7 countries are better informed about and have provided more input into Fund policy than their colleagues. U.S. officials, indeed, seem more capable of "working the system"[36] to advance their preoccupations in selected cases through contacts to staff early in a consultation process or in the preparation of a policy paper. It is less clear, according to our information, to what extent this asymmetry is due to greater resources and capacity to take initiatives or rather to differential treatment by management and staff. To some extent this is inevitable; all Fund members are not of equal weight, as the Board voting system recognizes. However, the tensions caused by this asymmetry do apparently detract from collegiality within the Board.

[36]The expression was used by the Deputy Secretary of the U.S. Treasury. Lawrence Summers, Remarks to the Senate Foreign Relations Subcommittee on International Economic Policy and Export/Trade Promotion, January 27, 1999.

III Substance

1. This section deals with the quality, relevance, depth, and scope of Fund advice. The questions posed by the Board that are most pertinent here are the following.[37]

(i) How did the Fund's advice correspond to the short-term objectives and medium-term strategies of existing policies?

(ii) How did this advice correspond to the analysis and advice of other domestic and international institutions? Did the Fund's advice add value?

(iii) Has Fund surveillance paid sufficient attention to regional surveillance, to interaction among countries, and to the external effects of policies in major countries?

(v) Have the frequency and general focus of the Fund's surveillance been appropriate, with hindsight? Has advice been consistent? Has advice helped foster noninflationary economic growth?

(vii) Did the advice take into appropriate account the institutional, political, and social framework? Did it pay adequate attention to the uncertainties and political constraints that lead to "small" deviations from first-best policies?

2. In this light, we first discuss bilateral surveillance, beginning with what we were told about its general quality and consistency and following with a more detailed review of individual policy areas. Then we look at the scope and coverage of Fund surveillance. This is followed by a brief review of special considerations that might relate to surveillance of small states and a discussion of multilateral surveillance. We conclude with a brief comparative survey of other institutions' surveillance-type activities.

[37]Numbers in parentheses indicate the number assigned to the question in the original Executive Board request. See the Terms of Reference in Appendix 1.

Bilateral Surveillance

Quality

General View

3. Fund surveillance was generally regarded as being of high quality and as a process of exchange of views that many officials found stimulating. To cite, just as one example, the views of a couple of experienced European central bank officials, "the Fund consultation discussions are stimulating and always to the issues," and "the staff talk to many people and finish up with a view that is comprehensive and independent." However, the high praise tended to be limited to the Fund's work in the macroeconomic area. In more microeconomic, less demand-oriented, areas such as financial sector surveillance and structural questions, views were more critical.

4. Perhaps not surprisingly, therefore, the most favorable appraisals came from those whose lines of work bore close similarities to the Fund's—central banks and, to a lesser extent, finance ministries. To the extent that one can generalize about less positive reviews, it is fair to say that these tended to come from policymakers in areas other than demand management, and particularly from those who, for example, were not particularly taken with the prescription of cautious fiscal policies and monetary policies aiming at low inflation, combined with liberalization of product and factor markets, including removal of all capital controls, sometimes labeled the "Washington consensus."

5. Many favorable comments stressed that Fund staff were high quality, hard working, and well prepared. In general, staff visiting a country were seen to have a clear and reasonably comprehensive understanding of the principal economic problems. However, two criticisms recurred in a large number of our interviews, especially in nonindustrial countries:

- lack of flexibility in the Fund's analysis; and
- failure to appreciate adequately the political environment in which decisions are taken, and/or to allow for it in policy advice.

6. On the first point, while most of these critics agreed that it was useful—and intellectually stimu-

lating—to exchange views with the Fund, they were left with the general impression that missions came into countries with a preconceived template of ideas, based on a theoretical or textbook model, housed in Washington, into which they fed country information. This was perhaps particularly true in areas outside the Fund's traditional expertise, such as labor market or tariff policy.[38] In their opinion, the resulting policy recommendations did not adequately allow for, or perhaps were not permitted to allow adequately for, differences among countries. This tended to lead to a "one-size-fits-all" approach that they thought weakened the effectiveness of the exercise. As one Latin American official put it, "they come with a preconceived image of what the issues are, and this makes it difficult to look behind the surface to the real problems."

7. It should also be noted, however, that this apparent rigidity may still have a positive impact, especially in the core macroeconomic areas, as the following revealing quotation from an Asian official shows: "Strangely, it is worthwhile to go through the Article IV consultations that dispense this very standard, undifferentiated advice. It is like a confessional—the government sits on one side of the booth and the IMF is on the other side. Each knows what the other is going to say, but by repeating the lessons of an introductory course in macroeconomics to the sinning government, the IMF priest does help limit temptations to deviate too far from the orthodoxy."[39] This view of the Fund as a useful reality check was not uncommon.

8. The second criticism just noted related to the pressures applied by the Fund to achieve speedy implementation of "first-best" recommendations, without giving sufficient weight to political or institutional constraints. The authorities in one country were particularly upset when the mission's concluding statement suggested that legislation, recently passed with considerable difficulty and after much debate, "should be repealed immediately." Although use of such patronizing language seems to have been exceptional, there was, nonetheless, a perception—although not a universal one we should point out—that Fund staff did not sufficiently see it as their function to come up with policies that, while less than first-best, moved the country in the right direction and were politically and institutionally feasible.[40] At the same time, it was also pointed out to us that this argument should not be used to justify insufficient movement in policy to ward off a looming economic or financial problem.

9. On forecasting, the Fund's work was generally considered to be reasonably accurate—not exceptionally good. If there was any bias, our interlocutors thought it tended toward optimism. Private sector observers in particular thought that this reflected the fact that the Fund was not good at looking for, or incorporating, information and data from sources other than the authorities. At the same time, it should be noted that in one of our sample countries the staff resisted considerable pressure to produce a more favorable forecast, one that would be more in line with the domestic authorities' public target.

10. Another concern that should be ventilated here is one that featured strongly in the Fund's internal review of surveillance following the Mexican crisis—namely, the tendency of the Fund, particularly staff in area departments, to be insufficiently frank and direct in its assessment of a country's policies or economic situation (a culture of "clientism"). Not surprisingly, opinion among our interviewees was sharply divided on this topic. Only a few government officials whom we quizzed directly on this thought that the Fund was insufficiently frank in their own country's case (although some officials in Thailand conceded that in retrospect the Fund should, if anything, have been stronger in its language earlier). However, most if not all staff and former staff—including those in area departments—agreed that on the evidence this remained a serious problem for effective surveillance, as did a number of outsiders. In summary, it was far from clear that matters had improved much since the Mexican crisis.

11. Some blamed the incentive structure for this problem. For example, a former Fund official said that staff got ahead not by challenging or criticizing country policies, or by asking hard questions, but rather by "not rocking the boat." A senior staff member said that staff were still far too reluctant to risk forecasting a crisis that did not in fact happen. Many staff, especially in area departments, while recognizing the criticism, put the blame on officials in member countries. They said that a mission leader who was regarded as highly critical of government policy and insufficiently diplomatic in presenting such views could expect that next time he or she would not be granted meetings with more senior officials. This would prevent them from doing their job properly. In more extreme cases, it had been known for government officials to complain to the mission leader's superiors. Either way, this was bad for mission leaders' careers.

[38] See also the discussion of capital controls in Chile later in this chapter.

[39] This comment was actually made to one of the external evaluators of Fund research activities. Coincidentally, the official was from one of our sample countries.

[40] By contrast, in one country the Fund, while critical of a particular political commitment made by the government policy, provided detailed advice on its implementation that also softened the rougher edges of the measure. This was regarded as constructive and helpful.

Changes Over Time

12. Since opinions on the quality of Fund advice over time differed significantly, it is difficult to generalize. However, there appeared to be a fairly broad sense among interviewees that surveillance had become more difficult to do well, largely because of the capital account and financial sector issues discussed below.

13. Some current staff members and some government officials believed that the quality of surveillance had improved significantly in the last few years. They judged that it had managed to adapt its focus to ensure that it kept up on the right issues, and that the main emphasis of discussions had shifted to include more discussion of those issues. However, other officials and some former staff members we spoke to thought that the arguments of the Fund had become more routine, relying on textbook-like positions in the face of situations that were not covered in the textbooks. A view we heard was that discussions of possible different techniques in coping with policy challenges tended to end too early, with missions being less open to new approaches to dealing with problems. One interpretation was that a lowering of quality in advice had coincided with the rapid increase in Fund membership since the early 1990s. The resulting staff expansion meant that latterly staff were on average less experienced.

Consistency

14. If anything, the concern in countries we visited was that there was too much consistency in Fund advice rather than too little. As mentioned, a frequent criticism related to lack of recognition of country-specific characteristics. A central banker from a non-industrial country considered that "it would be better if the Fund took more account of the differences among regions and economies. Sometimes the policy advice is weakened because what it provides is merely a copy of advice elsewhere." Some officials complained that the Fund was tougher on small and medium-sized countries than on, say, the United States or Germany. What we can add here is that while it may be debatable whether what the Fund says is tougher, what is less open to debate is that admonitions from the Fund probably matter more in smaller countries.

15. There was also a general feeling (particularly among staff members, but also among officials and other outsiders familiar with the institution) that the Fund devoted a disproportionate share of surveillance resources to precisely those countries that needed them least and where the impact was least, that is, the G-7 and medium-sized industrialized countries, especially in Europe. This applied to both the quantity and quality of resources—a number of staff members observed that the most prestigious area department, and in their view the best staffed at middle and junior levels, was European I (dealing primarily with Western Europe).

Specific Policy Areas

Monetary Policy

16. On monetary policy we can be very brief. While there were occasional criticisms (from within the Fund as well as outside) of Fund techniques of analysis (such as an excessive reliance on "net domestic assets" as a tool of analysis; inadequate recognition as to how the demand for money can shift as a result of financial policy reform; and an insufficiently broad appreciation of what might constitute a domestic "nominal anchor"), and while of course there was not always full agreement with the particular advice that was given, most felt that the advice and the technical assistance given on monetary issues were useful and of high quality.

Fiscal Policy

17. Fiscal policy is front and center in most Fund documents, and there was general agreement that this was appropriate. The advice and, we should emphasize, the technical assistance provided are generally highly valued and highly rated. Furthermore, the Fund is seen as more sophisticated—and diplomatic—in dealing with fiscal issues now than in past decades.

Particular favorable mention was made of efforts directed at:

- making public finances more transparent;
- getting more complete public sector accounts;
- developing and clarifying the concept of a "quasi-fiscal deficit" stemming from central bank operating losses; and
- sorting out the analysis of structural and cyclical factors in government finance.

Some less positive comments were made, to the effect that

- the staff did not have a good understanding of the redistributive effects of some of the fiscal policy measures it proposed—or of the need to take such effects into account, and that
- missions tended to recommend fiscal tightening almost as a matter of principle, not distinguishing sufficiently between situations where tightening was urgent and essential, and others where it would merely be helpful.

This made national authorities discount advice in the former situations.

18. Finally, mention should be made of the sharp internal Fund debate in recent years over its fiscal advice to Japan. Without venturing into the details of this debate, what it makes clear is that there is still ample room for disagreement over the potency of fiscal policy and the desirable mix of policies, even among economists who share the same broad approaches and institutional objectives. Furthermore, the Fund's "line" on Japanese fiscal policy in recent years has shown a tendency to fluctuate. For a long period up to 1997, the main recommendation was that the Japanese authorities should not delay budgetary consolidation—though the line wavered as the Japanese economy ceased to grow for several years. When growth appeared to pick up in 1996 and early 1997, the Fund strongly supported raising the VAT rate from 3 to 5 percent. After the economy turned down later in the year, the Fund recognized this step as a mistake and subsequently advocated—in increasingly strong language—a budgetary stimulus despite the by then very large deficit.

Exchange Rate Policy

19. The analysis of exchange rate policies and appropriate exchange rate levels is bound to occupy a central role in surveillance. At the same time, what constitutes good, or even appropriate, exchange rate policy has been a question dividing the academic community and a prominent question in debates within the Fund. The institution's present position is, by all reports, quite pragmatic. Indeed, from different sources we heard criticism that the Fund was excessively keen on exchange rate flexibility; that it was too much in favor of fixed rate systems; and that it had no clear line on the topic.

20. Most observers were happy with the pragmatism shown, since it gave countries an opportunity to select a system that they thought was attuned to their history and characteristics. Accordingly, the Fund has tended, at least in nonprogram countries, to go along with national preferences in terms of the exchange rate system adopted.[41] However, it is also worth noting that it has seemed to emphasize pretty consistently, and appropriately, the need for other policies—basically fiscal, monetary, and wage policies—to be consistent with the exchange rate system chosen.

21. That being said, some of those interviewed were critical of what they saw as a lack of a consistent approach to exchange rate policy. The contrast between the high degree of flexibility recommended in the case of some Asian countries, while Russia was being encouraged to defend its nominal exchange rate peg came in for much comment. An academic observer noted that the Fund had bitterly opposed a currency board in Indonesia while effectively imposing one in Bulgaria, but in his view had not explained adequately the reasons for these different approaches.[42]

22. Many of the countries selected as part of our "representative sample" (but not selected for this reason) had traumatically abandoned their pegged exchange rate systems after prolonged experiences with them (Brazil, Chile, the Czech Republic, Korea, South Africa, Sweden, and Thailand). Many of those interviewed in these countries—even those who had earlier supported the pegged rate, and still thought that pegging was constructive in the right circumstances—criticized the Fund for not pressing them enough to abandon the peg at an earlier stage. The need to discuss exit strategies and alternative regimes was frequently mentioned. Several referred to a recent Fund Occasional Paper on this topic[43] that was felt to be a very useful reference point.

23. Some, both in governments and academia, noted that the current conventional wisdom on exchange rate systems seemed to be shifting toward the view that floating or firmly fixed exchange rates were distinctly preferable to anything in between. This would appear to be the emerging view in the Fund as well.[44]

Capital Mobility and Capital Account Convertibility

24. The issue of capital mobility and capital account convertibility remains a lively topic within and outside the Fund. It has persistently divided both the academic community and government officials, becoming even more contentious since the Asian crisis.

[41]One notable exception was the run-up to EMU, and in particular in the aftermath of the ERM crises of 1992–93, when Fund staff and management appeared to take a rather skeptical view both of EMU's feasibility and its desirability, suggesting instead that more exchange rate flexibility would be beneficial. Whatever the analytical merits of this view, it clearly tended to reduce the impact of Fund surveillance. However, with the introduction of the euro, this is water under the bridge.

[42]Note, however, that these commentators were not making the distinction between program and nonprogram countries that the evaluation team was asked to adhere to.

[43]Barry Eichengreen and Paul Masson, *Exit Strategies: Policy Options for Countries Seeking Greater Exchange Rate Flexibility*, IMF Occasional Paper No. 168 (Washington: IMF, 1998).

[44]See, for example, Stanley Fischer, First Deputy Managing Director, "The Financial Crisis in Emerging Markets: Some Lessons," speech to the Economic Strategy Institute, April 28, 1999. "We are thus likely in coming years to see more countries adopting flexible exchange rate systems or, if they choose to fix, to do so in a definitive way, for example by adopting a currency board arrangement."

25. Many of those we spoke to were critical of the Fund's advice in this area. There were two main criticisms. The first was that the Fund, being more wedded in general to analysis of flows rather than stocks, simply did not take capital account issues seriously enough, and as a consequence its surveillance in this regard had been too sanguine. For example, one particularly outspoken individual, in the financial sector in Europe, thought that the principal weakness of Article IV consultations was "the lack of depth and rigor in the treatment of capital account issues." Another comment, from a senior Asian finance official, was that "the Fund has not yet adjusted to an era when the capital account has become prominent in the diagnosis of, and remedies to, foreign exchange crises." Some observers thought that this lack of attention to capital account developments helped to explain the Fund's failure to foresee the Asian crisis. (We should in fairness note here that no institution, public or private, can be reckoned to have genuinely "foreseen" the Asian crisis.)

26. A second criticism was that while the Fund had been very opposed to the use of controls to limit short-term inflows, its opposition was based more on ideology than on a careful consideration of the evidence and the policy alternatives. While the Fund's line on this has changed recently, the general perception is that the Fund lagged rather than led the general consensus on this topic.

27. In this context, the case of Chile is particularly interesting. The Chilean officials we spoke to were familiar with the general arguments in favor of freedom of capital movements, and therefore believed they understood why the Fund favored the removal of controls. However, they were frustrated by what they saw as a failure of Fund staff to appreciate why their controls were a reasonable second-best response to the problems they faced—pointing out that the Fund did not produce any empirical evidence about the costs and benefits of Chile's control regime. Given this, they thought that the advice on the topic was neither convincing nor useful. More recently the Fund's interpretation of the Chilean experience has become distinctly more positive; the Fund now assesses the main impact to have been a modification in the maturity of foreign debt rather than in its total volume, resulting in a helpful reduction in the vulnerabilities in the Chilean financial sector.[45]

Financial Systems

28. Everyone who spoke to this topic agreed that having the assessment of financial systems and their vulnerabilities become an integral part of Article IV consultations was highly appropriate.

29. In our interviews, the Fund was often criticized for not having alerted countries to financial weaknesses and the imminence of a financial crisis. For example, it was marked down for not having warned Sweden about the weakness of its financial system toward the end of the 1980s and the possibility of a financial crisis, notwithstanding the fact that similar crises had already occurred at the time in Argentina, Chile, Finland, and Norway. It was also taxed with having missed the same kind of problems in Korea and Thailand, notwithstanding the experience of Mexico. As regards Korea, while the Capital Markets group had identified the weakness of the domestic corporate sector, and the potential implications for the banking system, the Asia and Pacific Department—and consequently its Article IV staff reports—had not focused on this area.

30. Clearly, the Fund has not performed well in spotting mounting weaknesses in financial systems before they trigger crises.[46] But it is also fair to note, although this cannot be a full excuse given the Fund's acknowledged responsibilities and store of international knowledge, that many officials in the relevant countries also allowed that they had not been aware of the importance of this issue. Some had thought that their financial systems were in good shape.

31. Looking ahead, a number of those interviewed thought that it was appropriate for the Fund to be charged with monitoring compliance with the code of good practices on monetary and financial policies that is now under discussion. But there was less consensus that the Fund should be in charge of its design. This task was best left in the hands of the Bank for International Settlements (BIS) or a committee of international financial regulatory authorities, some suggested. For one thing, rule making (regulation) is a conceptually different exercise from rule enforcement (supervision). For another, such a code would not be useful unless there was a feeling of "ownership" on the part of those who would actually

[45]See, for example, Stanley Fischer, First Deputy Managing Director, "Reforming the International Monetary System," David Finch Lecture, Melbourne, November 9, 1998: "We see no case for controlling long-term inflows, particularly of foreign direct investment, but can see the disadvantages of surges of short-term capital, both inflows and outflows, and therefore can support market-based controls, along Chilean lines, that are intended to discourage short-term inflows."

[46]However, we should also draw attention to the Fund's analysis of the framework for financial supervision in the euro area (see *International Capital Markets* report, 1997 and 1998), which warned of the potential risks of a lack of coordination of national authorities and of the absence of a clearly defined lender of last resort. While ECB officials believed this concern to be overstated, many in academic and financial circles shared the Fund's concern. At a minimum, the Fund's timely probing prompted the ECB to clarify its position.

have to live by it. The Fund was, in their view, unlikely to supply that "ownership" feeling.

32. In the same vein, there was also widespread agreement that while the Fund could well have a responsibility for monitoring the vulnerabilities of individual financial systems, this task could not be taken to imply a permanent in-depth analysis of all the microeconomic aspects of various financial systems. The Fund currently is short of this capability, and even though it has been trying hard to improve its skill set by recruiting new and experienced people, there is a general shortage of expertise in this area that cannot be remedied in the near term.

33. Providing technical assistance on financial issues and on bank supervision is considered vital if the new code of good practices is to be implemented effectively. Institutions such as the BIS, the World Bank, the OECD, and the Fund have supplied such assistance in the recent past, together with the help provided directly by individual central banks. However, there was a general feeling that this activity should not form part of the core activities of the Fund, since these needs could be better satisfied by other institutions. There was an underlying concern that the resources available in this area would be spread too thinly as different international institutions competed for them.

Interrelations, External Shocks, Spillover, and Contagion

34. A consistent theme in our discussions was that the Fund had failed to emphasize in its surveillance activities what many thought should be its main comparative advantages: its knowledge of the international macroeconomic environment; and its knowledge of the experiences of other countries in dealing with similar policy problems. It was very unusual for missions to ask questions such as: "Have you thought about the impact a measure implemented in another country (for example, a devaluation or an increase in interest rates) will have upon your country?" or "Have you evaluated the impact that the measures you are planning to implement will have upon other countries?" Similarly, it was unusual for an Article IV mission—unless specifically requested—to provide an analysis of how other countries in roughly similar situations had dealt with a specific policy problem, and of the pros and cons of different approaches. But, we were told, when such analyses were prepared, they were found to be helpful and of high quality.

35. Some observers considered that bilateral surveillance needed to be looked at more broadly and more preemptively in the light of changed global circumstances. There was a specific suggestion that the Fund be given a mandate to assess a country's vulnerabilities to specific shocks, and that it should discuss with the authorities what, if any, contingency plans the authorities had if the worst did indeed occur. While country officials saw the conceptual merit of such an approach, it was not clear how willing they were themselves to engage in such open-ended discussions.

36. Nonetheless, many of those interviewed emphasized that one of the most useful aspects of surveillance is the information that they got about *other* countries through the consultation material that the Fund distributes to its members. In this regard, the consistent approach and format of the Fund was seen as a plus.

37. While many thought that a greater role for regional surveillance might contribute to improving the effectiveness of surveillance, as noted in the previous chapter neither in Asia nor in Latin America did we find anyone who thought that recent Fund participation in (or organization of) meetings in those regions had constituted any kind of breakthrough. It was also noted that contagion is not just a regional problem. As a senior central banker emphasized, "Russia affected Brazil, which in turn affected Hong Kong."

Early Warning Indicators

38. There is, naturally enough, basic agreement that the development of macroeconomic and financial indicators, as part of an early warning system, would be useful for surveillance. It was considered that such indicators would be useful not only in current surveillance, but even more so if the proposed Contingent Credit Line were to be introduced. Our conversations with Fund staff, however, indicated that they were yet to be convinced that such indicators were sufficiently reliable to bear much policy weight. The Board has recently reviewed work on an early warning system (EWS) and found that "it could constitute an additional tool . . . [of surveillance]" and that it might, in particular "usefully supplement the current discussions on WEMD." The Board cautioned, however, against any use of EWS in publicly available documents because of the market-sensitive information contained in the analysis and, particularly, the risk of generating self-fulfilling expectations of crises. These issues are discussed further in Box 3.1.

Standards

39. One important strand in the current debate on the international financial architecture has been whether and how to apply internationally agreed standards in various areas. The most important of these so far have

been the Basle capital adequacy standards, but there has been discussion of standards in quite a few other areas, such as accounting systems, bankruptcy codes, corporate governance, as well as the code of good practices in the financial and monetary area that was referred to earlier. It was put to us that this general approach constituted a potentially major expansion of surveillance. Thus, the current system is based on giving advice on each nation's particular macroeconomic policies and, increasingly, on other policies as well, with the hope that consistent policy advice across countries would lead to a generally better outcome. The "new philosophy" is based more upon assuring the observance of internationally agreed standards in a range of areas, with the Fund playing a—perhaps *the*—leading role in monitoring them. It would mark a shift toward greater emphasis on rules and sound institutional designs to accompany the more traditional macroeconomic surveillance.

40. While this development has yet to have much of an impact on surveillance, we did ask a number of our interlocutors for their views. Some argued that it was impossible to apply universal standards to countries without taking into consideration their culture, history, and structural characteristics. Others—including many staff members—were not opposed in principle, but pointed out that the monitoring of standards in a wide range of specialized areas called for a very different set of talents from that needed for macroeconomic policy analysis, and that it was far from clear that the Fund was well equipped at present for this type of surveillance, or when it would be. We return to this challenge in Chapter V.

Scope and Coverage

41. There was a consensus that Article IV consultations should continue to focus on asking basic hard questions about key macroeconomic policies—monetary and fiscal policies and their implications for the balance of payments and the exchange rate. And as the discussion above shows, it was felt that the Fund does this quite well. At the same time, the Fund has gradually incorporated new issues to be examined in surveillance. In addition to the traditional macroeconomic demand-side topics, and above and beyond its more recent addition of financial sector and capital account issues, it has gradually become involved in more microeconomic and supply-side matters such as trade liberalization, labor markets, offshore banking supervision, tax reforms, expenditure streamlining, income distribution, poverty, land reform, environment, and so forth.

42. It was generally acknowledged that the expansion of Fund surveillance into financial sector and capital account issues was inevitable. These issues were seen as increasingly intertwined with the Fund's traditional analysis of macroeconomic and external sector issues. However, most observers drew a sharp distinction between such matters and the varied structural or microeconomic issues into which the Fund has recently been expanding. There was a fairly strong consensus—extending over government officials, present and former Fund staff, and academics—that this expansion detracted from the effectiveness of surveillance, for three reasons.

- It diluted the focus on basic macroeconomic issues, to the detriment of those issues, although they were still central to the Fund's mandate.
- Staff did not really have much to contribute on many of the issues that they were now expected to discuss, because they had neither the training nor the experience. Views varied about the quality of the advice provided in these new areas, but in general its quality was perceived to compare unfavorably with that offered in the more traditional macroeconomic areas. It also did not measure up well against the advice given by other international institutions that specialized more on the microeconomic side, such as the World Bank or—for most industrial countries—the OECD. Even apart from the question of quality, there was a general feeling that the Fund should rely more on the microeconomic work done by institutions with more specialized expertise.
- Some interviewees simply thought that as a matter of propriety or national sovereignty, the Fund was getting into issues—for example, military outlays, income distribution—that were "none of its business," taking into account its stated purposes and legal standing.[47]

43. Many interviewees felt that surveillance, insofar as it was useful, was useful because it was relatively narrow and focused. They felt that it should be kept a "limited-purpose vehicle," with the basic function of "bouncing off ideas" in a frank exchange, and that the Fund should function as a "clearinghouse" of ideas and experiences. As put by a highly experienced former minister of finance, "the essence of surveillance is not to try to verify the quality of government, but to have positive exchanges of views with the authorities."

[47]At the same time, it should be recognized that the reasons for Fund commentary in these areas can be quite subtle on occasion. We heard, for example, that commentary on military spending in one country was more or less invited as a way of strengthening the hand of government in its desire to curb military outlays.

Box 3.1. Early Warning Systems

Much academic interest has recently focused on the production of early warning systems (EWS) that might give early indications of looming balance-of-payments trouble based on selected economic indicators.[1]

In the current literature on early warning systems, two different approaches have been taken. The first is based on standard econometric estimations of qualitative response models (e.g., probit models) explaining the probability of the binary occurrence of a crisis with a set of explanatory variables. The second is a "signals approach," in which those indicators that typically show exceptional behavior preceding a crisis are singled out. Optimal thresholds for these variables are then estimated, so that indicators issue crisis signals when they surpass the threshold, and these signals are then combined into a composite crisis index. Finally, Berg and Pattillo (1998) suggest a combination of the two approaches by embedding the step-function of the signals approach in a probit model using several variables as regressors.

Variables that have typically been included in the EWS investigations include the real exchange rate, credit growth, and the ratio of M2 to reserves. Some studies have also included export growth, the government budget deficit, and the ratio of the stock of foreign direct investment to total external debt.

The essential test for the EWS, of course, is their ability to predict out-of-sample crises. That is, given the information available prior to a particular crisis, would an early warning system estimated prior to the crisis in fact have predicted it? In that connection, Berg and Pattillo (1998) test the out-of-sample properties of some of the recently proposed models during the 1997 currency crisis by excluding the recent observations from the complete data sample and then calculating the predicted crisis probabilities based on the in-sample estimations.

Here, the signals approach suggested by Kaminsky, Lizondo, and Reinhart (1998) seems to produce better out-of-sample predictions than the proposed standard probit models, but the combination of the two models as well as revised probit models, both suggested by Berg and Pattillo, also seem successful. The general performance of these models, however, still leaves much to be desired—even though some crises are indeed correctly predicted, the number of false alarm signals is high and most often outnumbers the true warnings. This current state, of course, stresses the fundamental dilemma between overlooking actual crises ("Type I errors") and wrongly predicting crises ("Type II errors"). The mixed results were also confirmed in EWS investigations carried out for this report based on the probit approach. The out-of-sample properties of the model were tested using periods of crisis for 7 of the 12 countries chosen as case studies.

One reason for the relatively limited success of the EWS is that the implicit assumption in these estimations of identical behavioral relationships across coun-

[1]A comprehensive review of the EWS literature, which has been highly influenced by research done at the IMF, is provided in Graciela Kaminsky, Saul Lizondo, and Carmen Reinhart, "Leading Indicators of Currency Crises," *Staff Papers*, International Monetary Fund, Vol. 45 (March 1998), pp. 1–48. An assessment of the capabilities of early warning systems to predict out-of-sample observations is contained in Andrew Berg and Catherine Pattillo, "Are Currency Crises Predictable? A Test," Working Paper 98/154 (Washington: IMF, November 1998).

44. One partial exception to the above range of views came from our meetings with NGO and trade union representatives, who considered it essential that the Fund understand fully the likely social and environmental ramifications of its advice, especially in the area of fiscal policy. For example, the NGO officials we spoke to were particularly concerned about the short time horizons that prevailed in the decision-making processes of governments, suggesting that good economics often called for a longer-term view. For example, they noted, environmental sustainability needed to be judged over a particularly extended horizon. They thought that such considerations were a very appropriate part of surveillance, given that under Article I of the Articles of Agreement the Fund is committed in their view to "the proper use of natural resources."[48]

45. However, these representatives too recognized that the Fund had little expertise in such areas, and they preferred to see it make more use of the work done by other institutions such as the International Labor Organization (ILO), the OECD, and the World Bank, rather than producing work itself that was unlikely to be as thorough. That did not mean the Fund should not have ideas of its own—and indeed the Fund should be asking "awkward questions" in these areas—but that it should be more prepared to incorporate the analysis of others in its work.

Small States

46. In general, the views of small states were not radically different from those of others. Their representatives generally thought that surveillance had been reasonably good and that policy debates were generally useful. However, they emphasized particularly that the Fund did tend to take a "one-size-fits-all" approach to policy. Among the particular concerns raised were the following.

[48]The relevant part of Article I is the following: "to facilitate . . . the development of the productive resources of all members as primary objectives of economic policy." See Appendix II.

tries and across time periods does not always hold. If this is not the case, the resulting estimations and predicted crisis probabilities may of course be misleading. For example, macroeconomic external and internal imbalances may previously have been more important, whereas variables capturing a country's vulnerability toward sudden capital outflows have become more important in recent years.

Another problem with the EWS is that potentially important variables are missing, for example, variables capturing financial sector weaknesses and more political and institutional variables such as poor corporate governance and the general level of administrative competence. In an attempt to address the potential importance of financial sector distress, a variable capturing the occurrence of banking crises was included in the EWS analysis carried out for this report. This inclusion did indeed correctly increase the predicted crisis probability in some cases (most noteworthy, Chile in 1982 and Sweden in 1992/93), but at the cost of increasing it wrongly in other cases. More analytical work on this issue, including attempts to improve the quality and availability of data, would clearly be desirable in future Fund work on EWS.

A possible explanation for the quite low ability to predict the timing of a crisis may also be the presence of self-fulfilling attacks as a consequence of the existence of multiple equilibria for certain ranges of fundamentals. It is clear that if this is the case, EWS can only give an indication of a country's potential vulnerability to an attack. Related to this issue, the likely presence of international contagion has so far largely been ignored in the EWS literature, which has primarily focused on country-specific indicators. It would be useful to focus more on this issue in future work.

EWS would obviously be helpful in surveillance if they could improve crisis projections as compared with the informed predictions by staff members. However, even if the EWS were neither systematically better nor worse than normal staff predictions, their objective nature could still make them a valuable contribution to surveillance. Our recommendations on this score are discussed in the text of Chapter V.

Some obvious objections to the likely success of implementing EWS, however, seem worth mentioning. First, the existence of a successful early warning system is almost a contradiction in terms, since corrective policy changes following an early warning signal might prevent the crisis and thus prove the original crisis prediction wrong. On the other hand, the publication of results from an early warning system might prove to be self-fulfilling if international investors were to use them as focal points of speculative attacks. Finally, if it is assumed that financial markets are efficient, a natural question seems to be why the private sector has not already acquired the knowledge assumed present in the EWS.

There is understandable concern, not least in the Board, that the current high number of both Type I and Type II errors could damage both countries' and the Fund's credibility if they were to be published. However, it is clear that the private sector will—and already does—provide this type of analysis. We see no reason why the Fund should not present the data it uses internally to evaluate vulnerabilities in WEO and ICMR, in the form of tables and graphs, without necessarily offering written analysis or conclusions.

- There was some concern that too much time was devoted to data issues rather than policy advice. (On the other hand, some staff members felt that this data work was, simply put, an essential prerequisite for any sensible discussions of policy issues.)
- Often it was necessary to educate the staff in the particular needs of small states—such issues as why social services tend to be expensive in archipelagos, or the difficulties in introducing a VAT in countries that do not have the requisite administrative capacities.
- Some representatives of small states thought that the Fund was excessively enthusiastic about exchange rate depreciation, failing in particular to appreciate sufficiently all the implications of a devaluation in a very small open economy.
- On fiscal issues, representatives expressed the view that general statements like "strong fiscal action is needed" were not very useful, since they required specific suggestions on tax issues and where cuts could be made. (Such states can of course receive technical assistance in the fiscal area. How well this assistance links up with the regular consultations we are not in a position to judge.)

Multilateral Surveillance

47. The Fund's published work on multilateral surveillance is widely recognized as being of high quality. We learned of many instances where the WEO was a basic source document and building block for officials engaged in monitoring and forecasting international developments. The ICMR was also highly rated, though clearly less widely known and used. While it appealed to a narrower audience than the WEO, it was particularly appreciated by those interested and/or involved in assessing international financial developments as bringing more analytical substance to the review of issues than is typically

found in other coverage available. The same seems true for WEO as well, although it has more direct competition from other public and private publications than does the ICMR.

48. At the same time, there is no doubt that the major errors in forecasts that marked, in particular, the Fund's assessment of output trends in 1998 have diminished the reputation of the multilateral publications. As shown in recent Fund documents evaluating the Fund's programs in the Asian countries most strongly affected by the financial crisis, the forecasts went from a sharp slowdown in the growth rate of output in five Asian countries to about 2 percent (forecast in late 1997) to more recent estimates, suggesting a decline in their aggregate 1998 output of 8 percent. The prospects for recovery in Japan in 1997 and 1998 were also evaluated far too optimistically. The magnitude of the reversal of short-term capital flows, obviously the most difficult element to assess in the macroeconomic outlook, was severely underestimated in a number of cases. Admittedly, these errors were only slightly larger than those of the so-called consensus. Nevertheless, it was put to us that the Fund, with its close contact with policymakers, privileged access to information, and substantial resources, must expect to live up to a higher standard than other forecasters.

49. We are aware that it may be unfair to attribute blame for the somewhat unsatisfactory state of the forecasting record of WEO—already documented in Artis (1996)[49]—only to the Research Department (RES), which is ostensibly responsible for its publication.[50] Global forecasting in the Fund is built up from the country analysis supplied by the area departments—that is to say, it is more "bottom up" than "top down." We were told of major disagreements in a number of cases in recent years, as well as earlier in the 1990s (when recessions in Japan and Germany were seriously underestimated) between area departments and the Research Department, which management seems to have resolved largely in favor of the former—with the consequence of worsening the forecast record further.[51]

50. Moving beyond forecasts, we also examined the Fund's multilateral surveillance, both published and unpublished, in the run-up to the Asian crisis. We found that the Fund—in both bilateral and multilateral surveillance—largely failed to identify the vulnerabilities of the countries that subsequently found themselves at the center of the Asian financial crisis, except in the case of Thailand. In particular, it failed until rather late in the day to address a number of systemic issues. Moreover, to the extent that surveillance did identify these vulnerabilities, the tone of published Fund documents—notably WEO—was excessively bland prior to the December 1997 update of WEO/ICMR, after the crisis had erupted.

51. WEO eventually did express concern over financial vulnerabilities in emerging market countries. But this was done in language that was not sufficiently clear to raise the attention level in the countries concerned or in the Executive Board. More pointed analysis was contained in unpublished material, especially on Korea, where the analysis of the Research Department was more hard-hitting than that of the area department. But this analysis, which was unpublished (and indeed not communicated to the Board) did not lead to a sharpening of country surveillance. We offer a more detailed assessment in Box 3.2

52. Mention must also be made here of the concept of equilibrium exchange rates. The Fund is charged above all with "exercising firm surveillance over the exchange-rate policies of members."[52] This puts a premium on using the best possible methods for assessing departures from sustainable exchange rates. Within the Fund, work in this area takes place primarily through the Coordinating Group on Exchange Rates (CGER), a working group established in 1995 by PDR and RES. Recent work by the CGER has been presented in an Occasional Paper[53] and some use is made of the analysis in bilateral surveillance of the major industrial countries, in WEO, and in the Economic Counsellor's presentations to the WEMD sessions (for a discussion of these sessions, see below).[54]

53. It is notable that while this work is both central to the Fund's mandate, and of high analytical quality, relatively little is published. Some observers suggested that regular publication of Fund estimates of equilibrium exchange rates would be useful to both policymakers and market participants.

54. Although much less known than WEO and the ICMR, the WEMD sessions also constitute an

[49]Michael T. Artis, "How Accurate Are the IMF's Short-Term Forecasts? Another Examination of the World Economic Outlook," IMF Working Paper 96/89 (Washington: IMF, 1996).

[50]It may be worth bearing in mind also that WEO and the ICMR are not, formally, documents of the Board, but rather of the staff. The Board reviews them but does not release them in its name; the May 1999 WEO includes for the first time a summing up of the two Board discussions of a draft.

[51]Although, equally, it was also pointed out to us that on a number of occasions the judgment of area departments had been more accurate than that of the Research Department.

[52]Article IV, section 3, reproduced in Appendix II.

[53]Peter Isard and Hamid Faruqee, eds., *Exchange Rate Assessment*, IMF Occasional Paper No. 167 (IMF: Washington, 1998).

[54]A different method for the modeling of real exchange rates has also recently been developed by Fund economists, with promising results for some developing countries. Ronald MacDonald, "What Determines Real Exchange Rates? The Long and the Short of It," IMF Working Paper 97/21 (IMF: Washington, 1997).

Box 3.2. Surveillance, Capital Flows, and Financial Crises

We looked at how Fund multilateral surveillance, especially as expressed through the Fund's two main publications, the *World Economic Outlook* (WEO) and the *International Capital Markets* report (ICMR), dealt with the issue of capital flows and financial crises since 1993; and at bilateral surveillance of Korea in the same period. Three main impressions emerge: the first two suggest an underestimation of the risks involved, while the third makes it difficult to avoid the conclusion that the risk of contagion was barely perceived prior to the crisis.

First, there was generally a positive evaluation of the sustainability of sizable inflows to emerging markets. Net capital inflows were projected to remain at high levels or even to increase. This evaluation was linked to the general euphoria surrounding growth prospects in emerging markets. International capital markets were perceived as well-functioning with the risk of reversals largely linked to the occurrence of excessively expansionary policies resulting in domestic overheating and external imbalances. Despite the Mexican experience, an optimistic perspective on the beneficial effects of capital inflows soon reemerged.

Second, when doubts about the sustainability of capital flows were voiced—more frequently in the ICMR than in the WEO—they did not put much emphasis on weakening financial systems in the capital-importing countries during the process of simultaneous liberalization of the domestic financial sector and of capital flows (both with the strong encouragement of the Fund).[1] As a corollary of this relative lack of priority to financial fragility, the interrelationships of the latter and balance of payments crises did not figure prominently in policy advice, particularly in the early period. This is surprising, since economists at the Fund have contributed significantly to the development of analytical insight into the area of the "twin crises."

Third, the importance of potential regional and international contagion of currency crises was given very little attention prior to the crisis, even in internal analyses. For example, after a mission from the Capital Markets group visited Asia in April 1997, an incisive memo to management warned accurately of the dangers of crises in Thailand and Korea, resulting, respectively, from an attack on the currency and from deepening problems in the banking sector. However, the same memo explicitly dismissed the risk of regional contagion. Indeed, even in late August 1997, well after the floating of the baht, a(broadly upbeat(memorandum to the Board on the risks of contagion in Asia did not even mention Korea.

[1]While the May 1997 WEO—by which time the Thai baht was already under severe exchange market pressure—did identify banking system fragility as a general concern, the discussion of Asian countries was generally quite sanguine.

The overall impression of Fund multilateral surveillance as expressed through the WEO and the ICMR is that while these documents did make a number of pertinent observations on capital flows and financial crises that are helpful in understanding subsequent developments in Asia and elsewhere, the risks were not forcefully presented. Nor did the documents draw the appropriate conclusions and present them in pointed, country-specific policy advice.[2]

Inadequate as the attention to risks appears to have been in multilateral surveillance, the evaluation of crisis signals was—with the benefit of hindsight—further divorced from reality in some cases of bilateral surveillance. We have looked at Korea as a prime case study.

In bilateral surveillance of Korea, the potential dangers of a rapid process of capital account and domestic financial liberalization were not properly assessed. In particular, little attention was paid to the vulnerability of Korean banks to a potential weakening of the won. Furthermore, it was only in early 1997 that critical views were first expressed as to the credibility of official estimates of nonperforming loans. More generally, overoptimistic forecasts of output growth in Korea—even in September 1997, the staff's judgment was that the authorities would weather the gathering storm and that a worst-case scenario was a deceleration of output growth to 4 percent for the year—delayed a realistic evaluation of financial weakness.

As regards exchange rate policies, Fund recommendations advocated a more flexible regime, clearly on the assumption that the currency would appreciate under the pressure of continuing sizable net inflows. This analysis was based strictly on traditional macroeconomic fundamentals without reference to microeconomic weaknesses in the financial and corporate sectors—even though such weaknesses had been identified by the capital markets mission referred to above.

Accordingly, almost up to the outbreak of crisis in November 1997, a low probability was attached to the occurrence of an external crisis. The real effective exchange rate measures did not show signs of overvaluation, the current account deficit had narrowed, available external debt indicators were not alarming, and remaining capital controls prevented foreigners from shorting the won. The recognition that domestic events, notably a banking crisis, could trigger pressures on the exchange rate, was not totally absent, but it was certainly not given much weight.

[2]In our interviews, staff suggested that such warnings were in fact present and indeed couched in language that was quite strong, in Fund terms. However, one well-informed and disinterested observer was of the view that the basic drafting strategy was to say as little about risks as possible, while at the same time still being able to claim, if the risks did become reality, that they had been addressed.

important element within the process of multilateral surveillance. In these sessions, Executive Board members, selected staff members, and management engage in relatively open and informal discussions of issues. These can range from the most recent developments in the international monetary system to an assessment of vulnerabilities in different countries around the world. Many participants have rated these informal meetings among the most interesting and important of Board meetings, and those eligible to attend are keen to do so.

55. Unfortunately, since the main goal of these sessions is to generate open and free discussions among participants, neither the background documents nor the thrust of the discussions are known much beyond the meeting room—except to the extent that they are relayed back to the home countries. We assume that these discussions do exert some influence upon what happens on other occasions in the institution, at least by ensuring that Executive Directors are well informed about the latest relevant developments.

56. The Fund is also charged with preparing background material for the Ministerial and Deputies' G-7 meetings. These notes are not openly distributed but they do receive attention at a high level prior to G-7 meetings. The Fund devotes considerable attention to this material, and some participants consider it one of the more important Fund instruments of multilateral surveillance. However, the material serves as useful background to the G-7 meetings rather than as a policy agenda.

Other Sources of Surveillance

57. There are a number of other organizations whose functions overlap with the Fund's surveillance role, although not all of them describe their functions as surveillance (in addition to regional surveillance institutions, which were discussed in an earlier chapter). We should first note that with just a few exceptions, there was a consensus among our interlocutors that, in the macroeconomic sphere, Fund surveillance taken as a whole, both published and unpublished (essentially Article IV consultation reports), compared favorably in terms of quality, focus, and coverage.

58. The "country examinations" of the OECD, representing presently 29 countries (overwhelmingly advanced economies), is perhaps the closest analogue to the Article IV process, and this was the organization to which the Fund was most often compared by interviewees. The OECD staff produces "country reports" (on a roughly biennial cycle) on each of its members, which are then discussed by country representatives. The key differences from the Article IV process are the following.

- The reports focus more on structural issues and less on macroeconomic conditions. As a consequence, they are rather longer and more detailed.
- The examination takes the form of an discussion, in which high officials from one or two other countries, on the basis of the country report, examine (candidly) the country's policies; the country representatives then present a defense.
- The country report is published, with the consent and after negotiation in a drafting session with the authorities of the country concerned. However, the record of the discussion is not published.

59. The OECD also has a multilateral surveillance role: it produces a semiannual Economic Outlook, which covers some similar ground to the WEO, and it hosts Working Party 3, at which senior officials from member countries discuss current global economic developments in quarterly sessions. Given the level of representation, this forum, in the view of experienced officials, tends to generate more interesting and lively exchanges than are possible in the Executive Board. No report on those discussions is issued.

60. In some of the larger countries, the OECD (which, as just noted, publishes its regular country reports and also issues a press release alongside) has been generally more in the public eye, while the IMF has had a lower profile. Most of those who spoke to these matters thought that both the Fund and the OECD did a good job in their respective surveillance processes, and that these processes were at least in part complementary. While most considered that the Fund's output was more useful overall, as noted earlier there was general agreement that the OECD did a better job in analyzing structural issues.

61. The World Bank, in countries where it is a major lender, occasionally produces a "Country Economic Memorandum," which gives a comprehensive overview—both macroeconomic and structural—of the country's economic situation. The World Bank also produces "Country Assistance Strategies" for borrowing countries. While these are not specifically designed as instruments of macroeconomic surveillance, lending operations clearly need to be seen in the context of the general macroeconomic situation. This is particularly the case for "structural adjustment" lending, which has become an increasingly important part of the Bank's operations in recent years. However, the general feeling was that it did not really engage in surveillance as such, at least not in the way practiced by the Fund, or by the OECD for that matter. Its focus appeared to our interlocutors to be much more on sectoral issues.

62. The BIS has a largely informal, but increasingly important, role in financial sector surveillance. As well as keeping an eye on industrial country situations, it monitors emerging markets and coordinates a network in developed countries of central bank economists who share information about developing countries. This process provides input to meetings of central bank governors hosted by the BIS—in particular when BIS management feels that a country presents a potential problem. The BIS will also provide the secretariat for the new Financial Stability Forum, which will effectively formalize these arrangements and also involve nonbank regulators (securities markets, accounting standards), as well as other international financial institutions, including the Fund. It also provides technical assistance, and is expanding its activities through a new Financial Stability Institute and a Hong Kong office.

63. In the private sector, rating agencies (and to a lesser extent investment banks) perform a surveillance function for the benefit of private investors. The methodology used by rating agencies is not dissimilar to that of the Fund, involving analysis of much the same data and a country visit to talk to the authorities. As a result, reports produced by rating agencies often cover similar ground to that of an Article IV consultation, albeit usually in less depth. The Institute of International Finance (IIF), an association of financial institutions, produces “Country Reports” that are closer both in form and function to Article IV staff reports.

64. The main difference is that private sector institutions generally take a much narrower view, guided by the changing thrust of market interest. Rating agencies, for instance, are concerned above all with the issue of whether a country would be able to service its debts, not with the general quality of its overall macroeconomic policies. This point was also emphasized to us by the rating agencies themselves, who made it very clear that they did not regard themselves in any sense as substitutes for the Fund.

65. However, it is also apparent that private sector institutions do a more explicit job of the assessment of risks, including political risks. While it is quite rare for the Fund explicitly to examine vulnerabilities, or to look at adverse-case scenarios, private agencies regard this as fundamental. More than one observer expressed the belief that the private sector was able to produce more up-to-date and precise information than the Fund for countries that have the market’s attention, with the added advantage of not having to be as polite to governments. At the same time, it was also noted by some that information put out by private financial institutions was in principle less trustworthy, inasmuch as it could reflect the financial interest of the institution. This would not, of course, be true of the IIF, which does surveillance work for private financial institutions in general. Its surveys were thought to be more narrowly focused than those of the Fund, and in any event, they do not have the same country coverage. Those who saw both the IIF country studies and the Fund staff reports considered that the IIF material was far from being a substitute for that of the Fund.

IV Impact

1. This chapter deals with the "bottom line," namely, did Fund advice make a difference? The questions posed by the Board that are most directly relevant here are:[55]

(iv) Did surveillance have different impacts in different groups of countries?

(viii) Was the Fund's advice implemented? If not, why?

(vi) How successful have been the specific efforts made since early 1995 to strengthen surveillance? What effect have these efforts had in the context of the difficulties emerging in some Asian countries in 1997?

2. Other questions also have an "impact" aspect—in particular, those that focus on communication and publicity, namely:

(vi) . . . How has the provision of information by the authorities affected surveillance?

(ix) . . . How useful were the methods to make surveillance available to the public? Should the Fund go further in publishing country reports?

(x) How did governments disseminate surveillance conclusions within and among government institutions? Was the circle of participants limited to economic agencies?

3. First we review the extent to which the impact does in fact vary by country groupings (question iv). We then move on to a discussion of the general considerations that stand out for the broad range of "middle" countries. This is followed by more detailed discussion of four instances in which financial and economic vulnerabilities became particularly apparent. There we focus on the advice given and the impact that the Fund had as developments unfolded. We then describe the results of the Fund's own internal efforts to improve surveillance since 1995. Finally, since they are so closely bound up with impact questions, we discuss matters of communication and transparency. This latter discussion covers the experience with Public Information Notices (PINs) since their start in 1997, as well as the broader questions related to dissemination of Fund surveillance material in general, and in particular the Article IV consultation reports. In the final part of this chapter, we discuss practices and views related to another aspect of communication of Fund views—that within government itself.

Impact by Country Groupings

4. Our review of country impact did not turn up surprising or anomalous results in terms of differences. Most members fell "in the middle." That is to say, for most members the impact of surveillance appeared to be sensitive not so much to the type of country but rather to more general factors.

5. However, size and sophistication always matter. And as was to be expected in the sample of countries on which we focused our interviews, Japan and the United States stood out in terms of the extent to which surveillance was seen as a low-impact exercise. Our nonsample discussions on country experiences also confirmed this. That being said, we were assured that in the largest industrial countries surveillance through Fund missions, etc., was taken seriously. Although a great deal was not expected from the consultations, U.S. officials in particular considered it especially important to "set a good example" in the way they entered into them—something also attested by the staff. However, for the large industrial countries, in no case would it be right to claim that the Fund had more than a marginal or occasional impact on national policy decision making, even in a case such as that of Japan, where economic and financial difficulties have been particularly pronounced. At the same time, some Japanese observers also made the interesting point that their bilateral consultations did "fill a gap." The Fund approach provided a blend of theoretical and practical analysis of issues that was dif-

[55]Numbers in parentheses indicate the number assigned to the question in the original Executive Board request. See the Terms of Reference in Appendix I.

ficult to replicate from Japanese sources such as academics (very theoretical) and private think tanks (focusing on business-cycle analysis). That being said, the general view in the public and private sectors in both Japan and the United States was that the issues on which the Fund was capable of pronouncing would receive such wide and intense discussion within the country that it would be surprising if the staff were able to add very much to what was already on the table, beyond an international voice—however hard they tried. At the same time, our official informants were virtually unanimous that it was always interesting to hear what the staff had to say and that it was worthwhile in terms of their own thinking to have to respond to the staff's informed probing.

6. Another aspect was that even in relation to *international* surveillance, let alone compared with the crucial and ever-present forces of *domestic* debate, the Fund was far from paramount. Some bilateral relationships were extremely important, and probably more so than the peer group influences, or even pressures, coming out of the G-7 process for example. Furthermore, the impact of the G-7 process was also greater than that of Fund surveillance. In this latter regard, however, mention was made of the usefulness of the Fund's input into the meetings of G-7 finance ministers and governors as providing background for discussion of macroeconomic issues, and even for "clearing some issues off the table." In Europe, the influence of the convergence process toward EMU had apparently dominated other external surveillance influences for all relevant Fund members.

7. The other countries in our sample were economically varied. However, the Fund's impact, although on balance apparently greater than in the very large countries, did not seem to vary in any very systematic way. The general tendency was to see Fund advice as an input that could on occasion be significant, depending upon the stage of the domestic policy debate.

8. There could well be from time to time an impact from new ideas or ways of looking at an issue brought by the Fund. One example is the advice that the Czech (then Czechoslovak) authorities received from the Fund in the early 1990s in setting up monetary and exchange rate policy. Another, already referred to in Chapter III and which has applied to a number of countries, is the Fund's work in sorting out the proper analysis of central bank operating losses—"quasi-fiscal deficits."

9. More mundanely, it was quite common for the Fund's views to be absorbed not as a revelation, as a new way of looking at an issue, but rather as support for a particular approach to policy that was already being advocated internally. In cases like this, the impact tended to be gradual, resulting from the continued reiteration of the same basic message over a longer period, and the building, perhaps, of a policy consensus. Furthermore, it was often the case that some policymakers were inclined to find the Fund's recipes more attractive than other policymakers within the same country—depending on which corner of the government policymaking apparatus they were located. As suggested earlier, central banks tended to find the Fund advice particularly congenial, given the emphasis on financial stability and the avoidance of fiscal excess. More broadly than this, a point made in South America was that as views on desirable policy on that continent shifted from earlier dirigiste, autarkic, approaches to more market-based, open-economy principles—an intellectual shift to which the Fund may have contributed—this helped to promote the acceptability of Fund advice. Domestic policymakers and the staff had more common ground on which to base their dialogue. At the same time, it was also noted that the level of economic policy sophistication had probably risen more rapidly over time in South American countries than it had in the Fund. This "catching up" would, naturally enough, tend to lessen the impact of Fund advice. Such a tendency, which in itself is by no means a bad thing, was also apparent elsewhere, although not as clearly identifiable as in South America.

10. Beyond the sample countries, and as already referred to in the previous chapter, we held special discussions with a group of small states. There, the surveillance impact, including a heavy dose of technical assistance (something also apparent, if to a lesser degree, in middle-ranking countries), was obviously large. Fund visits were a major event that involved virtually the entire economic policymaking apparatus. However, questions remained as to whether surveillance was being delivered as well as it could be, particularly with the turnover of staff. This was particularly apparent given the lengthier stretches between consultations and the fact that such surveillance is probably viewed as less high profile and less challenging by Fund staff.

Other Elements Shaping Impact

11. The methods and substance of advice have been dealt with specifically in Chapters II and III. Here, the focus is on what can be added to that discussion from the viewpoint of impact.

12. But before that, one general point. In quite a few instances it was volunteered, with emphasis, that Fund advice carried more weight when it was attached to a financial program. This itself is virtually a truism. However, we note that the implicit corollary is that Fund advice (as opposed to that of other institutions that do not lend) may carry some addi-

tional impact because it is an institution that *might* be called upon to extend financing. Furthermore, the focus in our remit on advice free of financing and conditionality[56] may well become less clear-cut still when the Contingent Credit Line becomes operational. Given our terms of reference, in our exchanges we did not dwell directly on these somewhat hypothetical considerations, and neither for the most part did our interviewees. However, we do review the implications of the Contingent Credit Line in Chapter V.

13. Reverting to *current* Fund practice, we present below our listing of the general features that appear to enhance or detract from the impact of Fund advice, other than any matters relating to communication and publicity. These are dealt with separately below.

14. Since these main features will already have been largely dealt with in the previous chapters on conduct and method and on substance, we aim to be relatively brief.

- In terms of general Fund approach, the most salient point was the value of conveying the ability to see the issues from the country's viewpoint. Put another way, quite often missions were seen as coming with a preconceived framework. However, the impact of advice was clearly enhanced when missions were able, without compromising the general principles of financial prudence on which Fund advice is based, to adapt the advice to the particular situation. In this regard, members placed great stock on a mission's ability not only to give good and/or creative policy advice but also to come up with concrete suggestions as to how it might best be implemented, recognizing the particular challenges the country faced. This was particularly true of small states. Here, the Fund's surveillance role overlaps with its technical assistance function. The functional departments (in particular Monetary and Exchange Affairs and Fiscal Affairs) clearly have particularly relevant roles to play in this regard.
- Obviously, the capacity to accomplish this comes in part with experience, as well as from having specialized resources. In that regard some concern was expressed that many Fund economists had limited experience outside the Fund. The feedback we received was that they were good macroeconomists, especially good at theory, but often lacked the additional credibility from experience in practical policy-making—at least from the country side—or in implementation.
- Staff turnover from one mission to another, already mentioned as a clear problem for small states, was seen more generally as something of a difficulty. Correspondingly, it seemed to a number of our interviewees that the institutional memory was quite limited. This meant that more country time was spent getting members of a mission up to speed than would be desirable, and consequently that there would be less of an impact on policy.
- In terms of attitude, certainly there were cases where difficulties had arisen because of what was seen as peremptoriness on the part of individual staff. However, these were, as noted earlier, very much the exception. On the other hand, as discussed in Chapter III, concern was also raised, both within the Fund, particularly from functional departments, and within countries on occasion, that missions were quite often more accommodating than was desirable if the real policy issues and vulnerabilities were to be adequately addressed.[57]
- While the Fund had begun, especially following the Mexican experience, to look at the quality of the domestic financial sector in most of the countries we examined, it did not appear that the analysis was particularly deep or sophisticated, or that it had yet had any significant impact. This may well reflect the Fund's traditional macroeconomic focus and the training of its economists as well as the fact that improving the financial sector is often a long and difficult task. At the same time, it is also evident that countries have tended to accept closer examination of their financial systems at best cautiously, sometimes probably out of concern over what an outside look might turn up.
- Questions relating to the microeconomic and structural scope of the Fund's advice have been dealt with extensively earlier. Here, however, it may be noted that the very breadth of that advice tends to dilute the impact. In part this can be because the Fund is almost invariably seen as having less competence in microeconomic and structural areas generally (where it tends to rank below the OECD and the World Bank, for example) than in macroeconomic areas. Further to this, the impact of the main macroeconomic policy messages can be directly lessened by signals emanating from

[56]"Countries [that] received no, or at most sporadic, disbursement of Fund resources."

[57]This would of course be one argument, but a second-best one, in favor of rotating Fund staff.

other areas where advice was given. In one instance, for example, while the fact that the Fund was keen on curbing the deficit was well taken, the fact that the mission stressed "poverty reduction" as well, reportedly provided a confusing message at the political level as to whether it was *really* advocating fiscal restraint. Of course, the two objectives are not contradictory, but it is easy to see how the clarity of the message can be reduced.

- Besides the potentially dilutive or contradictory effect of advice given over a broad range of matters, an important question mark arose over the extent to which country advice adequately reflects the Fund's comparative expertise. That is to say, it was clear from our interviews that missions were not at all active in bringing to the consultations an explicit view of the international (or regional) economic and financial background into which specific country policy advice might usefully be situated, thereby improving its impact. Nor did they often bring international comparative experience directly to bear, although they would seek it out if asked. However, when such advice was provided, often by functional departments, it was generally regarded as being of high quality (for example, information provided to Sweden on other countries' experience with inflation targets).

Impact in Four Countries

15. In one of the countries looked at in this section, a financial statesman made the comment that "If the objective of the Fund surveillance is to prevent crises, then it clearly failed in our case. The question is why?" Warding off crises is not the only element in surveillance, but given its emergence as a particularly important component, it merits special attention. In this light, we look here at the impact of surveillance in Brazil, the Czech Republic, Korea, and Thailand—which have all experienced a financial and economic crisis in their recent history.

16. Looking at the advice actually given in the period leading up to the crisis, three policy areas are of particular relevance: fiscal policy, exchange rate policy, and capital account liberalization.

- For all these countries, the Fund was for some time counseling fiscal consolidation to a greater or lesser degree. Even if, as some contend, it is generally too quick to advocate fiscal tightening, and even if such tightening was at best only part of the right recipe (in particular in Korea and Thailand), it is hardly conceivable in these four cases that more fiscal action along the lines of Fund recommendations would have brought on a crisis. Rather, it would have lessened the probabilities.
- On exchange rate policy, the advice was less clear-cut and more problematic. In the case of Brazil and the Czech Republic, the authorities' strong desire to maintain a pegged exchange rate did get mild Fund support over an extended period, even as the financial pressures were accumulating. In regard to Brazil, the exchange rate (the "real plan") was *the* confidence anchor, and the Fund was unwilling to argue strongly for a regime change, even though staff believed the real to be significantly overvalued.[58] For the Czech Republic, an important domestic consideration in holding the exchange rate, which the Fund went along with, was convergence with the EU. Some will argue that in these instances the Fund acquiesced too readily to exchange rate pegging. Perhaps, but where it did express consistent concern was whether domestic financial policies, again in particular fiscal policy and in the Czech case wage policy as well, were adequate to support the peg. For Korea and Thailand, the advice was clearly tilted toward increasing exchange rate flexibility. In no case (except, arguably, Brazil, where in the latter part of the period the advice came together with massive conditional financing) did the Fund positively encourage a member to hold on to the peg when it became broadly apparent that some kind of exchange rate change or exchange system change could become necessary in response to the emerging crisis.
- On the issue of capital account liberalization, however, the Fund's advice certainly did not help prevent the crisis. In particular, in Korea, it encouraged capital account liberalization with little attention to problems of appropriate sequencing implied by liberalizing short-term foreign borrowing before foreign direct investment. While the Fund would have preferred liberalization of foreign direct investment first, the tone of its advice was that the approach taken by the Koreans was better than nothing.[59] In fact, in retrospect, it was probably

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[58]Indeed, these concerns were expressed—albeit in very guarded terms—in the published Recent Economic Developments sections of the 1998 staff report (published as IMF Staff Country Report 98/24, April 1998). See in particular Chapter VII, "The Post-Real-Plan Developments of Tradables and Nontradable Prices and the External Current Account."

[59]For example, the 1996 Article IV staff report states: "The recent acceleration in the schedule for capital account liberalization and the somewhat greater precision on prospective measures are welcome."

worse than nothing, as the Fund has now recognized.[60] In Thailand, Fund advice suffered from a similar defect, albeit to a lesser extent.[61] By contrast, advice to India, which did not suffer a financial crisis, was more nuanced and gave considerably more weight to the sequencing issue—as did the Indian authorities themselves.[62]

17. However, what is more directly relevant for the purposes of this discussion is that in all these cases the authorities' determination of the policies actually pursued was apparently not affected very much by Fund advice.

18. Why did the Fund have little impact? No single factor stands out, but a number of considerations, relating to both the Fund and the recipient of advice, can be noted.

- It is contended by some in Thailand that while there was forceful advice that trouble was coming, including through visits from senior management, it did not come early[63] enough as regards the mounting difficulties in and via the banking system, that is, by 1995 or early 1996. By the time forceful advice did come, "it was too late" (although policy mistakes continued to be made until, and during, the onset of the crisis). In other cases, the advice, early or not, was not nearly as strong.
- In two instances, Korea and Thailand, the Fund collectively[64] was not focusing on the problems of financial structure—banks and bank debtors—that proved to be at the heart of the eventual confidence crisis. Nor was the Fund able to obtain from the authorities all the statistical information—on international reserves and foreign debt—that would have enabled it to make a more forceful case. This was especially important in the case of Korea, where the fiscal and current account deficits, the usual vulnerability signals, were both relatively modest.
- In some of these instances (something that also can probably be generalized across Fund membership), the authorities were apparently not very sure themselves what the actual banking cum external indebtedness situation actually was. They also likely lacked the mechanisms to find out, to the extent that they in fact wanted to. And they did not accede readily to the Fund taking a look—even late in the day.
- In no case does the Fund appear to have come close to going public with its advice, although to do so would surely have increased its impact substantially. Indeed, in three of the four cases, Brazil being the exception, communication of Fund advice, even *within* government, was not good. However, few of those we spoke to—either in the countries concerned or in the Fund—suggested that the Fund should have gone public (although in the case of Thailand interviewees did allow that going public could hardly have made things worse).
- In all these cases there was an exchange rate peg, and that peg had political importance. So even if the Fund had advocated a change more forcefully, it might not have had an effect.
- Finally and emphatically, the political situation was either difficult or delicate throughout the relevant period in all four cases. And exchange rate policy, in particular, was a highly political issue. Political difficulties are of course likely to lead to policy inertia, whatever the advice received, and however skillfully or forcefully it is presented.

19. To summarize, what was common to these situations, and what might therefore be reasonably

[60]See, for example, Stanley Fischer, First Deputy Managing Director, "Economic Crises and the Financial Sector," speech to the Conference on Deposit Insurance, Washington, September 10, 1998: "Although country circumstances differ, the general advice on international financial sector liberalization is first to open to longer-term investment, particularly foreign direct investment, and only to open at the short end when the necessary preconditions, in the form of macroeconomic stability and a strong banking and financial system, are in place. This was not the path chosen in Korea and Thailand."

[61]The 1996 staff report argued that "particular progress [in structural reform] has been made in the financial sector; the mission believes that consideration could now be given to relaxing restrictions on foreign equity participation in the domestic capital market." While this might indeed have been helpful, the report failed to caution on the dangers associated with the then prevailing system, which tended to encourage short-term foreign borrowing.

[62]It is interesting to note in this regard that while the important "Report of the Committee on Capital Account Convertibility" issued by the Reserve Bank of India in May 1997 put major emphasis on the importance of the proper preconditions and sequencing for capital account liberalization, its message has not, according to one of the authors of the report, been properly interpreted. Rather than, as the report proposed, getting on with establishing the necessary preconditions and lining up the appropriate sequencing so as to be able to progress with capital account liberalization, the policy lesson many have drawn has been rather that liberalization itself is a poor idea.

[63]Of course, whether advice given earlier would have been taken is quite another question. Quite possibly it would not have been, but that does not contradict the basic point that early warning is better than late.

[64]By "collectively" we mean in terms of advice actually given by the staff to the member. *Within* the Fund there were different levels of awareness of the precariousness of the domestic financial situation—especially in regard to Korea. Another consideration is that while the Mexican crisis of 1994–95 had been in part a consequence of a weak banking system, this aspect of financial vulnerability had not been fully absorbed across Fund area departments.

viewed as the "explanation" of the lack of impact, was a politically important exchange rate peg; domestic political difficulties or uncertainty; and Fund advice that was not, in the event, forceful or early.

Internal Reviews

20. The preceding section puts into relief one of the specific questions posed to us, namely, "how successful have been the specific efforts since early 1995 to strengthen surveillance?" With that in mind, we examined the Fund's main internal reviews since then, and looked at the extent to which their recommendations had been implemented.

21. The review in 1995 was dominated by the experience of the 1994–95 Mexican crisis and its spillovers. It highlighted the need for members to provide timely and accurate official data, and specific initiatives were agreed upon to improve statistical reporting. It was also agreed that the Fund should be more aggressive in pursuing surveillance—in particular with more continuity and follow-up, cross-checking official data against market information, and generally being more pointed in its analysis. The need to take a much more explicit account of capital flows was recognized, as was also, although less emphatically at that point, the need for greater attention to domestic banking soundness.

22. From early 1995 to mid-1997 the world economy experienced a relatively crisis-free period on the financial front, and the biennial review conducted in early 1997 reflected this. The main concrete result of that review was the introduction of PINs. The staff document discussing surveillance that provided background for the 1997 Board review did note, rather circumspectly but not inappropriately given what transpired later in the year, "that progress has been made; that some pitfalls remain;[65] and that further efforts are needed." However, the summing up of the Board discussion was much more positive, in that it was recorded that "Directors observed that steady progress had been made, not least in our ability to detect emerging financial tensions at an early stage." The final report on the review process, in the spring of 1997 to the Interim Committee, noted that "current surveillance procedures have generally worked well."

23. Clearly, the events of the past two years showed that this equanimity was not warranted.

24. On the evidence to date, the answer to the Board's specific question has to be negative. As illustrated in earlier chapters, and particularly in the section immediately preceding this one, there has remained a significant gap between the Fund's general efforts to strengthen its surveillance procedures, especially in regard to vulnerabilities, and satisfactory operating results.

25. This gap was underlined by the Fund's special, post-Asian crisis, review of surveillance that was undertaken in the spring of 1998.[66] From this review, less extensive but more country-intensive than earlier ones, the Board drew five lessons: (1) the importance of timely availability of accurate information; (2) more attention to banking system and capital account issues; (3) greater attention in bilateral surveillance to policy interdependence and the risks of contagion; (4) the importance of transparency in improving policy credibility and restoring market confidence; and (5) the fact that Fund surveillance will only be effective if members take the advice.

26. The first two items on this list are reiterations of, and to that extent serve to reemphasize, themes in previous reviews. The third, highlighting policy interdependence and contagion, is a new emphasis, and something we address in our conclusions. The fourth, focusing on transparency, also remains an issue, and one that we will also be taking up below and in our conclusions. The fifth, noting that members needed to be willing to take the advice, is an issue that we have confirmed, particularly in our examination of four countries that went into crisis. As we pointed out there, the reasons why the Fund had less impact than might have been hoped depend as much on the country as they do on the Fund, with political factors being prominent.

Transparency, Publicity, Communication

27. This set of issues has attracted great attention within and outside the Fund. In particular, the team was aware that the Group of 22 (G-22) Report on

[65]In this regard, particular note should be taken, especially given the eruption of the Asian crisis a few months later, of the cautionary observation in paragraph 71 of that document: "While substantial attention has been paid to financial sector issues in surveillance, the coverage of these issues in Article IV consultations appeared in most cases to have been backward looking. Moreover, it is difficult to infer from the language the extent of the risks seen by the staff. In part, this hesitation may reflect the fact that the extent of banking problems often emerges only with a delay together with practical limitations on the ability of the Fund to attempt to identify banking problems in advance." More generally, the staff review also cautioned in the same piece that "the absence of major crises with systemic effects does not provide evidence that Fund surveillance has become more effective. Such welcome developments may reflect good management by countries unrelated to Fund activities, good luck, or other factors."

[66]The conclusions of the review are summarized in the 1998 IMF *Annual Report*, pp. 34–38.

Transparency and Accountability, including a chapter on transparency and accountability of international financial institutions, had been released in early October, soon after it started work. That report made the case for having "international financial institutions adopt a presumption in favor of the release of information, except where release might compromise a well-defined need for confidentiality." Against this background, the team raised transparency issues on many occasions, with particular focus on the pros and cons of publication of Article IV consultation reports and, linked to this, on experience with PINs.

28. By way of further background, the team did meet with individuals who had participated in the G-22 exercise. We were particularly interested in learning of any progress in the transparency working group in specifying what constituted "a well-defined need for confidentiality." We were informed that, unfortunately, no real progress had been made. This was essentially because no agreement in principle could be reached on whether to publish the Article IV consultation reports themselves. In those circumstances, discussion of what might constitute appropriate confidentiality would have been academic.

29. The team's interviews covered both the matter of report publication and how one might go about spelling out "appropriate confidentiality." These will be reported on below. However, before that, it is useful to discuss the experience with PINs.

Experience with PINs

30. Most countries in our sample have authorized PINs. Among officials, the consensus was that the introduction had gone quite smoothly, at least in the sense that the PIN release had not made a splash but had made news in a more sober fashion. Indeed, in a number of instances the news had apparently been so low key that a number of the people interviewed in the private sector, while quite knowledgeable about the Fund, could not recall PIN-based reports in the media. In any event, the consensus was that release had been constructive in helping to inform and demystify, and ripples were probably better than waves. As one official observer in Asia put it, it was just as well for the PIN not to be "sensational," even if this meant that the impact was not as great as it might have been.

31. This being said, there were reservations on language and substance, although it must be emphasized that these were far from being from the same direction.

32. A worry that went to the very heart of the concept of the PIN as a vehicle for communication was over the extent to which the PIN might be abused by the media rather than merely used. This was expressed by a minority, vehemently, and seemed to relate essentially to the media's continual search for material that could embarrass a government or at least make people sit up. PINs have indeed occasionally given rise to embarrassment. In one case the authorities suggested that they might discontinue PINs—the first had gone well, but the second had given rise to headlines emphasizing, or perhaps *over*emphasizing, Fund criticism. At the same time, it should be pointed out that the country's economic and financial situation was more challenging by the time the second PIN came around, in 1998, than it was the first time.

33. In any event, PINs are evidently drafted very carefully. Indeed it is apparent that the authors take great pains to avoid loose, exploitable, words or phrases—above and beyond the question of the deletion of "highly market-sensitive" material that is a Fund Board precondition for their being authorized in the first place. However, this has led to a concern that points in the opposite direction from the criticism just mentioned. That is to say, a common complaint was that the language then became so bland, so "unplain," that it failed to communicate well—which, after all, is the ostensible purpose of the exercise.[67] No one would mistake the PIN for a press release, even if its original name was *press* information notice. As one experienced businessperson in Latin America put it when shown a PIN for his country, "the language is very much like that of auditors—precise, but not easy to pierce if you are not familiar with it."

34. In terms of substance, we should underline that the revisions to the summing up of the Board discussion that are made before a PIN is issued have on occasion—and contrary to the spirit of the PIN exercise—gone beyond the exclusion of market-sensitive information. Deletions have also included material that was thought to be politically embarrassing by national authorities. We know that the staff and the Board are conscious of this weakness, including the possibility that the summing up may itself be watered down ex ante to avoid having such changes pressed when the summary is sent to the Executive Director concerned.

35. Two Board reviews of PINs have taken place since their inception, and it is apparent that after the first review there was a noticeable drop in the number of deletions. However, to what extent this drop represents greater restraint on the part of Directors

[67]By way of example, fairly randomly chosen, the reader is invited to peruse the following PIN sentence for the main message: "[Directors] stressed, however, that fiscal consolidation at both provincial and federal levels had been reflected in substantial efforts to contain the growth in outlays for medical services and to improve the efficiency of the health care system, but they were doubtful that that approach could be relied upon to contain the increases in health care costs that were likely in the future."

or more concern on the part of the staff to avoid provoking changes is not clear to the team. Evidently, while the PIN represents progress in explaining Fund surveillance, it is still work in progress both in terms of its own definition of what it aims to be and in terms of enhancing Fund transparency.

36. Anticipating the discussion of Article IV consultation reports that follows, it is also worth recalling here that a number of countries release the staff statement that is given to the national authorities at the conclusion of an Article IV mission.

37. This is at the least curious. The concluding statement represents, first, only the staff's view, and second, its view before it leaves the country and actually writes the consultation report that will be considered by the Board. That report is the more complete and considered view of staff. It has the imprimatur of management. And the consultation is not in principle concluded until the Board has considered that report and said whatever it has to say. Then, of course, a PIN may be issued on the basis of the summing up of the Board discussion. In fact, virtually without exception, the countries that have released the concluding statement have also authorized PINs. Any possible contrast between those statements and what is said in the corresponding PINs has not been an issue to date.

38. When queried on this situation, country representatives (including here Board members) allowed that it was at the least untidy, but in the words of one, "at this stage, more transparency, more publication, is better than less." Others, whose authorities had not released the concluding statement but had issued a PIN, were concerned at the evident breakdown in orderly procedures and the consequential devaluation of the Board discussion.

39. As a final comment, it may be that for publication "hawks," issuing a concluding statement has the advantage that its language does tend to be more direct than that typical of a PIN and to that extent communicates better. It also represents a single view rather than a summary of differing views, and this would also present a better package in terms of communication process, if not necessarily in substance—that is, peer as opposed to staff surveillance.

Article IV Consultation Reports

40. Our discussions of transparency issues and what the Fund might publish focused very much on these reports—the basic document of the country consultation process. The report embodies an analysis of economic and financial developments, a discussion of policies, a discussion of staff (or the authorities') views, and the authorities' (or the staff's) reactions to them. In addition to the basic question of whether to publish or not, our search for views on what might constitute appropriate confidentiality included ascertaining whether there might be analogies outside the Fund surveillance framework per se. We begin with a general discussion of confidentiality in principle and practice, and then turn to the question of publication of the Article IV staff reports.

Confidentiality: Principles

41. We were told on quite a few occasions that if the Fund published the results of its consultations, then the quality of discussion would surely suffer. This would be even more the case if there was any attempt by the Fund to deepen the consultations through more analysis and exchange on hypothetical risks facing a country. Such hypothesizing is done rather little now, and the officials with whom we discussed this possibility were noncommittal about undertaking it—with or without the protection of confidentiality.

42. As noted already, there was almost total agreement—and not just among officials, we should emphasize—that some part of the consultations between the Fund and a member might well be kept confidential. One yardstick, in the terms of the PIN, is material that is "highly market-sensitive." This evidently refers to the exchange rate, but doubts were expressed whether it really extended beyond that, to interest rates for example. More broadly, a number of officials, and some academics, thought that there were also *politically* sensitive issues that countries were entitled to keep confidential, including in relation to a PIN—for example, impending legislative proposals. One close and experienced observer of the Fund scene thought that in any event for many countries the truly unique and valuable part of the reports was the statistical tables, given that the Fund staff puts a lot of effort into getting country statistics into internationally comparable shape in the main financial areas—fiscal, monetary, and balance of payments. Of course, statistical tables—but not forecasts—are now published in the RED, although it was not clear how many outsiders realize this. He wondered whether there was much need for the publication of Fund opinion. A number of other commentators thought that a start at least would be to publish the statistics, although it was less clear whether this injunction covered forecasts as well. Quite possibly not.

43. Some more conceptual discussion of the confidentiality question took place with central bankers. They have had to think about the basis for confidentiality quite a lot in recent years, given the thrust toward increased transparency in monetary policy decision making. One take on this issue was that confidentiality was justified to the extent that it was necessary to do the job mandated for the institution by the legislature. Arguing for confidentiality in those terms implies being very clear on what are the

objectives of the Fund's surveillance mandate. Another view, in another country, was that transparency was particularly important in describing the considerations that lay behind specific policy decisions. However, it was not considered at all necessary to divulge—in the published minutes of monetary policy discussions, for example—analyses of hypothetical situations, or "what if" questions. An awkwardness of this analogy for our purposes is that little of the material in a regular Fund consultation report actually culminates in a specific decision by the Board.

44. Finally, one interviewee, a U.S. academic, raised the possibility that progress in spelling out confidentiality guidelines might be made by considering the distinction between microeconomic risk events and more macroeconomic ones. Thus, the Fund might be well advised to be very public as regards systemic risks—for example, where a banking system has been borrowing heavily in foreign currency and lending on in local funds—but not so in regard to how far particular institutions themselves were from the precipice. In this latter situation, which can also well represent the tricky situation sometimes faced by a banking supervisor, it could be bad luck (or, as the academic put it, "a stochastic event") that would make the difference. To the team's mind, however, it would also make an important difference how good the Fund was, or was allowed to be, in practicing early intervention. Clearly, if it rang the alarm bell late, this could itself bring down the banking system, as well, of course, as individual banks. Indeed, one central banker drew explicitly the analogy between Fund surveillance and that of a banking supervisor in terms of the dilemmas faced. In that regard, he noted, transparency looked better on paper than it did in practice. Of course, we can add, the analogy may not be perfect because presumably a supervisor can take direct steps to remedy a bad situation, whereas the Fund can only cajole, whether publicly, semipublicly, or confidentially.

Confidentiality: Practicalities

45. In terms of the practicalities of making surveillance analysis and conclusions more public, a number of points were made.

- It was obvious, said some, and as already noted, that at least statistical data could be released. But, we also note, it is doubtful whether data alone would help much in providing a basis for accountability on the quality of policy advice.
- It was suggested that lags in publication could help to reconcile the polar views on keeping things confidential, provided however that the lag was not very long. The Fund has recently decided to cut publication lags, but the lags are still years rather than, say, months.
- Perhaps, some wondered, there could be a shorter, confidential, report alongside the consultation report itself. However, others saw this as nonviable since it would become known that there were "Report I and Report II," and the same issues of publication and confidentiality would arise again.
- Some interest was shown, obviously in regard to situations of particular concern, in a phased process where the Fund was, initially, a "silent whistleblower" engaging with a country in a dialogue "on behalf of the rest of the world." Then, the advice could become gradually more open through other vehicles such as speeches and WEO. As one commentator put it, it was highly desirable to avoid the "nuclear option" in cases of imminent vulnerability, potential contagion, moral hazard, etc. So, mechanisms for a more progressive approach needed to be found.
- A point made related to the above was that in starting publication, timing is important. As in the case of a PIN, it is desirable to establish the process in a period of relative market calm, rather than to launch it at a time that is less settled.
- Peer pressure was considered by some to be a potential avenue of persuasion short of going public. But no one could point to examples of success. As one Asian central banker put it, "countries are just too polite to each other." Whatever the criticisms of Fund missions to the effect that they are too accommodating to the countries they deal with, they are not seen this way in relation to other available vehicles of surveillance. In fact, Fund reports were generally seen as more rigorous than those of other international organizations—in particular those of the OECD, which are published, but only after country vetting, or those of the European Commission.
- Finally, one seasoned observer, formerly a staff member but now outside, emphasized that it is all well and good to have rules about how and with what to go public, but there always remains the question of the will to do it. This is not an academic point, given the fact that the Fund has time and time again shown great reluctance to deploy the sanctions against a member that are already at its disposal.

Publication of Staff Reports

46. As can be readily gathered from Board discussions and the G-22 report, views were quite polar on

the desirability of publication of Article IV staff reports.[68] All the same, the views we collected were probably more varied and nuanced than in the above because we were not seeking *the* official view but rather insights on the question.

47. In regard to considerations favoring publication, most emphasis was placed on considerations relating to accountability and incentives. Much was made, above all in the private sector, of the importance of material being available on which to judge the quality of Fund advice. It was contended that this exposure would help to ensure that advice stayed good, or got better if not good. On the other hand, considerably less was made of the view that publication would help markets function better generally—on the basis of presumably more complete information—although this view was also evident in the private sector. As one businessman in Latin America put it, he thought that the additional information would provide a better perspective on the risks he and others faced, and then markets would work better. Then again, another observer, from a debt-rating agency, was concerned about "volatility feedback" resulting from publication—at least as a possibility that could not be disregarded.

48. On the other side of the ledger, concern was particularly intense over the effect of publication in *causing* crises rather than preventing them, and the consequential "moral hazard" issue facing the Fund. More generally, the point was made more than once that the Fund was predominantly a provider of advice to its members rather than a "whistleblower." Furthermore, publication of that advice, in particular in regard to possible future policy moves, would adversely affect the nature of the relationship, whether the danger of causing a confidence crisis was thereby increased or not.

49. All this being said and recorded, no doubt not for the first time in the extended debate that has taken place in different forums, there was general acceptance among propublication ranks (as also recorded in the G-22 report) that some material emanating from consultation discussions would probably need to be kept confidential. We discuss this issue in Chapter V. But before concluding this section it is important, given the thrust of our recommendations, to convey our understanding as to what kind of distribution Article IV reports actually do receive after copies are produced.

50. What is very clear is that Article IV reports find their way quite readily outside the circle of authorized users. It was obvious from our interviews that outside circulation was quite common[69]—whether among financial institutions, debt-rating agencies, the media, etc. Furthermore, not all the distribution is completely unauthorized. In particular, national authorities evidently quite often make the reports available to debt-rating agencies, which in turn use them in coming to their assessments of sovereign risk. These agencies told us that they find them useful.

51. Another feature is that because of this reality, or perhaps as a general precautionary measure, the reports themselves are apparently unlikely to reflect the full extent or depth of the consultation discussions that actually take place. This was confirmed both by country authorities, some of whom said that they spoke to Fund staff on the understanding that nothing that was not already effectively public would appear in the written staff report, and by Fund staff, who made it clear that they practiced a substantial degree of self-censorship. According to a senior staff member, "nothing really confidential appears in a staff report." Looked at from another angle, it is interesting to note that in a couple of cases academics had, as a condition of being interviewed, insisted to their authorities on being given access to the relevant Article IV reports. Their reaction was that there was not much material in the reports that they did not know already from other, regular, sources of economic and financial news and debate. So they wondered what the fuss was about.

52. Interpreting why, given the fact of general leaks, there may be concern about publication even in fairly "open" societies, our impression is that it may importantly reflect worry about adverse media headlines that then have to be dealt with. As was also noted in our discussions, in many places the Fund is seen as very powerful, so its advice simply has that much more popular impact. Wide release could, therefore, cause embarrassment even if all the investment houses in the world had already obtained the relevant report and made of it whatever they could.

Communication Within Government

53. The issue here, simply put (and spelled out more formally in the specific question (x) put to the team), is whether the advice got to the right people in government. At one level, it can refer to whether the advice was distributed *widely* enough. At another it can

[68] We should note that in April 1999, the Board did agree on a compromise pilot project of publishing Article IV consultation reports for about 20 countries on a voluntary basis—to be reviewed after 18 months. Our own views on publication come in Chapter V.

[69] Bear in mind that they are sent, among other things, to 182 countries. In this regard, we were told of one instance where the public had access in a country's central bank library to all Article IV reports.

be whether the advice went *high* enough in the decision-making apparatus.

54. What is apparent from our discussions is that practices vary a great deal in both respects. What is less apparent, without a far more extended and searching discussion than the team was able to undertake, is how much difference this has made. However, communication within the government did not appear to be very widespread. In a couple of instances (that is, two out of the four cases discussed in detail earlier), there had been a clear breakdown in communication between the central bank and some other parts of the government in the period leading up to a crisis. In one case this was compounded by frequent changes in government. On a less pathological note, it is worth recording that there was a general tendency for Fund advice to remain, if not entirely at least very greatly, the property of the ministry of finance and the central bank together. This may well reflect bureaucratic prerogatives, besides any more general considerations relating to who really needed to know what. At the same time, it was also pointed out in response to this line of questioning that distribution of Fund material beyond the two institutions referred to could compromise confidentiality. Prominent officials in other ministries, even when visited by the Fund team and in cases where their area of work was the subject of recommendations in the staff report, did not necessarily get to see those recommendations—or the full Article IV report. However, it also seemed that the recent tendency in countries has been to circulate Fund surveillance conclusions (but more likely the mission's concluding statement than the Board summing up) more widely within government rather than less. This would follow particularly from the fact that the surveillance conclusions have in recent years ranged beyond issues of fiscal, monetary, and exchange rate policy. Still, there was no indication anywhere that the circle of participants went beyond economic agencies, or that any thought that this was desirable or necessary.

55. As regards more vertical dissemination, our impression is that this would generally be quite limited and almost invariably in a summary form—sometimes reported upon orally around the cabinet table and sometimes circulated in the form of a cabinet memorandum. A minority of countries have developed the habit of putting the staff concluding statement (but not, it appears, the PIN as well) on the agenda of a cabinet meeting. At the same time, it is not unusual for the Fund's views to be used in internal cabinet debate to bolster a policy position. A regular pattern seemed to be for the views to be used to bolster the case for fiscal restraint. As one senior finance ministry official in Asia put it to us, while he was not convinced that it was necessary to go as far as the Fund wished in cutting the deficit, ministers tended to want to do less than was needed in this direction. So perhaps, he suggested, the net result of exposing politicians to the Fund's views was about right.

V Conclusions and Recommendations

1. As can be seen in the preceding chapters, the team reviewed a wide range of surveillance issues with a wide variety of parties—as called for under its terms of reference. Correspondingly, our findings and recommendations also cover many different aspects of surveillance—both in regard to the Fund's dealings with its members and in regard to its internal procedures.

2. However, before going through the individual recommendations together with the reasoning behind them, we want to present a broader picture of what we found.

3. Not surprisingly, and paralleling the experience of member countries, Fund surveillance has been playing catch-up to the globalization of financial markets and the vastly increased importance of private capital flows. This has shown up very clearly in internal post mortems on the Mexican, and then the Asian, crises. One challenge for the Fund, along with everyone else, has been to reach an adequate understanding of the forces at work on the global capital scene—including their role in the phenomenon of contagion. In that regard, we think that in its ex post internal reviews the Fund has identified quite well the areas where action needed to be taken in regard to broad surveillance approaches, both by countries and by the Fund itself. However, it appears to have had some difficulty translating its broad intentions into corresponding action in the field. Notwithstanding the lessons of Mexico, the implications, particularly in terms of capital account risks and vulnerabilities in the domestic financial sector, did not register uniformly, and with the appropriate intensity, throughout the institution. We say this even allowing for the fact that translating broad intentions into solid actions inevitably takes time. Indeed, one of the weaknesses of the Fund's internal workings that drew our attention was the difficulty it has in transferring relevant knowledge and experience across the organization.

4. It is also noteworthy that this process of catch-up to globalization is continuing at a rapid pace—as evidenced by the emphasis in recent months on the development and monitoring of international standards of conduct over a range of economic and financial activities and on the development of the Contingent Credit Line as an additional source of liquidity. Accordingly, the team found itself to a degree focusing on a moving target. We discuss later in this chapter the various implications for surveillance of these new international initiatives. However, we were pleased to see that many of those implications only served to reinforce points we had emphasized in looking at the surveillance framework that was already in place.

5. Another challenge in evaluating the effectiveness of surveillance was the evident gap—one that is, it should be emphasized, more apparent outside the Fund than inside—between the general impression, or expectations even, of the impact of surveillance and the Fund's actual degree of "clout." It is therefore worth reiterating the staff's observation in the 1997 biennial review that "Fund surveillance is only one influence, and generally not the predominant one, on members' policy and performance." We can confirm this in regard to the range of countries that we surveyed—in particular through the study of the four countries that went into crisis in the recent period; see Chapter IV. So while Fund influence will no doubt vary by country and within a country over time, depending on particular circumstances, it surely has to be accepted that surveillance is hardly ever going to be a primary influence on a country's policy actions.

6. The best the Fund can realistically hope to do is contribute over time to building or maintaining a consensus across the membership on the broad policy framework; and to tip the balance in situations where policies are in fact genuinely in the balance. However, the latter requires the existence of a reasonably clear domestic political will or consensus to change policies if necessary—something that was, for example, certainly not apparent in the four "vulnerabilities" cases that we focused on. Indeed, we were left with the impression that a financial crisis may be, unhappily, a crucial ingredient in concentrating the necessary political will—or, alternatively, that domestic political considerations will almost always dominate over Fund warnings, even in the face of a looming crisis. Part of the task regarding sur-

veillance may therefore be seen as seeking mechanisms to concentrate that will before a crisis strikes. Here, more transparency, in the sense of publicity, in surveillance conclusions is obviously an important issue, and some of our recommendations aim to encourage further movement in that direction.

7. Turning to a review of the broad thrust of our conclusions, one of the key elements is the need to focus surveillance more directly on the international aspects of a country's situation, the linkages across countries, and the lessons countries can learn from other experiences. Member countries have expressed a lot of interest in such material, and here the Fund has substantial talent and advantages that are not yet used to best effect. Furthermore, to maximize the effective use of those resources in the international interest, more flexibility in monitoring country situations is called for. In particular, more resources should be devoted to multilateral and cross-country issues and less to individual Article IV assessments of industrial countries—other than the very largest, where the implications of their policies for the international financial system should be the focus.

8. As regards the general substance or quality of advice, we found it was generally good in the Fund's core areas of macroeconomic and financial analysis. It was less surefooted when it ventured into more structural areas. But, in any event, Article IV consultations themselves should, while becoming more international and less "bilateral" in approach, also be more focused on a relatively tight range of core issues. Ensuring this focus needs not only strong guidance from management, but also Board support in light of the ever-present pressures and inducements to expand the scope of the Fund's activities in country surveillance. Our judgment is that this expansion, which continually adds to the surveillance load, detracts from its effectiveness.

9. We believe that the time has come to publish all Article IV consultation reports. Those reports already get significant informal, but privileged, distribution outside. However, broad, regular, distribution should yield important gains in both accountability and understanding. Besides improving the accountability of the Fund generally, publication should help also in maintaining or improving the quality of advice by exposing its views more to outside assessments. This will also help to limit "clientism"—the inevitable pressures on staff to avoid raising clearly with a given country difficult but important issues that should be addressed in the interests of international financial stability.

10. We also tackle a range of internal issues where we believe that shifts of policies or procedures could benefit the surveillance effort. In a number of these, in particular the problem of inadequate knowledge transfer, increased publicity for consultation reports will help. However, in questions of staffing and internal organization, more direct steps appear to be called for.

11. Mention should be made here of a quite distinct internal issue, that of the role of the Board. It is beyond our scope to deal with the underlying governance issues that exist. However, as regards surveillance, we are strongly of the view that the Board's contribution would be greatly improved by the effective use of a committee structure.

12. In the next five sections we present our detailed findings and recommendations. The first deals with objectives and priorities, with particular emphasis on where surveillance might usefully be expanded and where cut back. We then look at the quality of advice—appraising Fund counsel in some particular areas, but also examining broader questions relating to the Fund's general approach in developing its advice. This is followed by a section that tackles a number of organizational issues: internal organization and resources; the style and intensity of contacts with member countries, and the extent to which such contacts might usefully vary across members, i.e., "selectivity"; and finally here, the role of the Board in surveillance. The fourth section deals with communication, above all with the much-debated issues of transparency and confidentiality in surveillance. Finally, as already indicated, we comment on two newer developments that have substantial implications for all aspects of surveillance—the growing emphasis on monitoring rules of conduct over a range of financial and economic activities and, finally, the Contingent Credit Line.

Objectives and Priorities

International Added Value

Multilateral Surveillance

13. Fund multilateral surveillance is of generally high quality, and its work in this area, particularly as expressed through WEO and the ICMR, received much favorable comment. Some particular issues are dealt with later in this chapter, but the basic point that these publications are well regarded should be recorded here.

14. If there is a broad shortcoming, it is the lack of integration of multilateral and bilateral surveillance. The staff's comparative advantage is in analyzing international systemic issues and economic interdependence, not least when the latter gives rise to vulnerabilities. A number of our recommendations below focus on how the multilateral and international expertise of the Fund staff can be harnessed to still greater advantage.

Bilateral Surveillance

15. This is the main focus of our attention in the area of international value added. Simply put, we, and many of those we spoke to, found the Article IV consultation process to be insufficiently international in focus—too "bilateral," in fact. This is also the implication of the Fund's own "third lesson" in relation to surveillance and the Asian crisis.[70]

16. Given the shift in the international environment on account of the vastly increased importance of private capital flows, the increasing openness of economies through trade, and the increased sophistication in many countries in the field of domestic macroeconomic policies,[71] the Fund's comparative advantage now lies at least as much in bringing international considerations and experience to bear as it might in giving broad advice about domestic policies per se. However, this is not the way Fund consultation discussions are shaped at present.

There are three different aspects of Fund value-added to consider here:

- the desirability of a Fund mission explicitly bringing to the consultation table its view of the international economic and financial situation and prospects, with particular emphasis on those features that are most relevant for the country in question;
- a more systematic attempt by staff to explore beforehand and then volunteer pertinent experiences from other countries, whether in terms of issues or policies; and
- more direct focus on how a member might incur and absorb shocks coming from the outside, whether they come through direct economic interrelationships and spillovers or through more general contagion from market disturbances. Even if, as may well be the case, the member is not inclined to respond directly, or at all, to these hypothetical issues, it would still be worthwhile to raise them consistently, thus leaving an imprint.

17. For the very largest countries or policy areas (i.e., the euro area), the focus in this third aspect would be as much on the implications of their own policies for the rest of the world as on the likely impact from developments elsewhere.

18. Besides the direct advantages of explicitly including such considerations in the consultation process, this more international focus would have the important collateral gain of forging greater linkage within the Fund between the multilateral and bilateral aspects of its surveillance work. These links, as discussed in more detail in the section on organization, below, are quite weak.

> ***We recommend that consultation guidance be restructured to give explicit attention to international aspects along the lines indicated above.***

Regional Surveillance

19. In the Fund canon, "regional" surveillance is not generally seen as a separate category, but here it merits separate discussion. Internal reviews of surveillance have given some attention to regional aspects. However, this attention has been more on the mechanics of the institutional side, focusing on evolving regional economic and financial associations such as the European Union, and monetary unions such as the CFA franc zone and the Eastern Caribbean Currency Union. At the same time, another set of regional-type issues—regional economic and financial spillovers and contagion, and the potential for constructive application of regional peer pressure—has been driven increasingly to the fore by recent events in Asia and Latin America.

20. The first, institutional, set of questions has to deal with how the surveillance process copes with evolving regional arrangements. For the euro area, as noted in Box 2.2, the challenge of finding the appropriate set of surveillance arrangements is particularly complex, involving as it does political as well as technical considerations. However, despite this complexity, the replacement of 11 monetary and exchange rate policies with one, formulated exclusively at the euro area level, should lead to significant resource savings. Clearly surveillance over monetary and exchange rate policies—the raison d'être of Fund surveillance under Article IV—will have to take place via the European institutions. However, even in the case of fiscal policy, given the intensive, and intensifying, degree of monitoring at the euro area level, we believe that the Fund is much more likely to have an impact if it concentrates its efforts at this level.[72]

> ***We recommend that surveillance of the euro area center around the ECB and other EU bodies. Surveillance of individual participants in the euro area should largely take place at the euro area level, and through EU institutions.***

21. As regards the second set of regional issues, the Fund has taken some initiatives to address them

[70]IMF, *Annual Report, 1998,* p. 37.

[71]Our conclusion is that in a preponderance of cases it is not an understanding of economic policy principles that inhibits a country from doing "the right thing," but rather, as we have already indicated, the challenge of summoning up the critical mass of political will to do so in a timely fashion.

[72]The same is true for structural policies. But, in any case, as set out below, we recommend that the Fund aim to reduce the resources devoted to the surveillance of structural policies across the board.

through its participation in regional meetings, including at the highest level of management, and, indeed, in taking the initiative to arrange a meeting of ministers of finance and central bank governors of the Americas in September 1998. On the evidence to date, what surveillance results should be expected from such gatherings? In our view, probably not more than broad familiarization and consciousness raising. This is because even where country policies cause concern among their neighbors, peer pressure is unlikely to be applied very actively—and in any case convincing evidence of any significant impact has yet to be produced. Furthermore, the Fund is not, and practically speaking cannot be, more than a facilitator of such meetings,[73] with any associated exhortations from senior management that might give increased focus to the event. At the same time, the Fund documentary contributions have not been as much to the point as they could, and should, be. They have been focused more on supplying material that exposits individual country situations than in highlighting the regional interactions and issues agenda that could usefully be explored if participants really had a mind to do so in such a forum. The same is often true of internal Fund material; for example, that presented at the Board's Informal Country Matters sessions, which were originally intended to have a regional focus.

22. That being said, we suspect that even if the Fund did prepare more compelling documentation along the lines just indicated (which it should of course aim to do in any case, since it is the right thing to do even if it ruffles a few country feathers), the diplomatic niceties of large gatherings would continue to constrain direct discussion, and hence any results from peer pressure.[74] Accordingly, we do not see that regional surveillance in this form can in the end realistically be a substitute for country surveillance. However, country surveillance should in any event emphasize regional and spillover issues.

> ***We recommend that (consistent with an increased focus on international aspects) the Fund bring spillover issues, whether regional or multilateral, directly to the table in its various country consultations and in Board discussions.***

23. Conceivably, this kind of focus could also lead, over time, to more fruitful regional exchanges—at the margins of such meetings if not at formal sessions.

[73]As it also is at G-7 meetings.

[74]It is interesting to note that in the most thorough published analysis of surveillance, Guitián (1992), who was then a senior staff member, saw the key challenge as how—in the absence of any coercive power—surveillance is to be made effective through peer pressure. See Manuel Guitián, *The Unique Nature of the Responsibilities of the International Monetary Fund*, IMF Pamphlet Series No. 46 (Washington: International Monetary Fund, 1992).

Cutting Back

More Concentration on the Core of Surveillance

24. The recommendations just made fit squarely into the Fund's statutory mandate to exercise "firm surveillance over the exchange rate policies of members." However, the same cannot be said of other elements that have come to be included in bilateral surveillance.

25. In recent years, the surveillance agenda has expanded rapidly. This expansion into nonfinancial, structural areas was described earlier, in Chapter I, and will not be repeated here. What should be noted, however, is that the pressures for expansion come from more than one source and may also reflect different priorities.

- Governments and/or their legislatures. Here, the outstanding example has been the recent U.S. law authorizing the latest increase in the U.S. quota in the Fund. This legislation requires the U.S. government to press for a whole series of initiatives to be undertaken by the Fund. These include promoting, besides "market-oriented reform, trade liberalization, and economic growth," also "democratic governance and social stability" in member countries. Doing this will involve, among other things, "establishing or strengthening elements of a social safety net" and "the maintenance and improvement of core labor standards" as well as pursuing "macroeconomic stability while promoting environmental protection." Another very recent example is the June 1999 G-8 communiqué, which calls upon the Fund to give "more attention" to "the development of sound social policy and infrastructure in developing countries" and "to give particular priority to core budgets such as basic health, education, and training to the extent possible, even during periods of fiscal consolidation."
- Nongovernmental organizations. In some areas NGOs are also pressing for similar expansions of the Fund's role to those just described (see also our report on discussions with NGOs in Chapter III).
- The Fund's own view of its evolving role. It has increasingly concentrated on medium- to long-term issues such as stabilization sustainability and growth, which it now considers key to surveillance. In this regard, it perceives a need to examine a wider range of issues, micro or structural in nature. In addition, the Fund has of course been attempting to deal with the demands for any additional activity in surveillance along the lines just noted in the previous bullets.

26. Our basic concern is that raising a broad set of issues in a consultation will not enhance, but rather dilute, the quality and impact of surveillance advice. For one thing it can, as we were told, lead to confusion on the part of national authorities as to what in fact is the basic thrust of that advice. For another, while the staff are well equipped to deal with macroeconomic management and international financial questions and perhaps in time even structural questions relating to the financial sector, they cannot credibly lay claim to nearly the same level of expertise in nonfinancial structural and/or microeconomic questions, social policy questions, environmental questions, and the host of other issues that are being put on the agenda. And this apparently shows in consultation discussions. To be sure, we were told of cases where a team had indeed been effective in providing advice in noncore areas. But the basic issue is rather whether Fund resources as a whole would be better applied, and surveillance thereby become more effective, if the focus were more targeted to the core topics. We believe that there would be an improvement. This is especially so given the evident need to focus, in addition to domestic macroeconomic policies and exchange rate matters directly, more on financial system and capital account issues in light of their propensity to generate exchange rate disturbances. This conclusion is strengthened further should the Fund find merit in the increased international perspective that we believe it should also bring to the bilateral consultation process.

27. Evidently, the pressure for expanding the scope of surveillance comes in important measure from evolving views as to what needs to be addressed in Fund programs rather than from the evolution of surveillance itself. The design of programs is outside our mandate, and we shall not deal with the controversial questions as to what needs to be included in them. However, while we can certainly see the logic of the argument that because the Fund might be obliged to involve itself in a wide range of economic (and perhaps even noneconomic) issues in programs, these should also be put on the agenda for surveillance, we are not persuaded by it. The reason it is not persuasive is because we believe that surveillance, even in the relatively narrow, relatively "traditional," sense in which we see it, is difficult enough to do successfully without adding to the menu a range of other kinds of interventions whose relevance depends on hypothetical future needs.

28. Accordingly, given the Fund's competencies, and given the evident need for further improvement in the Fund's work on exchange rate policies, and the associated macroeconomic and financial framework, particularly in regard to the international dimensions, it is our view that the quality (if not the quantity) of surveillance would be better served if the Fund were to concentrate more centrally on the above areas. The alternative, if one takes literally the demands now placed on surveillance, is a vast expansion, without any foreseeable limit, of varied and specialized resources devoted to Fund monitoring of economies.

29. It is important to emphasize that a more central focus on what might be considered the traditional core of surveillance does not mean that important linkages between macroeconomic management and other policies should not be recognized and addressed as part of surveillance. However, the criterion for addressing other issues should be the extent to which they actively and directly impinge upon the effective conduct of macroeconomic policy. To give a specific example, labor market policy clearly can have implications for macroeconomic management. But the Fund should normally confine its advice and analysis to those implications—and not attempt to resolve the more general question of what "good" labor market policy might be.[75] Moreover, the burden of proof should rest upon advocates for including additional items to show how they would improve the effectiveness of surveillance. This too would help focus the overall surveillance agenda.

> ***We recommend that surveillance focus, above all, on the core issues of exchange rate policy and directly associated macroeconomic policies, in particular the international implications of such policies. Other analysis should only be undertaken if directly relevant.***

30. We recognize that the views just expressed regarding a tighter focus for surveillance may not fit too well with the kind of role foreseen for the Fund in the application of international standards or codes of conduct. In particular, this role, as currently envisaged, may involve monitoring standards in fields that are less clearly financial and more microeconomic (e.g., accounting standards and governance). It seems to us that here the Fund has been viewed as not so much the chosen instrument as, practically speaking, the only available instrument, given its current surveillance infrastructure and global membership. We discuss this issue in the section below on recent developments.

31. Our view implies that the Board should act as a skeptical, restraining, influence on any widening of the surveillance agenda beyond its core. In other words, the presumption the Board should adopt is that of a limited approach, focused on well-specified core topics in which the Fund has a clear comparative advantage.

[75]Of course, we recognize that what is directly relevant to macroeconomic management will differ from country to country. Labor market policy may be directly relevant in one country but not in others.

32. Turning to individual bilateral consultations, we see a similar need to set priorities. At the moment, staff feel obliged to produce reports that cover the entire surveillance agenda of the Fund. Even with our proposed refocusing and reduction of that agenda, the pressure will remain to produce a comprehensive report that touches relatively lightly on a large number of issues, rather than one that focuses in more depth on a limited number of key issues. We believe that what is required is a systematic structure that ensures that bilateral surveillance takes the latter approach.

> ***We recommend that a systematic process be developed whereby the Board would discuss and sign off on the main issues to be raised at forthcoming individual Article IV consultation discussions.***

33. Proposals in this regard would be submitted by the staff, and the Board could then augment or subtract from them, and at least discuss or take note of them. Such proposals would not be the detailed briefing for the mission—best in our view left with management. Rather, they would come before the briefing and would allow the Board to reflect on the two or three main issues that the consultation should principally address.[76]

34. Such a process would also afford the Board greater ownership of the consultation process that culminates in a Board discussion (something that appears lacking at present), while providing greater assurance that the process would be focused on what is truly important.[77] This recommendation has to be seen also in the context of our recommendations regarding the role of Board committees in surveillance that are developed later, in the section below on organization. However, anticipating that discussion, it is worth emphasizing here that this process is aimed not at generating more work or a slower pace of work in getting the Fund's surveillance business done, but at helping to streamline work by setting an earlier, better focus on what are the real priorities in each country's surveillance.

Less Attempt to Find Optimal Policies in All Areas

35. Not surprisingly, every staff report suggests some modifications to current policies—for example, a small tightening in fiscal policy, or an acceleration of financial market reform. No country is perfect. However, this may lead to two problems. First, it leads to staff making suggestions for relatively marginal improvements. But while countries may sometimes find this helpful, it is unlikely to be the best use of resources. Second, it tends to reduce the impact of Fund criticism when matters are seriously awry. Since every report contains some criticism, and since all criticisms are to some extent muted by the subtle and specialized phrasing in which they tend to be couched, it is easier for countries to disregard warnings that really do require immediate policy action.

> ***We recommend that staff focus policy advice on issues of serious or immediate concern and distinguish such advice clearly from analysis of whether relatively small or judgmental policy shifts would be helpful.***

Implementation

36. One point that struck us in comparing our review and conclusions with earlier internal reviews is the extent to which the problems—and to some extent the solutions—that we identify have already been discussed. There is, it seems, something of a disconnect (or at least a very long lag) between the broad policy directions outlined by the Board in review and policy discussions, and actual practice in day-to-day surveillance work, particularly bilateral consultations. Accordingly, we are inclined to think that if the periodic reviews of surveillance are in future to lead to more effective surveillance in practice, substantially more attention should be given to the extent to which decisions by the Board affecting surveillance have been implemented.

> ***We recommend that in the next internal review of surveillance, more attention be given to measuring in some detail (by topic and country) the extent to which the specific operational guidance that has been put forward on behalf of the Board is actually followed in Fund consultation reports, and, equally important, if not why not.***

37. This will require a less general, more fully documented, approach by the staff. We also wish to emphasize that a fully adequate discussion of these matters involves reviewing not only what the Fund did or did not do, but also what kind of response was forthcoming from the country in question. The Asian crisis review went some distance in this direction, but was of course limited in country scope.

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[76]This recommendation would also address a related problem; perfectly naturally, individual Directors are inclined to raise particular issues during a Board discussion that they feel staff might pursue in future consultations. There is certainly nothing wrong in this. But if all such requests are pursued—and certainly the incentives are for staff to do so—then the net effect is a continual expansion of the agenda. The proposed system would help Directors to consider whether such suggestions were consistent with a focused approach to surveillance, and with the resources available.

[77]Note that this issue also comes up in relation to matters of transparency, in particular "self-censorship," discussed in the section of this chapter on communication.

Substance

Clientism

38. The problem of insufficient frankness is one of both substance and language. Fund staff are sometimes unwilling to probe deeply into areas where the authorities are sensitive, although these are also likely to be the areas where deeper examination is most warranted. Alternatively, the staff may diagnose a problem but present their analysis in rather indirect language. This allows the staff to claim that they have covered the issue. However, they will not have alerted the international community, and possibly not the authorities either, to the significance of the problem. The consequences of a lack of directness can be particularly serious in the area of vulnerabilities. For example, the Fund staff have been more prepared by and large to tell a member that its fiscal position, while basically sound, should ideally be tightened further than they have been to focus clearly on problems in a banking system.

39. This problem has long been recognized, yet it has persisted. It was raised in successive reviews of the Mexican and Asian crises. Most staff, including those directly responsible for country work, are well aware of the problem and do try to minimize it. However, in light of the extremely strong incentives for the staff to maintain a close relationship with country authorities, and the fact that countries tend to react badly to criticism, especially when they have difficulties, it seems unlikely that further exhortation alone will improve matters much. Nonetheless, it should be possible to improve the incentives to the staff for more candid advice.

40. Proposals elsewhere in this chapter to focus surveillance more closely on identifying and addressing the major priorities, and in specifically tackling potential vulnerabilities, will help. Furthermore, the publication of staff reports should provide important support over time for greater frankness. With publication of views, the evidence will be more out in the open and can be judged accordingly.

41. Such steps should also help to change perceptions within the Fund. However, a view that exists in the institution is that a report that is incisive but offends the authorities is damaging to a mission chief's career while one that is bland and later turns out to be lacking in some important respect will be overlooked.

> ***We recommend that the Board, management, and senior staff attempt to alter the incentive structure by making it clear that they will, if necessary, back up staff who give frank advice.***

42. We recognize that the line between a lack of diplomacy in presenting advice and frankness may sometimes be difficult to draw, and that the latter should not be seen as an excuse for the former. However, given on the one hand the Fund's express, and well-founded, wish to offer more candid advice, and on the other hand the built-in incentives to avoid offering it, such an affirmation is very unlikely to redress clientism bias too far.

Template

43. We do not believe that, in general, the criticism that the Fund applies an overly rigid "template" or "model" to every country is justified. There is nothing wrong with the fact that the Fund has a framework within which staff analyze macroeconomic issues; indeed, it would be worrying if this were not the case. In bilateral surveillance,[78] the staff use mainstream open-economy macroeconomic models, and their particular approach makes a point of enforcing consistency in the analysis of macroeconomic and financial flows. This can only be to the good. However, there has been a more limited emphasis on stock variables. This results in weaknesses in the analysis of capital flows; some specific points relating to capital account issues are described below.

44. It is appropriate to raise here a related problem. Staff appear in general to be reluctant to give advice that is country-specific—that is, advice that takes into account the political and institutional constraints within which policymakers have to operate. In other words, Fund advice often focuses on identifying the first-best general policy. There is nothing wrong with that, and politicians need to hear it in as direct a form as possible. But when policymakers, quite reasonably, respond that they live in a second-best world, staff are apparently not as good at suggesting how the first-best might actually be implemented in practice, or at developing and analyzing alternative, specific, policies.[79]

> ***We recommend that surveillance devote more attention to policy implementation and to the identification and analysis of alternative policy options.***

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[78]In modeling for multilateral surveillance purposes, the Fund uses its own multiregion macroeconomic model (MULTIMOD). See Douglas Laxton, Peter Isard, Hamid Faruqee, Eswar Prasad, and Bart Turtelboom, *MULTIMOD Mark III: The Core Dynamic and Steady-State Models,* IMF Occasional Paper No. 164 (Washington: IMF, 1998). MULTIMOD is generally recognized as being on the cutting edge in this field.

[79]As noted in Chapter II, this is in part a problem of success. Once, it may have been sufficient to focus with many country policymakers on what the first-best was, since they didn't know. Now, in many countries policymakers know full well what the first-best policy is, but would like advice and assistance in identifying the best available alternative policy option or modification, even if the Fund will also underline (as it certainly should) that it is indeed only a second-best.

45. This is consistent with our general recommendation that surveillance give much greater emphasis to cross-country experiences.[80] The ability to give such advice depends to some extent on having staff with sufficient policymaking expertise and experience, which may be difficult to obtain within the Fund; some recommendations in this area are set out below. Another consideration here is the need for the Fund to take account of the differences in economic and institutional structures between different countries.

Capital Account Issues

Policy

46. The Fund has been severely criticized for being too enthusiastic about capital account liberalization. Without entering into this debate at length, we note that it does appear that the Fund has in the past been keen to liberalize as fast as possible, and as a consequence has given insufficient attention to the proper sequencing of capital account liberalization—in particular, the need for domestic financial sector reform as a precondition for external liberalization. However, policy appears to have shifted significantly since 1997; while the potential benefits are still recognized,[81] much greater attention is now being paid to the risks of liberalization if the financial sector is weak. We believe this more nuanced attitude is broadly appropriate. However, for it to be properly implemented in the context of bilateral surveillance there will need to be more detailed and sophisticated analysis of the financial sector than the Fund has developed so far, a topic we discuss below.

Analysis

47. Distinct from its policy recommendations, the analysis of capital account issues in surveillance has suffered from a number of weaknesses. There are a number of related problems here.

- A traditional Fund method of analysis—financial programming—tends to treat a substantial part of capital flows as a residual. This leads to a lack of attention to the capital account and the forces driving its various main components. However, in recent crises, reversals in capital flows have been the force behind current account reversals.
- Concentrating on the current account and its sustainability,[82] as much Fund analysis does, can lead to a lack of attention to autonomous forces driving the capital account—and therefore driving the current account as well.
- A lack of attention to the capital account is also likely to lead to an inadequate appreciation of the domestic macroeconomic effects across countries of shifts in capital flows.

48. These problems arise even though there are staff who have a detailed knowledge of capital account issues and problems; indeed, some Fund economists are in the forefront of research on these topics. However, they are mainly in the functional departments (especially Research) while area departments take the lead in bilateral surveillance. Without adequate interdepartmental cooperation or coordination, these internal arrangements have led to inadequate knowledge transfer within the Fund. But with the increased importance of international capital flows, and in particular the role played by sudden reversals of capital flows in recent crises, it is clearly essential that bilateral surveillance—not just research and multilateral work—devote as much attention to analysis of capital account issues as it currently does to current account issues.

> ***We recommend that Article IV staff reports give greater attention to the forces driving the capital account, and to capital account issues in general.***

A number of our other recommendations are also particularly relevant in this area:

- The increased attention to vulnerabilities that we recommend should focus more attention on the analysis of the possibility and consequences of large capital outflows.
- Improving interdepartmental relations (partly a job for senior management), and ensuring that knowledge is transferred between different parts of the Fund, should help to ensure that the expertise that does exist on these issues is deployed in bilateral surveillance.

Financial Sector

49. In response to the Mexican and Asian crises, and to the clear desire of the international community, the Fund has greatly increased the emphasis given to

[80]To give a concrete example, it would probably be more useful to a country experiencing large capital inflows to have a Fund analysis of other countries' policies and experiences, and what the lessons might be for the country in question, than to be told that capital account liberalization was a good thing.

[81]Here it is worth recalling the point made in Chapter IV—that stressing the importance of proper preconditions and sequencing should not at all be taken to imply that capital account liberalization is a bad thing.

[82]We are not suggesting here that the current account and its sustainability is not an important subject of analysis.

surveillance of the financial sector. We believe that this is appropriate; the close linkage—in both directions—between domestic financial sector crises and exchange rate/balance of payments crises justifies the Fund's involvement. However, we note that improving financial sector surveillance was identified as an important task as long ago as 1995, and the pace of improvement has been slow. So far, area departments have tended to treat this remit as another add-on, which they do not have the time and expertise to fulfil in more than a pro forma way, especially if countries drag their heels in providing information. In short, the infrastructure and the push have been lacking.

50. The proposed Financial Sector Stability Assessments (FSSAs) to be undertaken by MAE should help to remedy this. However, to be successful, the Fund will need to be able to draw on the appropriate specialized staff; we discuss this in more detail below. Moreover, it will be important to ensure that the work done by MAE is properly integrated into the Article IV process.

Vulnerabilities

51. At the moment, Fund documents tend to add some general remarks about "downside risks" to an elaborate central scenario for a country's economic prospects over the next year or two. However, notwithstanding the analytical and procedural complications that are evidently involved in going further, it is important for the Fund to strive to bring the analysis of vulnerabilities more to center stage.

> ***We recommend that surveillance devote substantially more attention to vulnerabilities.***

52. In the following, we sketch how this added focus on vulnerabilities might be brought about. Some further implications for the Fund's work are discussed in the sections of this chapter.

We envisage that this process would proceed in three stages:

- identification of vulnerabilities prior to Article IV missions, in part with the aid of early warning systems (EWS);
- information gathering from the private sector; and
- presentation of vulnerabilities analysis to national authorities.

Identification of Vulnerabilities

53. The starting point for a Fund team going on an Article IV mission would be to examine, together with functional departments (notably RES and MAE), potential vulnerabilities of the country in question. As part of this process, the team would explore the latest position of the country in relation to the set of indicators used in the Fund's EWS.[83] Such a discussion would become an integral part of the review of the mission brief, but the subject would lend itself better to a meeting of the team with staff from RES and other functional departments than to written exchanges.

54. Although it remains very difficult to predict the timing of a crisis, it is not a random event. Given the high stakes—and the poor record of both the Fund and outside observers to date—even a modest ability to predict crises would be very valuable.[84] In any event, one important advantage of the EWS approach for bilateral surveillance is its quasi-objective nature; a poor score will force area departments and, we hope, country authorities to focus their attention on problem areas even if they would prefer to avoid the topic. So, even if the indications from EWS are no better than the staff's informed judgment (and we would not normally expect that they would be), they may have a role in combating pressures for "clientism." Of course, this additional tool should not rule out staff using their own judgment and analysis to identify what they consider to be the country's principal vulnerabilities. Furthermore, the application of country-specific analysis can, in turn, help to improve the construction of EWS.

Meetings with the Private Sector

55. To follow up this part of its preparation, participants in the mission would make a point of searching out information from the private financial sector—through analysis of market commentary or interviews along the lines already conducted by a mission from the capital market divisions in RES when it visits a global or regional financial center before preparing the ICMR. Such information may, for example, relate to the buildup of large open positions in the currency concerned, or to the interpretation of recent movements in short-term indicators additional to those used in EWS, notably bond spreads.

[83]We explain the main elements in EWS and comment on its use, primarily in multilateral surveillance in Box III.1, while focusing here on its application to the Article IV process.

[84]One observer has likened the difficulties of forecasting balance of payments crises to those of predicting earthquakes. See Barry Eichengreen, *Toward a New International Financial Architecture* (Washington: Institute for International Economics, 1999). We find this analogy excessively unfavorable to EWS for two reasons: first, earthquakes are even more difficult to predict than financial crises; and second, their occurrence cannot be influenced by human action—only their consequences can be mitigated—while balance of payments crises can, in principle, be forestalled by timely warnings.

Presentations to Country Authorities

56. The mission would take up the issue of vulnerabilities against its central scenario for the country's prospects. It would not only assess the risks but also comment upon the feasible policy responses.

57. We are aware that not much reaction can be anticipated from many national representatives. The team's interviews indicated that officials, while recognizing the merits of the exercise, were wary of engaging in a dialogue about such matters. The knowledge that the consultation report was going to be published would presumably reinforce such wariness. However, we nonetheless believe that even just presenting this material on a regular basis is valuable and important for the surveillance process.

58. With time, actual discussion of vulnerabilities (as opposed to the consultation presentation itself) should become a standard part of Article IV consultations. Such an outcome will be helped along by two parallel developments. One is the greater familiarity with the analysis of vulnerabilities and EWS that will develop as past crises are dissected in the multilateral publications. The other development is the introduction of the Contingent Credit Line. This would require the analysis of vulnerabilities and the risks of contagion to take center stage in some bilateral consultations—and to have the discussions reported to the Board in cases where a country wanted to qualify for a contingent facility. We return to the implications of this in the section on recent developments below.

Multilateral Surveillance

59. While there are competitors, the comprehensiveness of the Fund analysis tends to make WEO and ICMR indispensable to anyone interested in an objective and detailed perspective on the global economy and the increasing interdependence among its components. We reported in Chapter II that some officials and academics saw value in more regular publication of the analysis, particularly the forecasts, contained in WEO. We also note that in December of both 1997 and 1998, a combined "interim" WEO/ICMR was produced. We suggest that the Fund take a further step in this direction.

We recommend quarterly publication of the WEO forecast.

60. This is not intended to imply that the Fund should produce much more material than it does at present; simply that rather more should be published. In terms of forecasts, descriptive material, and short-term policy analysis, it is clear that most of the necessary material already exists internally, and indeed is presented to the Board at the regular WEMD sessions (and the quarterly private sector financing notes). We see no reason not to publish this material with greater frequency.[85]

61. As regards the longer and more systemic background studies that currently form part of WEO and the ICMR, these could be reserved for a larger publication—either WEO and ICMR separately or with the two documents combined, such as the one that appears at the time of the Annual Meetings—or they could be incorporated quarterly as and when available. Again, we are not suggesting any increase in the amount of material produced by the Fund.

62. We also believe that this change in publication should be accompanied by two changes in the accountability for the publications that would strengthen their objectivity.

63. There are presently two problems for the objectivity, and hence the authority, of the multilateral publications. On the one hand, the forecasts are not clearly the responsibility of the main authors in RES. On the other, members of the Executive Board at times appear to lean more heavily on the staff to modify judgments of policies in their respective countries than is healthy for the long-run reputation of WEO and the ICMR.

64. As regards the former point, we have noted in Chapter III that forecasting in the Fund is to a large extent a "bottom-up" rather than a "top-down" exercise, that is, global forecasts are built up from the country analysis of area departments. Although a consistency check is obviously provided by RES, we suspect that this process is likely to result in a general bias toward optimism (although, clearly, there are no doubt occasions when area department forecasts are more accurate than RES ones).

65. Furthermore, this leads to the serious problem that no one is willing to accept ownership of the WEO forecast. This was evident from our interviews with staff; RES staff disclaimed responsibility for forecasting errors in the published WEO—although the rest of the world is given to understand that it is their product—saying that the forecasts were really the responsibility of area departments. Area departments, by contrast, regard the forecasts as the collective responsibility of the staff. We do not regard this situation as appropriate.

We recommend that ultimate responsibility for the WEO forecast be vested clearly in RES.

[85]The current WEO forecast schedule might not fit too well with a move to quarterly publication, since at present WEO appears in late April and late September, leaving a gap of only five months. Either this timetable could be adjusted slightly, or the new summer WEO could be particularly lean—perhaps simply containing forecasts and descriptive material.

66. Of course, RES will continue to rely to a very great extent on the work done, and the material provided, by area departments; we are not suggesting a shift in resources here. And where there are disagreements, it will doubtless wish to take their views into account. However, in the end, if RES is to be accountable for the quality of the forecast exercise, it should be clearly responsible for making the final decision on contentious issues.[86] Time will tell if it is correct.

67. The second issue in regard to accountability—and candor—is the nature of the Board's involvement before publication. While the Board has the intention of letting WEO and the ICMR be issued on the staff's responsibility, it is evident that Board review can become Board pressure for change to protect individual country interests. This obviously reduces the overall value of what is published.

We recommend that the Board make it clear that the presumption is that the staff draft should be published as it stands.[87]

68. Indeed, simply as a matter of practicality, the review and Board clearance process would need to be streamlined considerably if the WEO forecast were to be produced quarterly.[88]

Organization

69. This section deals with the organization of surveillance under three main heads: first, the organization of surveillance relations with countries, including the organization of missions; second, internal aspects; and third, the role of the Executive Board.

[86]One potential objection to this recommendation is that it would simply reverse the problem; area departments would feel a loss of ownership of the Fund's forecasts for the countries for which they are responsible. While this might occasionally cause difficulties on the rare occasions where there were sharp disagreements (although we do not see any great problem in general in being quite transparent about divergences of view and the reasons for them), we do not see that it would undermine the conduct of bilateral surveillance to the extent to which the present situation undermines the credibility of the WEO forecast.

[87]Of course, the Board would still discuss the draft in advance of publication (and WEO could record the views in an Appendix, as was done with the May 1999 issue). But the staff should decide how to deal with the points raised at the discussion.

[88]WEO is currently discussed by the Board four to five weeks before publication, and Board members require three weeks to review it before the Board discussion. As a consequence, while it only takes about two months for the staff to produce a draft WEO document—even with the current elaborate internal review procedures—it takes another two months before publication can proceed, with relatively little value added.

Country Surveillance

Greater Flexibility in Monitoring

70. Members vary a great deal in their characteristics, and more selectivity in how surveillance is applied is therefore appropriate. It may be contended that there are risks involved(it would have been easy to argue, for example, that Korea in 1995, a successful country with what the Fund and many others believed were largely sound policies, required relatively little attention.[89] However, our broad judgment is that significantly fewer staff resources could be devoted to industrialized countries overall without any loss in effectiveness or impact. This reflects these countries' risk characteristics, and the greater public availability both of data and economic analysis. In large part, Fund efforts here are duplicative of other work performed in both the public and private sectors.

We recommend the following:

- ***For all industrial countries but the very largest, full Article IV consultations should be less frequent than annually.***[90]
- ***For the very largest industrial economies,***[91] ***in light of their systemic impact, annual consultations are still called for. However, to improve the payoff, surveillance should focus more on the international implications of these countries' domestic policies and correspondingly less on advice regarding the policies themselves.***
- ***The particular issues in surveillance of the euro area are discussed in more detail in Box 2.1. But regardless of exactly how surveillance is organized, there is a strong case for cutting back the resources allocated to the euro area, which are now more than four times those devoted to the United States.***

71. The changes recommended for industrial countries overall should yield significant savings in resources. Some could be applied to lessening the problems of overloaded surveillance agendas that are noted below. However, it should be possible also to transfer resources to the other areas that we identify as priorities: the international dimension and harness-

[89]It is also worth bearing in mind that the deterioration in Korea's circumstances in 1996/97 was in any event not signaled by current, nonselective surveillance procedures.

[90]This would not imply that staff would only visit countries every two years; we would expect short, smaller missions to visit more frequently than this. See also our recommendations on more continuous surveillance below.

[91]The United States, the euro area (i.e., consultations focusing on the area as a whole), and Japan.

ing cross-country experience.[92] In saying this, we are not arguing for any particular allocation of resources between area departments on the one hand and functional departments on the other (although, clearly, there will need to be some reallocation across area departments). But we do see it as important that the resources within area departments—again, taken as a group—should in important measure be refocused to deal with these priorities.

Small States

72. Small states[93] clearly have concerns that their economic policy problems are qualitatively different, and that the Fund fails to take sufficient account of this. Moreover, the impact of surveillance is probably greatest for small states (see also our discussion of technical assistance, below). It seems appropriate to try to respond to these concerns.

73. While we did analyze the possibility of setting up a special coordinating division to take the lead in dealing with such members, we abandoned this idea as being too complicated to implement unless one also shifted small states out of their respective area departments. However, what we do propose is that the Fund establish a project to analyze the economic effects of small country size from the macroeconomic management point of view—to see whether their situations are indeed substantively different in ways that are relevant to the Fund's surveillance competencies. Then, surveillance might be reviewed in this light.

74. Of course, the basic challenge still remains: how should the level of surveillance resources devoted to small states be decided in the light of two conflicting considerations—that these states are numerous and attach great importance to surveillance, but their share of the total world economy is very small. Clearly, a substantial reduction in these resources would not pose any systemic threat to the world economy, while freeing up resources for use elsewhere. To the extent that surveillance should focus on issues of concern to the international financial system, such a reduction appears to be justified. However, the negative impact on individual countries might be significant, amounting as it would to an effective reduction in development aid or technical assistance. This trade-off is essentially a political question; but it should be recognized as one that essentially is not about the deployment of resources within surveillance, but rather concerns choices between surveillance and aid. As such, it is largely outside our remit.

[92]We note that the Fund is already increasing the resources devoted to financial sector surveillance.

[93]Without aiming at any precise definition of "small states," we can note that there are some 40 Fund members with populations of less than one million.

More Continuous Surveillance

75. More continuous surveillance has for some time been a Fund objective, and a range of measures such as midyear visits and Board informal country and WEMD sessions have now become a regular feature, along with the long-standing practice of ad hoc bilateral meetings at the time of the Interim Committee and Annual Meetings. These features are further augmented by the work of functional departments—in particular the visits of the capital markets groups from RES, whether to countries or to capital market centers.

76. Can the process be improved further? We think it can. While missions themselves apply modern technology to communicate with headquarters, the surveillance cycle and process as a whole has not fully adapted to it. The process appears very much as when it was designed in the 1960s, despite the increase in the quality and availability of telecommunications and the ease of transmission of data and research on the Internet. That is to say, in the normal course of events the episodic nature of relatively large-scale physical visits still dominates—with a gear-up and wind-down, and a relative lessening of focus as staff turn to other endeavors. But while missions are no doubt an essential way of taking stock from time to time, they should not be allowed to overshadow these other means of communication and information gathering. The staff need to develop such channels with their country contacts. This might mean taking a leaf out of the book of the way these things are done in the private sector, which consciously maximizes electronic contact and minimizes the length of physical visits. We should emphasize that we are not trying to devalue actual visits as part of continuous surveillance. Rather, we are suggesting shorter, more targeted, and perhaps (but not necessarily) more frequent visits.

77. Our discussions with country representatives certainly indicated some receptiveness to updating the process in this way, with consequential savings in the time spent by missions and by their hosts. Accordingly, we think that the Fund should actively experiment with receptive members in enhancing the role of telecommunications in data gathering and in other areas to see what improvements and efficiencies in surveillance can be gained—as a complement to or substitute for actual visits. In the same way, experimentation should also be undertaken in making consultation missions shorter by trying to increase the amount of work that can be done in advance.

> ***We recommend a more conscious focus on the use of electronic means of communication, initially on an experimental basis, with a view to maintaining close contact with policy officials and to reducing the length of consultation missions.***

Technical Assistance

78. While Fund technical assistance as such is outside our remit, surveillance is often to a greater or lesser degree technical assistance. This is particularly the case for small states. However, as we observed and as noted in the 1999 internal review of technical assistance, surveillance and technical assistance are not always as well coordinated as they might be.

> ***We endorse the recommendations of the internal review in this regard—in particular, that area departments should, through the consultation process, seek to integrate the support provided to members through technical assistance and surveillance activities.***

External Contacts

79. Fund missions have been expanding their range of contacts outside the traditional circle centered on the central bank and the ministry of finance. But this expansion does not appear to have been systematic. And while it is understandable that staff would tend to meet people who they feel speak the same language—academics and financial market participants rather than trade unionists, nongovernmental organizations, or others who are often critical of the Fund—this tendency should not be allowed to dominate completely.

80. Although decisions will still need to be taken on a case-by-case basis, we believe there is a role for central guidance to encourage breadth of contact.

> ***We recommend that the External Relations Department monitor and assess Fund practices and experiences to date with a view to giving guidance with the Fund's explicit backing regarding external contacts.***

81. The purpose of such contacts is twofold; both to explain to such bodies what the Fund is and what it does, and to allow those representatives to give their views in areas relevant to the Fund. Meetings should be focused on the surveillance agenda, with the staff making very clear what in that context the Fund does and does not do, and why.[94] We have already made proposals earlier in this chapter for tightening this focus in the Fund's own work in the interests of more effective surveillance. Furthermore, given the interest in shorter missions where feasible, such contacts also would have to be well focused. However, we think that an allocation of a small part of a mission's time for such endeavors is worthwhile.

[94]We believe that this can also help to correct a general and significant lack of understanding of what the Fund is and what it can do.

82. In the same vein, the Board may wish to consider inviting from time to time informed outside observers of the Fund to meet with the Board.

83. On a related topic, in some countries we were informed that representatives of the government, usually the central bank or the department of finance, made a point of accompanying a mission to all meetings, whether with government or private sector representatives. This may be for administrative convenience. Nevertheless, it can in some cases be inappropriate for effective surveillance. However, missions are understandably reluctant to tell governments so.

> ***We recommend that the Fund make clear where necessary that meetings with nongovernmental representatives should take place without the presence of government officials.***

Relations with World Bank and Others

84. We found that coordination between the Fund and the World Bank remained uncertain, particularly in the financial sector area, where the greatest overlaps exist. We are aware that this topic has been studied numerous times, and we do not have any further suggestions to make. However, as is discussed further below, we believe that the Fund should make more effort to make use of work done by others, particularly in areas where it does not have expertise.

Internal

85. In earlier chapters, particularly that on conduct and methods, we described a range of surveillance challenges internal to the institution that emerged from our interviews. These are addressed further here.

Skills Mix

86. In light of the evolving demands of surveillance, in particular the emphasis on more specialized and more sophisticated policy skills, more diversity would seem desirable in three principal areas.

- More financial sector expertise. If the Fund is to fulfill the new demands placed on it in this area, it clearly needs more staff with authoritative experience in the financial sector. This means both people with regulatory and supervisory experience and people with private financial sector experience.
- More policy expertise. Policymaking experience appears to be particularly helpful in surveillance, and this suggests that a sustained effort should be made to encourage it through recruitment—as well as through secondment or

interchange programs—with relevant policymaking institutions in member countries. This may also mean giving greater weight to policymaking expertise in deciding the level at which individual staff are recruited to the Fund.

- More outside experience in general. The dangers, given the large proportion of staff who spend virtually all or most of their careers in the Fund, are insularity, conformity, and lack of hands-on experience. This suggests greater use of external consultants, interchange with member governments, academia, and private sector institutions, and so on.

87. The Fund is aware of its needs in the first area—financial sector expertise. However, more of a conscious program may be needed in regard to the other two.

We recommend consideration of the following specific policy actions:

- ***More emphasis on policy experience, and therefore less on academic credentials, at all recruitment levels, including the Economist Program; and***

- ***Fund staff should be positively encouraged to spend one or more assignments outside the Fund before reaching management grades. Current programs in this area should be expanded, if that proves necessary to ensure adequate opportunities.***[95]

Accountability

88. The Fund has a strong sense of hierarchy, and one downside of this is a lack of individual accountability for the quality of the output. Surveillance material that is submitted to the Board is regarded as the collective output of the Fund, with the full endorsement of management. As a result, responsibility is pushed upward, to management or to the Fund collectively.[96] While it is clearly helpful to the cohesion of the institution for there to be a sense of collective responsibility, it is damaging to internal accountability and incentives if junior or midlevel staff do not feel individual "ownership" of Fund policies or outputs to which they contribute directly. We think that there could be more individual accountability, with the associated good incentives, without damaging cohesion.

We make the following specific recommendations:

- ***There should be as much accountability as possible for papers, staff reports, and the associated policy recommendations. In particular, the staff member most directly responsible for authorship of a paper or staff report, or with greatest knowledge of the country being discussed, should be the main presenter at any Board discussion.***

- ***In the surveillance context, it should generally be the case that one staff member—normally the Division Chief in the area department—has overall responsibility for operational dealings, including leading missions, with an individual member state, and should be held accountable for them.***

89. The Fund is not alone in facing the problem of ensuring that staff are rewarded according to the quality of their output. We do not underestimate the difficulty of this task, which is particularly marked in public sector organizations like the Fund, where pay differentials are smaller and separations rarer than in the private sector. However, at the moment the perception—both inside and outside the Fund—is that success and failure, certainly in the surveillance context, do not translate into career prospects as directly as they might. We are aware that the Fund administration is conscious of these difficulties and has taken some steps to mitigate them. We are also aware that the concentration of elevated ratings under the performance evaluation system is not a totally fair reflection of the extent of differentiation in performance recognition that does go on. Nevertheless, there still remains a problem in sharpening incentives.

Interdepartmental Relations and the Review Process

90. We view communication among departments as being relatively poor. A lack of collegiality between departments inhibits learning from others' experiences and, more generally, the transfer of knowledge within the institution that is so important for its effective functioning. As a result, the Fund sometimes appears to be less than the sum of its—often very impressive—parts.

91. This is particularly apparent in regard to the interdepartmental review process through which all surveillance documents must pass. We certainly do not dispute the necessity for a review process; it is

[95] It has been suggested to us that the role of resident representative offers this kind of experience. We agree that it is different from being in Washington, but we are not convinced that the experience overall is sufficiently different.

[96] The same process takes place within departments; material—even of a relatively mundane nature—is not generally circulated to other departments until it has been collated, reviewed, and approved by departmental front offices. This issue is also addressed below.

clearly essential both for quality control and for knowledge transfer. But, as currently constituted, it is extremely cumbersome, being time-consuming and generating a considerable amount of paper, and perhaps excessively adversarial on occasion. And as a result, as was very clear from our discussions with staff, it is often frustrating for the participants, in both area departments and functional departments, and less constructive than it might be. We think that the process could be streamlined, and the number of participants considerably reduced, while maintaining and indeed increasing the value of the exercise. We think that this could also help knowledge transfer, with less focus on checking and more on adding ideas.

92. While we refrain from making formal recommendations on a detailed organizational matter of this nature, we do have a number of specific suggestions that the Fund might wish to take into account in any examination of its internal processes.

- At present all drafts and comments pass through front offices. As well as reducing accountability and adding an extra level of review, this also takes time away from the other responsibilities of front office staff, discussed below. It is not clear why drafts could not be circulated by their principal authors directly to other departments, with the internal departmental review taking place simultaneously.
- There could be greater use of informal communication rather than written memoranda. The issue behind many written comments could be resolved more efficiently and less adversarily by phone or e-mail. It would be worth experimenting with meetings and the more flexible exchange, even debate, that will then occur—short, focused, and only with the necessary participants—instead of paper messages.
- As noted above, the individuals primarily responsible for reports should be accountable for their quality. It should therefore be their responsibility to solicit comments from other departments and to decide how to take account of them. Other departments should normally restrict their comments to their areas of responsibility, and avoid drafting comments.

93. In this context, it is worth mentioning the role of PDR, which provides an important central monitoring and quality control function, and whose signing-off role should therefore be retained; although this does not imply that PDR, like other departments, could not reduce the resources devoted to the process. It is in large part PDR's responsibility to ensure that general policies are implemented, and that staff reports do indeed address the key issues, focus on international aspects, and are frank and direct. Correspondingly, our proposals to limit the scope of consultations should help to reduce the burden of checking off that all consultation bases are touched.

Front Office

94. The Fund departmental management structure appears to be rather top-heavy; in particular, the current number of staff in departmental front offices appears large compared to other organizations, public and private sector. And, as noted above, front office staff seem to spend a disproportionate amount of time on the interdepartmental review process—both in approving the drafts of their own departments, and preparing and collating comments on other departments' drafts—an activity which could be streamlined considerably.

95. If, as we see it, many in the front offices of area departments act in effect as senior division chiefs, it is appropriate to see whether they should be moved into divisions, with a corresponding reduction in the size of the front office. This would help internal accountability. Another concern that we were left with is that while an important role of the front office in general should be to take an overall view—particularly as regards knowledge transfer—we are not at all convinced that this key role is being filled under present arrangements, where keeping up with the area's own country surveillance agenda dominates everyone's time and thinking.

> ***We recommend that front offices in area departments be made clearly accountable for ensuring that bilateral surveillance incorporate cross-country and multilateral perspectives.***

96. This will involve keeping up with relevant analysis and research both in other Fund departments and outside.

Overwork

97. There is no doubt that many Fund staff are chronically overworked. While the willingness of staff to work long hours is commendable, and contributes to the Fund's impressive capacity to respond quickly to crises, this inevitably reduces the general effectiveness of surveillance, as well as that of other activities. In particular, it is conducive to "tunnel vision"—the inability to look outside, take the long view, or examine alternatives—simply because the pressure of deadlines in getting through the regular surveillance calendar is in many instances so great.

98. On a related topic, there is a need for more and higher-quality research assistant level staff to relieve junior professional staff of low-quality work. This is

being pursued, but we note that at the present pace it will be some time before the professional/research assistant ratio is comparable to that of other similar institutions.

99. The greater focus and prioritization in surveillance that we recommend, together with a number of the other recommendations, could help to relieve the pressure on staff. However, for this relief to be realized, the organization as a whole needs also to practice constant vigilance and restraint so as to avoid getting drawn into interesting but lower value-added areas.

We recommend that the overall volume of surveillance work be reduced relative to the number of personnel engaged in it.

General Organizational Issues

100. The Fund faces a rapidly changing external environment. This constantly generates new demands and challenges, both for surveillance and for the Fund's other functions. With the current debate over reform of the international financial architecture, this is the case now more than ever. In this context, we think it is worth examining whether the internal workings of the Fund—its organizational structure, how it is managed, the recruitment, composition, and skills of its staff, and its internal functioning and procedures—are well adapted to these new challenges.

101. The challenge of rapid change is not unique to the Fund. A number of the issues discussed above, in particular those related to accountability, incentives, hierarchy, and management structures, are ones that are faced by most large public sector institutions, and that have been sharpened by recent changes in the role of the public sector. These issues are particularly difficult in "policymaking" institutions like the Fund, and we do not wish to minimize the complexities here, or suggest that management and senior staff are not seized of the issues. However, we do note that many policymaking institutions—as well as large organizations in the private sector—in the Fund's member countries have undertaken fundamental management and organizational changes in the past 10 years; the example of New Zealand springs immediately to mind, but many others have gone at least part way down similar roads.

102. The Fund has not in recent decades undertaken a fundamental review of its organizational and management structure in the light of its objectives. However, we are not aware that the Fund is so different from other policymaking institutions that have benefited from such reviews. Given the changes taking place in the international financial architecture—and the Fund's evident integral role—current circumstances might provide an opportunity for such an examination.

External Relations and Relationships and Review

103. This is a broad area, and we limit ourselves to some observations directly related to surveillance.

104. The Fund has moved a considerable distance in the amount it publishes on surveillance (as well as on other subjects). However, the basic point we want to underline here is that it is desirable for the Fund not only to communicate the results of its work and thinking to others, but also to take pains to show that it listens to and learns from others.

105. In this regard, we were struck by the fact that staff reports typically do not contain references either to academic literature or, perhaps more tellingly, to the output of other organizations, or to the financial press.[97]

We recommend that the staff:

- ***systematize and organize their use of outside information with a view to applying it in surveillance; and***
- ***refer to and/or summarize work produced by other organizations where relevant.***

106. Finally, we note that while the Fund should of course continue with its internal reviews of surveillance, and while publication of consultation reports should help in terms of accountability and maintaining or improving quality, we also believe that a systematic external review process (as distinct from external evaluation) would also help to provide continuous upward pressure on quality.[98] For example, external review of some proportion of individual staff reports by invited outside reviewers (normally academics with country-specific knowledge or possibly former officials) would be relatively inexpensive, but could provide a salutary check on the internal process and conventions.

We recommend that the Fund experiment with external review of a sample of staff reports.

Executive Board

107. In the earlier chapter on conduct and methods, we summarized our discussions regarding the role of the Board—pointing to a number of problems that had been registered. Some of those problems are

[97]One staff member pointed out that the 1996 staff report on Korea was produced just after an *Economist* survey, which had a detailed description of the financial problems of Korea's corporate sector. However, the staff report did not cover this topic, and made no reference to the *Economist* survey.

[98]The external evaluation process, of which this evaluation is a part, can only look at issues in a one-off fashion. It is not the same thing as an ongoing process of external review and evaluation of the day-to-day surveillance output of the Fund.

congenital, reflecting the way that the international community has designed the basic arrangements for Fund governance. Nevertheless, everything we know about institutional governance indicates to us that a group of 24 is, to put it mildly, extremely large for useful exchanges of views, discussion, and group decision making. Accordingly, the Board starts with a major impediment. This impediment is particularly striking in the area of surveillance, given the huge workload and given the crucial role that the Board is supposed to play in the Article IV consultation process.

108. If a regular, functioning, Board committee structure were easy to set up, it surely would have been by now. The glaring absence of meaningful committee work speaks volumes for the constraints under which Directors apparently operate, de facto if not legally, as country and constituency representatives. That may well mean that in tackling the question of the Board's role in surveillance we are looking at symptoms rather than causes. However, on the assumption that there is a general desire to have the Board operate more effectively in the process, and that a look from the outside is worth something in this regard, we strongly urge that serious consideration be given to instituting a committee structure that specifically aims to make the Board's contribution more effective.[99]

We recommend that all Article IV staff reports be discussed in the first instance in a committee rather than by the full Board.

109. We should emphasize that this does not mean that the full Board would not get a chance to discuss individual countries; nor do we mean that each staff report should be discussed in depth twice, thus increasing rather than reducing the workload. Rather, those discussions would take place on the basis of a committee report that provided focus and, where possible, grouped countries in the same region or facing similar issues. Indeed, by allowing a committee to set the agenda for a focused discussion of the full Board, our proposal should strengthen the Board's involvement, and perception of ownership, in the surveillance process. Consistent with our general recommendations, the full Board should aim to focus its discussions on the international environment and cross-country issues, as well as on the main domestic issues.

[99]Agreement on two or three lead speakers to focus each discussion at Board surveillance meetings, as they are presently constituted, would be an improvement over current arrangements. However, we believe that the gains in terms of a more active Board contribution to Fund surveillance activities would be much greater through a committee structure.

110. We believe that, if implemented effectively, such a system could both improve the Board's contribution to the surveillance process—and consequently the process as a whole—and reduce the time spent by individual Directors discussing surveillance material. While there may be some additional work for staff as a result, we think this would be a worthwhile tradeoff. It will, however, require the Board—collectively and individually—to adopt the working practices necessary to make a committee structure function efficiently. Without this determination, a committee system would not improve matters.

111. An illustrative committee structure is described in Box 5.1. Clearly, other structures would be possible. However, if significant benefits are to be realized, a radical change in the Board's working procedures is necessary.

Communication

Publication of Article IV Reports

112. Transparency, whether to enhance accountability, to help markets function better, or to increase the effectiveness of surveillance, now appears well established as an internal principle in the Fund. The difficult issues in regard to surveillance have come not in relation to this principle, but rather in agreeing on how far or in which direction transparency can be extended without in some respect compromising the effectiveness of surveillance.

113. On this latter score, the chief reservations against extending transparency through publication of the Article IV consultation reports have been twofold.

- The Fund's role as policy adviser would be weakened severely by publicity. Governments will be unwilling to engage in frank discussions about policy options if the results of those discussions are to be made public.
- Publication of policy analysis and views could precipitate exactly the sort of crisis that it was meant to avert. Indeed, this might occur even if the analysis is actually incorrect or merely overly pessimistic.

114. However, in weighing the benefits and costs of publication from the viewpoint of surveillance, the team found these costs to be distinctly less onerous than they might appear in general.

115. Our main reason for discounting the damage that might result from publication is the fact that Article IV reports are not, in the event, kept very confidential. When one considers the worldwide distribution that such reports have to receive, it would be surprising indeed if they were not fairly readily accessible to a determined, informed, interested party.

Box 5.1. Possible Board Committee Structure for Surveillance

We propose that most surveillance work be conducted through committees. In particular, the first consideration of all Article IV staff reports should be at the committee level. We suggest that these committees be organized on a regional basis. This would have the additional advantage that the committees could have an input into regional surveillance as well as into the bilateral Article IV process.

The main points of such a structure might be as follows:

- There would be one Executive Board committee for each area department, so a total of six committees.
- Each committee would have eight members. Ideally, four of these would be from within the relevant geographic region, and four from outside.[1] Each Executive Director would thus be on two committees; his or her own regional committee, and one other:[2]
- The committees would consider Article IV staff reports. In addition, they could commission and consider additional analysis from the area department on regional issues.
- The committees would, on the basis of proposals from staff, agree on the two or three key issues on which upcoming Article IV consultations would focus (see the section of this chapter on objectives and priorities).[3]
- Nonmembers of the committee could attend as observers, but normally would not speak. They could submit written views if they wished, but this would not be encouraged.[4]
- The committees would propose to the full Board draft Article IV conclusions, normally on a lapse-of-time basis. These conclusions would only be discussed by the full Board if there were a significant difference of view within the committee or if there were significant objections from nonmembers of the committee. Any Board discussion would focus on these areas of disagreement.
- Every quarter, the full Board would discuss each region, on the basis of a report from the regional committee. This report would discuss developments in the region and would highlight major regional issues and potential problem countries. Reports, which would be the responsibility of the committee, would be drafted by staff from Directors' offices, with input from area department staff as required.

The advantages of this procedure would be the following:

- A substantial reduction in the amount of time spent by Executive Directors on Article IV staff reports. Each Executive Director would be on two committees out of six, and would thus consider approximately one-third of all staff reports in the first instance.
- More constructive discussion on reports, since they would be discussed in a committee of 8 rather than a Board of 24.
- More focused discussion in the full Board, which would only discuss important issues, problem countries, and issues where there was a significant disagreement among Directors.
- Greater attention to regional surveillance and cross-country issues.
- An opportunity for the Board, through the committee process, to have a more systematic input into the issues considered by staff in bilateral and regional surveillance and into the agenda of the full Board.

[1]Since area departments do not each contain four Board constituencies, this will have to be adjusted in some cases.

[2]Chairs would rotate and be from outside the region. Alternatively, it would be worth considering having Deputy Managing Directors in the chair, if this were thought to improve the process.

[3]In practice, staff could prepare a brief report to the committee each quarter, stating that Article IV consultations were scheduled and what the main focus of discussions would be for each.

[4]This is a small but important point. If all Directors feel they must participate in all committees, little increase in focus will result, while the demands on the time of Directors and staff will increase.

Debt rating agencies may obtain them directly from a country being rated. Others may get hold of them through third parties. Our discussions with a wide range of interviewees fully confirmed this view.

116. To be more precise, it is a sound assumption that the major international market participants already have, in various ways, fairly ready access to these reports. Furthermore, to the extent that they find them useful to act upon, they will do so. It then follows that any adverse market impact from publication would be quite modest. Note, however, that the modest nature of the impact applies both ways—not only in mitigating the adverse effect of actually precipitating a crisis through publication, but also in lessening any favorable effects through improved market information and, presumably, market discipline.

117. There is a second consideration as to why the costs of publication would be low. The fact that Article IV reports are very likely to have a significant circle of unauthorized readers also appears to affect what is put in them. Again, our wide-ranging discussions led us to the view that either governments do not engage in as frank and as confidential discussions as many suppose, or, alternatively, that mis-

sions (quite possibly with the tacit agreement of officials) filter those discussions to minimize potential embarrassment in the written report.[100]

118. Clearly, this should affect one's view as to the importance of the first concern with publication that was mentioned—namely, that the frankness of the consultations would suffer. Equally clearly, anyone who still feels that they are likely to find bombshells if they get their hands on a Fund report is likely to be disappointed.

119. One conceivable conclusion from this is that it is not particularly worthwhile to publish the reports—their contents already having been absorbed by market participants, in addition to having been leaked occasionally to the media. However, this would in our view not be the correct conclusion. Admittedly, there is little to be gained in terms of market functioning or even Fund impact through markets. However, there are still definite gains to be had. One, of a subsidiary nature, is that consistent publication would establish a more level playing field as regards the information available—a generally good thing. More broadly, publication would increase the Fund's accountability.

120. One aspect is the increased accountability to the public in general—the taxpayer, the voter. This also enhances the Fund's broad political legitimacy. Another, of particular interest to the team, is the systematic availability of more comprehensive information on the kind of advice given. This in turn should allow more informed criticism, favorable or otherwise, of that advice. And this should, correspondingly, act to enhance the quality of that advice, or at least keep it up to the mark. In particular, referring back to earlier discussion in this chapter, there would be a wider range of judgment as to whether the advice was sufficiently frank in the circumstances ("clientism") or whether the Fund diagnosis or model was adequate or too rigidly applied ("template"). To the extent such criticisms held water, the incentive to improve would be greater.

121. One possible objection to publication is that this would provide material that could be used to criticize, even unfairly, the member government, and that some are better able to deal with such criticism than others. We appreciate this point but do not regard it as conclusive. Dealing with criticism is not necessarily a bad thing. Furthermore, it is now generally accepted that the Fund is not infallible, and publication of its advice is as likely to draw criticism of that advice—again, fair or unfair—as it is to be used to criticize the recipient.

We recommend that the Fund should publish on a regular basis the complete text of all Article IV reports.[101]

122. It should be added here that we believe that these reports should not be vetted before publication, either by the member in question or by the Fund, to remove "highly market-sensitive" material. This is consistent with our position that the reports already receive substantial self-censorship, given the chances that they would be leaked. Also, of course, such vetting would muddy the waters as regards accountability. While we appreciate the reasons for the "highly market-sensitive" reservation, in the circumstances that we have analyzed in this section, we are not persuaded by them. However, if the reservation is kept, we think that the process would become more internally transparent, and hopefully more rigorously consistent, if proposals for exclusion were brought back to the Board for active consideration rather than being left to the Director in question and the staff to resolve, as is now the case with the PIN.

123. We are aware that there is now a pilot project that involves the voluntary publication of about twenty Article IV staff reports over a year. It is not clear to us what this process will demonstrate, given the self-selection bias that is involved in what is published, although we are aware that efforts are being made to gather a "robust sample" of countries. It would, however, set a precedent along the lines that we recommend pursuing on a comprehensive basis, except that the project envisages, as in the case of the PIN, the exclusion from publication of material that is deemed highly market sensitive.

Where Confidential Exchange Fits In

124. Given the importance that some members have placed on their ability to have a confidential exchange with the Fund, we return here to that question.[102]

125. The basic point made in this section is not that confidential exchange should be ruled out. Rather, it is that the consultation process—involving as it does an inevitably broad international peer review of a

[100]An interesting recent example—since it relates to a large industrial country whose economy is generally performing well and which might therefore be expected to be less sensitive—is the United Kingdom. A number of Executive Directors complained that the most recent staff report made only passing reference to EMU—clearly the most pressing medium-term macroeconomic issue—and expressed their belief that this reflected the staff's view that the U.K. authorities would not welcome such a discussion.

[101]We recognize that there are some legal issues here. The Fund could publish a staff report—provided that it did not contain the views of the Executive Board or any confidential material provided by the country—without the country's permission. However, if the report contained the Board's views, significantly more restrictive criteria would apply. We take the view that if the Board decides in principle in favor of this approach then these issues can be resolved.

[102]See also the note by Chairman John Crow, "Confidential Exchange—An Elaboration," included as Appendix V of this report.

member's policies in the light of that member's statutory obligations to the Fund, in other words, "firm surveillance"—is not realistically to be thought of as a confidential exchange. Furthermore, as we have suggested, given the on-the-ground reality of consultations, little in terms of the quality of the consultation should be lost by making the reports public. And, on balance, with the increased openness the impact of surveillance would be enhanced.

126. We also believe that any need for confidential exchange, as there might well be, for example, over hypothetical policies, should be dealt with outside the framework of the Article IV consultations. Any such discussions could only be reported to the Board in a quite general way if their substance was expected to remain confidential. Such confidential discussions (as one of our interlocutors put it, "to bounce off ideas") could be held at mutual convenience and in any form or venue that seems appropriate. They could even take place in the margins of the formal Article IV discussions (as, we suspect, they already do).

The Role of the PIN

127. Where would our recommendation leave the PIN? While its general significance would clearly be diminished, it would in one crucial respect not be superseded—namely, in regard to the expression of Board views that concludes the consultation process. Of course, it might well be that views expressed in the Board will sometimes be at variance with those in the staff report. Then, outsiders would see this more clearly. This should not be a particular cause for concern. Of course, if differences were to persist, this would be a cause for concern that the Fund would need to address—as it would even if the reports were not published.

128. The issuance of a PIN should also, of course, be standard, not voluntary.

129. In particular, the PIN should set out clearly the consensus or majority view of the Board on the main policy issues (rather than, as now, emphasizing the diversity of views). Furthermore, perhaps now that some two years of experience have elapsed, there will be more confidence in moving the PIN to a more straightforward level of communication.

We recommend that the Fund intensify its efforts to make the PIN more reader-friendly.

Recent Developments

130. As we have worked on this report, a number of new proposals related to surveillance have emerged from policymakers inside and outside the Fund. We were not able to discuss these new initiatives in depth with country officials and other interviewees, since they were—and are—still in the process of development. However, in this section we discuss two—the application of international standards in country surveillance, and Contingent Credit Lines—that are likely to have particularly important implications for the topics that we cover.

International Standards

131. The Fund has made significant progress in implementing better statistical standards for an important segment of its members. Similarly, in two of its areas of core competency—fiscal and monetary policy—the Fund has developed a "Code of Good Conduct on Fiscal Transparency" and is well on its way to formulating a similar code for monetary policy in cooperation with major central banks and the BIS. These efforts are intended to help in making important aspects of surveillance more standardized and objective through the detailed checklists provided by the codes.

132. However, it is worth noting that even in the Fund's core area of expertise, this will present challenges. Monitoring standards of fiscal transparency is not the same thing, and does not necessarily require the same skills, as monitoring the stance of fiscal policy. Monitoring standards is likely to require substantially more institutional knowledge, cross-country experience, and perhaps background in policy formulation and implementation (and correspondingly rather less in the way of basic macroeconomic modeling skills). This reinforces a number of our earlier recommendations:

- the need for a more diverse skills mix among Fund staff;
- the increased focus in surveillance on knowledge transfer and cross-country experience; and
- the need to integrate better the work of functional and area departments, with missions making greater use of functional department staff.

133. These points are perhaps most important in the financial sector area, which has proved once more during the Asian financial crisis to be closely related to the Fund's macroeconomic concerns, and which, as discussed above, is clearly important to more effective surveillance. For a limited number of countries—perhaps a dozen a year—specialized missions that would prepare Financial Sector Stability Assessments (FSSAs) are now envisaged. This will require additional staffing, largely in the form of temporary support from central banks and other financial supervisors, in addition to intensified cooperation with

the World Bank, particularly in nonindustrial countries. The Fund's plans in this area seem realistic and appropriate, provided the Fund can succeed in attracting temporary contractual expertise to assist its permanent staff, since it would take a long time to build up in-house expertise in the areas required for the FSSAs.

134. However, this task seems demanding enough. We are concerned that if, as the G-7 finance ministers propose,[103] Article IV consultations are expected to cover, in addition to the financial sector issues addressed by FSSAs, monitoring of country compliance with numerous other international standards, then overstretch is inevitable. In our view, in areas such as securities market regulation, accounting and auditing, bankruptcy legislation, and corporate governance, the Fund staff lack the professional capacity to participate in developing the relevant international standards, and arguably even to monitor them. In most of these cases, other international institutions such as the World Bank, the OECD, the Basle Committee for Banking Supervision, and private or international organizations—the International Organization of Securities Commission (IOSCO) and professional associations of lawyers, accountants, or auditors—have developed international standards on which international monitoring might be built. But in several cases the standards remain incomplete, either because there are outstanding disagreements or because the geographical coverage of the preparatory work has been far less than global.

135. More important, monitoring these standards is in most cases not a simple matter of "ticking boxes," as it is sometimes presented; it requires a considerable degree of professional expertise, and the ability to ask probing questions in a variety of areas. Without in any way detracting from the capacities of Fund staff, we think it is unreasonable to ask them to acquire the requisite expertise across such a wide range of topics, especially given the overstretch that exists already. In other words, we do not believe it to be realistic to incorporate the monitoring of international standards outside the Fund's core areas of responsibility[104] into Article IV consultations.

136. Instead, we are attracted by the idea developed, for example, by Eichengreen (1999), that not only the formulation of the international standards, but also their monitoring, should to the largest extent possible be the responsibility of the above-mentioned organizations and associations. The Fund would simply report their views on country compliance in an annual publication and on its web site (as the *Annual Report on Exchange Arrangements and Exchange Restrictions* already does). Not only would this reduce the problem of overstretch, it would also soften a potentially serious conflict of interest for the Fund, since compliance with standards will be one of the criteria that the Fund will have to consider in connection with elegibility for the Contingent Credit Line (see below).

We recommend that outside the Fund's core areas, monitoring international standards to the maximum extent possible be delegated to the responsible international bodies, with the Fund's role largely confined to that of a clearinghouse for information.

Contingent Credit Line

137. The Contingent Credit Line (CCL) is a direct response to the contagion observed in and around the Asian crisis. In particular, some argued that while financial crises in certain countries were clearly related to macroeconomic imbalances or weaknesses in the banking system, the crisis quickly spread to other countries where weaknesses were less obvious or immediate. In other words, some international investors were simply pulling out of all emerging markets, without looking closely at individual countries' fundamentals. For example, immediately after the Russian devaluation and default of August 1998, there was a dramatic widening of interest rate differentials between almost all emerging markets and the large industrial countries—even though economic fundamentals in many emerging market countries were clearly wholly different from those in Russia.

138. The CCL proposes to provide a form of insurance to Fund members with sound fundamentals, by allowing them to "prequalify" for the use of Fund resources, if they are affected by a crisis of confidence not obviously linked to their own policies and performance. Ideally, if the CCL succeeds in its objectives, the resources themselves need never be used, since their availability should in itself give the markets confidence that the country will not suffer a financial crisis.

139. A decision to set up the CCL, initially for one year, was adopted by the Executive Board in April 1999. For a country to qualify, the Board will have to satisfy itself that four sets of conditions have been met:

- that the member is unlikely, on the basis of current policies, to need Fund resources;
- that its policies have received a "positive assessment during the latest Article IV consultation"

[103]Communiqué of April 25, 1999.

[104]To reiterate, we consider that the core areas of responsibility are exchange rate policy, macroeconomic policy, financial systems, and capital account issues. While the Fund's current view of the core seems more expansive than that—see, for example, the discussion in Chapter I of this report—it does seem that on this question of international standards, the Fund's view and ours do coincide.

and beyond; and that the member adheres to "relevant internationally accepted standards";

- that the member has appropriately involved private sector creditors in limiting external vulnerability; and
- that a satisfactory economic and financial program has been submitted.

140. The CCL will blur the previously clear distinction between Fund surveillance and application of conditionality. We have in our interviews and analysis accepted the time-honored distinction in these two types of relationships between the Fund and a member; surveillance is the peacetime activity, while the conditionality attached to the use of Fund resources involves much tighter monitoring, typically based on quantitative performance criteria.[105] However, this neat distinction between surveillance and conditionality would not be applicable following the introduction of a CCL. This would clearly have major implications for surveillance procedures in all the dimensions that we have tried to evaluate: conduct and method, substance of advice, and impact. We believe that these implications tend to reinforce our principal conclusions:

- Surveillance would have to become more continuous, since if policies went off track between annual consultations, the Fund would have to withdraw access to the CCL.
- Staff appraisals and Board conclusions would have to become clearer and more unambiguous, since the Fund would have to determine whether a member is or is not eligible for the CCL.
- Surveillance would have to become more focused on the macroeconomic and external issues that are the core competency of the Fund, since it is these that will be most relevant to a country's ability to qualify for the CCL. Moreover, more attention will need to be paid to external vulnerabilities.
- Since it will presumably be made public which countries have qualified for the CCL, the case for publishing the Article IV staff reports, which will form the principal basis on which the Fund decides whether a country should qualify, will be strengthened.

141. The new facility also has attractions in terms of increasing the impact of surveillance. We have noted that in general, impact has been low; and that in large part this is simply a consequence of the fact that as long as members do not expect to have to draw on Fund resources, external advice is unlikely to have as much impact as internal forces. But since a positive assessment of economic policies and performance is a prerequisite for qualifying for use of the CCL, the clout of surveillance is likely to increase significantly. From this perspective, a well-designed CCL would add to the potential effectiveness of surveillance.

142. However, we do have some concerns. Our earlier discussion suggests some grounds for skepticism as to the ability of the surveillance process, as currently constituted, to discharge the demanding tasks highlighted by the adoption of the CCL. In particular, we see three possible problems:

- the difficulties of applying internationally accepted standards in an increasing number of complex areas, discussed above;
- the additional tension between the Fund's traditional role as a policy adviser and the need to become in effect a rating agency; and
- the likelihood that the Board will come under pressure to become lax in its judgment as to whether a member has met the criteria for qualifying for the CCL, and the even greater difficulty of withdrawing the CCL if a member's policies or situation deteriorate materially.

143. As regards transparency, we have tried above to define what we understand as the remaining scope for confidentiality prior to the adoption of the CCL. Since the whole idea of the CCL—a public demonstration of the Fund's faith in a country's policies and prospects, designed to engender market confidence—requires publication of the decision to commit resources to a member under the new facility, the CCL can only enhance the need for transparency. On the other hand, some national authorities may be unhappy at the prospect of discussing their reaction to possible unfavorable disturbances in the knowledge that such exchanges would be included in a published document. Even when such discussions become essential in prequalifying for the CCL, some role may need to be preserved for confidential exchanges, though the Board will need to be more fully informed than through subsequently published Article IV reports. This would enhance the role of the informal country matters and WEMD sessions in the Board.

[105]Some of the countries we have looked at more closely have passed from one state to the other as they entered into Fund programs: Thailand in July 1997, Korea in December 1997, and Brazil in November 1998. In accordance with our terms of reference, and since the Fund involvement in—and influence over—a member's policies changes qualitatively around such dates, we have confined our study to surveillance in the classical sense. Of course, as mentioned in Chapter I, the advice given in the surveillance context is to some extent likely to foreshadow program conditionality. But if, as in these countries, the program follows a crisis, circumstances will have changed significantly, and so necessarily will the Fund's policy prescriptions.

144. Finally, there is a clear risk that the Board, given the tradition for individual Executive Directors to defend the interests of their respective constituencies and to show considerable deference to each other, will be reluctant to deny CCL status to a country that seeks it. Even more so, it will be very difficult, given the possibility of adverse market reaction, to "downgrade" a country whose performance has deteriorated since the initial commitment (of course, this problem exists already with respect to Fund-supported programs). In our view, this emphasizes the need for greater frankness in staff reports, greater transparency, and more pointed discussions in the Board. Moreover, formulations such as "some Directors felt . . . ; however, other Directors stressed . . ." will not be useful in a published PIN, no matter how accurate the rendering of the discussions. The Board will have to assume a greater degree of collective responsibility in cases where a CCL decision is proposed than has been customary in discussions of Article IV reports.

145. On balance, the addition of the CCL facility should add to the effectiveness of surveillance by raising the demand for high-quality assessments by Fund staff and the Board and by adding financial clout to surveillance, hence strengthening its impact. But the CCL and the associated reliance on complex, largely judgmental, considerations and on a number of international standards will also further expose some of the weaknesses in past surveillance to which we have drawn attention in this report.

Appendix I Terms of Reference

1. Purpose of the Evaluation

The Executive Board of the International Monetary Fund has decided to request independent external experts to conduct an evaluation of Fund surveillance over members' policies under Article IV of the Articles of Agreement. The purpose of the evaluation is to assess the effectiveness of Fund surveillance and to make recommendations for improvements consistent with the purposes of the IMF as defined in Article I.

2. Focus of the Evaluation

The evaluation will focus on the effectiveness of all aspects of Fund surveillance over members' policies and will be carried out by three independent external experts, as indicated in Section 3 below. The experts are requested to include in their evaluation all channels and instruments of Fund surveillance, including bilateral surveillance, regional surveillance, multilateral surveillance and the content and format of the World Economic Outlook, and surveillance of international capital markets and financial systems and of the provision by member countries of economic and financial data to the IMF and the public. The experts are requested to consider four broad topics in their evaluation of Fund surveillance, including on the basis of case studies as indicated in Section 4 below:

A. The effectiveness of surveillance in identifying those macroeconomic, structural, and financial weaknesses and imbalances in member countries and the world economy that are an obstacle to achieving sustainable noninflationary economic growth and external viability.

B. The substance of Executive Board and Fund staff surveillance recommendations: are these policy recommendations of the appropriate relevance, realism, and timeliness?

C. The impact on members' policies of the Fund's surveillance recommendations: has an appropriate impact been achieved, and what does impact depend upon?

D. The conduct and methods of surveillance: how helpful are the procedures of surveillance, the resources and staff skills employed, the means of interaction with member country authorities, and the dissemination methods of Executive Board surveillance conclusions?

In focusing on the above topics, the experts may wish to be aware of the following more specific questions that are of interest to Executive Directors:

(i) How did the Fund's advice correspond to the short-term objectives and medium-term strategies of existing policies?

(ii) How did this advice correspond to the analysis and advice of other domestic and international institutions? Did the Fund's advice add value?

(iii) Has Fund surveillance paid sufficient attention to regional surveillance, to interaction among countries, and to the external effects of policies in major countries?

(iv) Did surveillance have different impacts in different groups of countries?

(v) Have the frequency and general focus of the Fund's surveillance been appropriate with hindsight? Has advice been consistent? Has advice helped foster noninflationary economic growth?

(vi) How successful have been the specific efforts made since early 1995 to strengthen surveillance? What effect have these efforts had in the context of the difficulties emerging in some Asian countries in 1997? How has the provision of information by the authorities affected surveillance?

(vii) Did the advice take into appropriate account the institutional, political, and social framework? Did it pay adequate attention to the uncertainties and political constraints that lead to "small" deviations from first-best policies?

(viii) Was the Fund's advice implemented? If not, why?

(ix) Did the Fund balance openness and sensitivity appropriately from the authorities' perspective? How helpful were the documents that emerged from bilateral surveillance? How useful were the methods to make surveillance conclusions available to the public? Should the Fund go further in publishing country reports?

(x) How did governments disseminate surveillance conclusions within and among government institutions? Was the circle of participants limited to economic agencies?

(xi) How do you assess the role of the Executive Board in surveillance?

3. Evaluators and Their Independence

Mr. Ricardo Arriazu, Mr. John Crow, and Prof. Niels Thygesen, working as a team, have agreed to conduct the evaluation; Mr. Crow will serve as chair. They shall conduct their work freely and objectively and shall render impartial judgment and make recommendations to the best of their professional abilities. At their full discretion, the evaluators may wish to take into account the views of member country authorities, parliamentarians, academic experts, representatives of other international organizations, representatives of the business and financial market communities, representatives of civil society and the media, and Fund Executive Directors and staff.

4. Selection of Countries for the Case Studies

The evaluators are requested to base their conclusions, in part, on the study of a limited number of country cases. The selection of country cases will be the responsibility of the evaluators. Countries chosen for study should be representative of the Fund's membership in terms of size, geographic location, and the variety of the macroeconomic, structural, and financial issues encountered. The effectiveness of Fund surveillance in these countries should be evaluated over a time period that is long enough to allow such insight as is possible into acceptance and outcome of surveillance recommendations and during which the countries received no, or at most sporadic, disbursement of Fund resources.

Appendix II Articles of Agreement

For the purposes of the surveillance evaluation exercise, the following are the relevant parts of the Fund's Articles of Agreement.

Article I

The purposes of the International Monetary Fund are:

(i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The Fund shall be guided in all its policies and decisions by the purposes set forth in this Article.

Article IV

Section 1. General Obligations of Members

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

(i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

(ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;

(iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and

(iv) follow exchange policies compatible with the undertakings under this Section.

Section 3. Surveillance Over Exchange Arrangements

(*a*) The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article.

(*b*) In order to fulfill its functions under (*a*) above, the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies. Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies. The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members.

Appendix III List of Interviewees

The list below is set out as follows. We do not separately identify Fund staff or Executive Directors by name. We list the people we met on our country visits by country, identifying their position at the time of the interview, or relevant former affiliation. Separately, we list officials of other governments and international institutions, academics we saw outside specific country visits, private sector, and NGO representatives. A number of those we met were former members of the Fund staff or management, or Fund Executive Directors; these are identified by an asterisk. We apologize for any errors or omissions.

Staff

We met with a large number of Fund staff (more than 50). Among senior management, these included the Managing Director, Deputy Managing Directors, and senior management from the relevant area and functional departments. We also met with the staff directly responsible for surveillance for the countries in our sample, and, formally and informally, with numerous other staff in a variety of departments and at a variety of levels.

Executive Directors

We met with a number of Executive Directors (representing the majority of Executive Board constituencies), their Alternates, and Advisors.

Brazil

Ana Teresa H. De Albuquerque, Secretaria do Tesouro Nacional
Edmar Bacha, Creditanstalt, formerly Secretaria do Tesouro Nacional
Fabio O. Barbosa, Secretaria do Tesouro Nacional
Gustavo Bussinger, Banco Central do Brasil
*Daniel L. Gleizer, Credit Suisse, First Boston
Eduardo Refinetti Guardia, Secretaria do Tesouro Nacional
Francisco L. Lopez, Governor, Banco Central do Brasil
Gustavo Loyola, Tendências Consultoria Integrada, formerly Governor, Banco Central do Brasil
Demosthenes Madureira de Pinho Neto, Banco Central do Brasil
*Alvaro Manuel, Ministry of Planning
Alkimar R. Moura, Escola de Administraçao de Empresas de Sao Paulo, formerly Banco Central do Brasil
Claudio Ness Mauch, Banco Central do Brasil
Mailson F. Da Nóbrega, Tendências Consultoria Integrada, formerly Minister of Finance
Marcelo Piancastelli de Siqueira, Secretaria do Tesouro Nacional
Roberto Egydio Setubal, President, Brazilian Bankers Association
Jose Tavares, Ministry of Planning

Chile

Vittorio Corbo, Universidad Católica de Chile
Alejandro Foxley, Senator, formerly Minister of Finance
Guillermo LeFort, Banco Central de Chile
Carlos Massad, Governor, Banco Central de Chile
Joaquin Vial Ruiz-Tagle, Ministerio de Hacienda
Juan Villarzu, Empresa de Obras Sanitarias de Valparaiso, formerly Secretary General to the Presidency
Roberto Zahler, Zahler & Co., formerly Governor, Banco Central de Chile

China

Weiping Di, State Development Bank
You Guo, China Everbright Bank
Hongbo Huang, State Administration of Foreign Exchange
Weiping Huang, Renmin University of China
Hongmei Han, State Administration of Foreign Exchange
Xuejun Kang, Ministry of Finance

Mingzhi Liu, People's Bank of China
Zhengming Liu, People's Bank of China
Yiping Peng, China Everbright Bank
Jie Shao, State Administration of Foreign Exchange
Hong Sheng, Beijing UNIRULE Economy Research Institute
Gouqing Song, Beijing University
Sining Tang, State Administration of Foreign Exchange
Benhua Wei, People's Bank of China
Fulin Wu, China Everbright Bank
Ping Xie, People's Bank of China
Junmei Yang, Ministry of Finance
Xian Zhu, Ministry of Finance

Czech Republic

Richard Falbr, Confederation of Trade Unions
Ota Kaftan, Czech National Bank
Miroslav Hrncír, Czech National Bank
Vaclav Klaus, Member of Parliament, formerly Prime Minister and Minister of Finance
Ivan Kocarnik, Ceska Pojistovna, formerly Minister of Finance
Pavel Kysilka, Czech National Bank
Vera Masindova, Czech National Bank
Ludek Niedermayer, Czech National Bank
Pavel Stepanek, Ceska Spositelma
Josef Tosovsky, Governor, Czech National Bank, formerly Prime Minister

Hong Kong SAR

Gary Coull, Global Emerging Markets, Crédit Lyonnais
James Lau, Hong Kong Monetary Authority
George Pickering, Bank for International Settlements
Andrew Sheng, Hong Kong Security and Futures Commission

India

Shankar N. Acharya, Ministry of Finance
Montek Singh Ahluwalia, Planning Commission
Shri Chidambaran, formerly Minister of Finance
Tarun Das, Ministry of Finance
Sandip Ghose, Reserve Bank of India
Omkar Goswami, Confederation of Indian Industry
V. Govindarajan, Ministry of Finance
*Bimal Jalan, Governor, Reserve Bank of India
Vijay Kelkar, Ministry of Finance
Rohit Modi, Ministry of Finance
H. Prasad, Ministry of Commerce
T.R. Prasad, Ministry of Industry
Yashwant Sinha, Minister of Finance
M.R. Srinivasan, Reserve Bank of India
Satya Pal Talwar, Reserve Bank of India
*Sawak S. Tarapore, formerly Reserve Bank of India
*Asuri Vasudevan, Reserve Bank of India

Japan

Yoichi Funabashi, The Asahi Shimbun
Toyoo Gyohten, Special Adviser to Prime Minister, formerly Deputy Minister of Finance
Kyoto Ido, Ministry of Finance
*Takatoshi Ito, Hitotsubashi University
Masaaki Kanuo, Japan Economic Research Center
*Michio Kitahara, Bank of Japan
Richard Koo, Nomura Research Institute
Yutaka Kosai, Japan Economic Research Center
*Haruhiko Kuroda, Ministry of Finance
*Takashi Murakami, Bank of Japan
*Takehiko Nakao, Ministry of Finance
*Yoshio Okubo, Ministry of Finance
*Eisuke Sakakibara, Ministry of Finance
Seiji Shimpo, Economic Planning Agency
*Masahiko Takeda, Bank of Japan
Kazuo Ueda, Bank of Japan
Mikio Wakatsuki, Japan Research Institute, formerly Bank of Japan
Koji Watanabe, Keidanren
Masaru Yoshitomi, Long Term Credit Bank of Japan

Saudi Arabia

Mohamed Aba Al-Khail, Gulf International Bank, formerly Minister of Finance
Abdulwahab Attar, Minister of Planning
Ibrahim Al-Assaf, Minister of Finance
Tameel Al-Hojailan, Secretary General, Gulf Cooperation Council
*Muhammad Al-Jasser, Saudi Arabian Monetary Agency
Abdullah Al-Kuwaiz, Gulf International Bank, formerly Deputy Minister of Finance
Hamad Al-Sayari, Governor, Saudi Arabian Monetary Agency
Jobarah Al-Soraisry, Ministry of Finance
Kevin Taecker, Saudi American Bank

South Africa

Jim Buys, Anglo American Corporation of SA Ltd.
Estran Calitz, Professor of Economics, University of South Africa, formerly Ministry of Finance
Dennis Dykes, NEDCOR

Alec Erwin, Minister of Trade and Industry
Evan P.J. Franklin, SA Reserve Bank
Bernie L. de Jager, SA Reserve Bank
Christo Liebenburg, NEDCOR, formerly Minister of Finance
Mxolisi Lindie, Department of Finance
Trevor Manuel, Minister of Finance
Tito Mbowene, SA Reserve Bank
Guy Mhone, Department of Labor
Jay Naidoo, NEDLAC
Raymond Parsons, SACOB
Francois le Roux, Department of Finance
Chris Stals, Governor, SA Reserve Bank
Matthys Strauss, SACOB
Timothy T. Thahane, SA Reserve Bank
Ben van Rensburg, SACOB
Lambertus (Bertus) van Zyl, SA Reserve Bank

Sweden

*Krister Andersson, Skandinaviska Enskilda Banken, formerly Sveriges Riksbank
Claes Berg, Sveriges Riksbank
Sune Davidsson, Liberal Party of Sweden
Bengt Dennis, Skandinaviska Enskilda Banken, formerly Governor, Sveriges Riksbank
Thomas Franzén, National Debt Office
Ingemar Hansson, Ministry of Finance
Urban Hansson, Ministry of Finance
Lars Heikensten, Sveriges Riksbank
Stefan Ingves, Sveriges Riksbank
Tomas Nordstrom, Ministry of Finance
Svante Öberg, National Institute for Economic Research
*Eva Srejber, Foreningssparbanken
Ann Wibble, Industriforbundet, formerly Minister of Finance

Thailand

*Pisit Leeahtam, Ministry of Finance
Kleo-Thong Hetrakul, Bank of Thailand
Tarrin Nimmanahaeminda, Minister of Finance
Nukul Prachuabmoh, formerly Governor, Bank of Thailand
David Proctor, Bank of America
Ammar Siamwalla, Thailand Development Research Institute
Amaret Sila-On, Financial Regulation Authority, formerly Minister of Industry
Chatu Mongol Sonakul, Governor, Bank of Thailand
*Vijit Supinit, Parliament of Thailand, formerly Governor, Bank of Thailand
Jon Vanasin, Financial Regulation Authority
Vicharat Vichit-Vadakan, Financial Regulation Authority
Amnuay Viravan, Saha Union Co., Ltd., formerly Minister of Finance
Worawut Wesaratchakit, Financial Regulation Authority
Chaiyawat Wibulswasdi, formerly Governor, Bank of Thailand

United States

Steven N. Braun, Council of Economic Advisors
Tom Connors, Federal Reserve Board
Jeffrey Frankel, Council of Economic Advisors
Alan Greenspan, Chairman, Federal Reserve Board
Karen Johnson, Federal Reserve Board
Donald Kohn, Federal Reserve Board
Larry McDonald, U.S. Treasury
Nuriel Roubini, Council of Economic Advisors
David Stockton, Federal Reserve Board
Edwin Truman, U.S. Treasury

Small States

Representatives of Antigua, the Bahamas, Barbados, Botswana, Dominica, the Eastern Caribbean Central Bank, Jamaica, St. Vincent and the Grenadines, Samoa, the Seychelles, and Trinidad.

Officials of International Institutions and Governments Other Than Those of Sample Countries

Johan Barras, DG2, European Commission
Willem Buiter, Bank of England
Hervé Carre, DG2, European Commission
*Andrew Crockett, General Manager, Bank for International Settlements
Jon Cunliffe, HM Treasury, United Kingdom
E. A. Evans, Secretary, The Treasury, Australia
*Günther Grossche, Secretary, Monetary Committee, European Union
André Icard, Bank for International Settlements
Otmar Issing, European Central Bank
Donald Johnston, Secretary General, OECD
Mervyn King, Bank of England
Jürgen Krueger DG2, European Commission
John P. Martin, OECD
Thorvald Moe, OECD
John Murray, Bank of Canada
*Gus O'Donnell, HM Treasury, United Kingdom
Tommaso Padoa-Schioppa, European Central Bank
Rinaldo Pecchioli, OECD
Jean Pisani-Ferry, Tresor, France
Stephen Potter, OECD

Arnaud Schneiweiss, Tresor, France
Kumiharu Shigehara, OECD
Philip Turner, Bank for International Settlements
Ignazio Visco, OECD
John West, OECD
William White, Bank for International Settlements
*Nigel Wicks, Chairman, Monetary Committee, European Union
*John Williamson, World Bank

Academics

Ralph Bryant, Brookings Institution
Richard Cooper, Harvard University
Wendy Dobson, University of Toronto
*Barry Eichengreen, University of California, Berkeley
Martin Feldstein, National Bureau of Economic Research/Harvard University
Benjamin Friedman, Harvard University
Peter Kenen, Princeton University
Frederic Mishkin, Columbia University
Richard Portes, London Business School/Center for Economic Policy Research
Jeffrey Sachs, Harvard University
Jan Art Scholte, Warwick University

NGOs

Gemma Adaba, International Confederation of Free Trade Unions
Jo Marie Griesgraber, Center of Concern
Stephen Pursey, International Confederation of Free Trade Unions
Christine Real de Azua, Accounting for the Environment
Carol A. Webb, Friends of the Earth

Private Individuals

Jeffrey Anderson, Institute for International Finance
Kevin Barnes, Institute for International Finance
Eric Barthalon, Paribas
Fred Bergsten, Director, Institute for International Economics
*Sterie T. Beza
John Chambers, Standard & Poor's
Robert Chote, Financial Times
William Cline, Institute for International Finance
*Charles Dallara, Managing Director, Institute for International Finance
*Richard Erb
Gregory Fager, Institute for International Finance
*Joaquin Ferrán
*David Folkerts-Landau, Deutsche Morgan Grenfell
Lacey Gallagher, Standard & Poor's
*Morris Goldstein, Institute for International Economics
John Hartzell, Dresdner Bank
Randall Henning, Institute for International Economics
Helena Hessel, Standard & Poor's
Christopher Huhne, Fitch-IBCA
*Desmond Lachman, Salomon Brothers
*John Lipsky, Chase Manhattan Bank
Anders Ljungh, Morgan Stanley
David Malpass, Bear Stearns
Catherine Mann, Institute for International Economics
Ken Pinkes, Moody's
*Jacques Polak
Adam Posen, Institute for International Economics
Lex Rieffel, Institute for International Finance
*Douglas Smee, Citibank
Britt Swofford, BancOne
*Leo Van Houtven
Kal Wajid, Institute for International Finance

*Former Fund staff, management, or Executive Director.

Appendix IV Recommendations

Note: This list is attached for reference purposes only. Recommendations should be read in the context of the analysis and discussion in Chapter V.

1. We recommend that consultation guidance be restructured to give explicit attention to international aspects.

2. We recommend that surveillance of the euro area center around the ECB and other EU bodies. Surveillance of individual participants in the euro area should largely take place at the euro area level, and through EU institutions.

3. We recommend that (consistent with an increased focus on international aspects) the Fund bring spillover issues, whether regional or multilateral, directly to the table in its various country consultations and in Board discussions.

4. We recommend that surveillance focus, above all, on the core issues of exchange rate policy and directly associated macroeconomic policies, in particular the international implications of such policies. Other analysis should only be undertaken if directly relevant.

5. We recommend that a systematic process be developed whereby the Board would discuss and sign off on the main issues to be raised at forthcoming individual Article IV consultation discussions.

6. We recommend that staff focus policy advice on issues of serious or immediate concern and distinguish such advice clearly from analysis of whether relatively small or judgmental policy shifts would be helpful.

7. We recommend that in the next internal review of surveillance, more attention be given to measuring in some detail (by topic and country) the extent to which the specific operational guidance that has been put forward on behalf of the Board is actually followed in Fund consultation reports, and, equally important, if not why not.

8. We recommend that the Board, management, and senior staff attempt to alter the incentive structure by making it clear that they will, if necessary, back up staff who give frank advice.

9. We recommend that surveillance devote more attention to policy implementation, and to the identification and analysis of alternative policy options.

10. We recommend that Article IV staff reports give greater attention to the forces driving the capital account, and to capital account issues in general.

11. We recommend that surveillance devote substantially more attention to vulnerabilities.

12. We recommend quarterly publication of the WEO forecast.

13. We recommend that ultimate responsibility for WEO forecasting be vested clearly in the Research Department.

14. We recommend that the Board make it clear that the presumption is that the staff draft of the WEO/ICMR should be published as it stands.

15. We recommend that:
    - For all industrial countries but the very largest, full Article IV consultations should be less frequent than annually.
    - For the very largest industrial economies, in light of their systemic impact, annual consultations are still called for. However, to improve the payoff, surveillance should focus more on the international implications of these countries' domestic policies and correspondingly less on advice regarding the policies themselves.
    - There is a strong case for cutting back the resources allocated to the euro area, which are now more than four times those devoted to the United States.

16. We recommend a more conscious focus on the use of electronic means of communication, initially

on an experimental basis, with a view to maintaining close contact with policy officials and to reducing the length of consultation missions.

17. We endorse the recommendations of the internal review that area departments should, through the consultation process, seek to integrate the support provided to members through technical assistance and surveillance activities.

18. We recommend that the External Relations Department should monitor and assess Fund practices and experiences to date with a view to giving guidance with the Fund's explicit backing regarding external contacts.

19. We recommend that the Fund make clear where necessary that meetings with nongovernmental representatives should take place without the presence of government officials.

20. We recommend:
    - More emphasis on policy experience, and therefore less on academic credentials, at all recruitment levels, including the Economist Program;
    - Fund staff should be positively encouraged to spend one or more assignments outside the Fund before reaching management grades. Current programs in this area should be expanded, if that proves necessary to ensure adequate opportunities.

21. We recommend that:
    - There be as much accountability as possible for papers, staff reports, and the associated policy recommendations. In particular, the staff member most directly responsible for authorship of a paper or staff report, or with greatest knowledge of the country being discussed, should be the main presenter at any Board discussion.
    - In the surveillance context, it generally be the case that one staff member—normally the Division Chief in the area department—has overall responsibility for operational dealings, including leading missions, with an individual member state, and should be held accountable for them.

22. We recommend that front offices in area departments be made clearly accountable for ensuring that bilateral surveillance incorporate cross-country and multilateral perspectives.

23. We recommend that the overall volume of surveillance work be reduced relative to the number of personnel engaged in it.

24. We recommend that the staff:
    - systematize and organize their use of outside information with a view to applying it in surveillance; and
    - refer to and/or summarize work produced by other organizations where relevant.

25. We recommend that the Fund experiment with external review of a sample of staff reports.

26. We recommend that all Article IV staff reports be discussed in the first instance in a committee rather than by the full Board.

27. We recommend that the Fund publish on a regular basis the complete text of all Article IV reports.

28. We recommend that the Fund intensify its efforts to make the PIN more reader-friendly.

29. We recommend that outside the Fund's core areas, monitoring international standards to the maximum extent possible be delegated to the responsible international bodies, with the Fund's role largely confined to that of a clearinghouse for information.

Appendix V Confidential Exchange: An Elaboration

Note by Chairman John Crow

Questions were raised at the Board's informal meeting of August 3 regarding what, in the surveillance evaluation team's eyes, could represent confidential exchange between the Fund and the member, given the team's emphasis on having the staff assess "vulnerabilities" in the consultation discussions. This note reiterates and elaborates on our thinking.

As regards the vulnerabilities exercise, the important point to our mind is that the staff should present its assessment for the member's consideration as an integral part of the consultations. That assessment would, in large measure, be conducted with reference to the kinds of indicators entering into early warning systems, and would occur for all consultations. We also recognize that in the consultation exercise, the member may wish to respond to the assessment fully, partially, or not at all.

As regards confidential exchange, this could appropriately, as our report suggests, deal in general with hypothetical matters. And one part of any such exchange could of course, if the member chooses, be a discussion of issues arising from the vulnerabilities presentation, if the authorities did not judge it desirable to respond to such matters in the consultation itself. Other hypothetical matters (e.g., possible or pending government or legislative action) could also of course be discussed in such an exchange.

We are also of the view, on practical grounds, that the product of such confidential exchange would not be conveyed directly to the Board. By definition, it is not part of the formal consultation procedure—the results of which would be made public. Rather, it would be retained within the staff and transmitted to the Board in a general way, and at management's discretion.

Part 3

Statement by the Managing Director on the Report of External Evaluators on Fund Surveillance Executive Board Meeting, August 27, 1999

Staff Response to the External Evaluation of Fund Surveillance

Statement by the Managing Director on the Report of External Evaluators on Fund Surveillance

Executive Board Meeting, August 27, 1999

1. Management has been asked by the Chairman of the Evaluation Group of Executive Directors to comment on the External Evaluation of Surveillance. We offer our views as a contribution to the in-depth debate the Executive Board intends to have as it seeks to strengthen the process of Fund surveillance. We welcome the report, and express our appreciation for the careful work and considered judgments of the panel. We will discuss the major recommendations of the report, but will not comment on other details of the text, beyond noting our general agreement with most of it. We note also the staff's comments, which in our view constitute a considered response to the evaluation, presenting detailed reactions to and commentary on the individual recommendations of the evaluators. Our views differ at most in the nuances from those of the staff.

2. In paragraph 2 of their report, the evaluators usefully define six goals of surveillance: (i) policy advice; (ii) policy coordination and cooperation (among countries—but also, it becomes clear from the text, within countries); (iii) information gathering and dissemination (to member countries and the public); (iv) technical assistance (particularly in supplying macroeconomic expertise to smaller, developing countries); (v) identifying vulnerabilities (especially to governments, but also perhaps in the course of time to markets); and (vi) "delivering the message," that is, disseminating professional conclusions on policy matters to members, an extension of the advice role. Of these, we regard the first goal, policy advice, and the third, information gathering and dissemination, as primary, and the others as derivative, or as implied by the policy advice and information roles.

We have ourselves been struck in our discussions with many members how much they value not only the Fund's surveillance of their own economies, but also the information on the major economies and the world economy that they receive from the surveillance process; for countries not in the OECD, the great bulk of the membership, Fund surveillance provides their only systematic window on the world economy, and they value it highly. They value, too, the opportunity provided by Board discussion to comment on and seek to influence global developments and policies in the leading industrial countries.

3. The evaluators inject a valuable note of realism in their discussion of the impact of surveillance on a country's policies, for instance in paragraphs 5 and 6 of Chapter V of their report. Outside the context of programs, Fund advice should be viewed as "an input that could on occasion be significant, depending upon the stage of the domestic policy debate" (Chap. V, para. 7). Similarly, to the extent that Fund surveillance documents are made public, they will frequently be only one voice among many commenting on the global economy or particular countries—though their relative importance increases for the smaller and systemically less important countries. These observations emphasize the necessity to ensure that the Fund's analysis is first rate.

4. The report was written at a time when surveillance was undergoing major changes within the Fund, largely as a result of the crises of the last five years. Thus, as noted in both the evaluation itself and in the staff's comments, some of the recommendations, including those relating to enhancing surveillance of the financial sector, capital account issues, and policy interdependence and contagion, are already in the process of being implemented. Similarly, the experiments on publication of Article IV reports will help the Board decide whether to accept the evaluators' recommendations on publication of Article IV reports. Management supports publication, while recognizing that we need to find a way of publishing that takes account of valid concerns over the implications for the frankness of discussions with the staff, and possible market reactions.

We will next comment on the main recommendations of the report.

5. The authors recommend that we *give greater emphasis to aspects of analysis that the Fund is particu-*

larly well equipped to provide: (1) aspects of the international financial situation most relevant to the member country; (2) relevant experience from other countries; and (3) how the member can best absorb whatever shocks might emanate from abroad (i.e., how to deal with vulnerabilities). This—including the emphasis on the analysis of vulnerabilities—is an excellent idea, which deserves greater emphasis in our surveillance activities.

6. *Greater focus in Article IV consultations on the Fund's core issues,* macroeconomic and exchange rate policies, plus the financial sector. This recommendation runs counter to most of the pressure on us from the Board and the membership, who have given increasing emphasis to the interactions between macroeconomic and structural policies, ranging even beyond the financial sector. The evaluators base their recommendation in part on evidence that Fund advice outside the core areas is not regarded by the authorities as commanding the same authority as that on macroeconomic issues. The staff presents a careful response to the recommendation for more focus; we conclude, as they do, that while the core issues should continue to be at the center of the surveillance process, other areas will—depending on the country—have also to be included in the surveillance process. At a minimum, social sector issues and poverty will have to be discussed in most Article IV reports. In order to make surveillance in these areas more effective, the Fund will have to further strengthen its cooperation with other institutions, primarily of course the World Bank.

7. *Article IV consultations for small and medium-sized industrial countries should be less frequent than annual.* We recognize that the relative value added by the Article IV consultation to the policymakers in these countries, most of which are members of the OECD, is probably less than that in developing countries that receive less attention from other agencies and financial market participants. However, we agree with the comments of the staff on this recommendation and add one more factor: that much of the strength of the Fund as an institution derives from the symmetry with which countries are treated in the surveillance process, with each country having the right to comment on economic policies in every other country. We will need to consider the possibility of less frequent Article IV consultations for small and medium-sized industrial countries on a case-by-case basis, taking into account both the country's views on the desirability of annual surveillance for itself, and the views of other countries on the benefits of such surveillance.

8. *Regional surveillance should receive more emphasis.* We welcome the suggestions in this area, and accept responsibility for the fact that staff presentations in country matters sessions do not have a regional focus: management has hitherto taken the view that given the particular orientation of these sessions, it would be more appropriate to concentrate on country-level problems. There are two senses in which the term regional surveillance is used: first, that common policy issues and spillover effects should receive more attention; and second that, as in the EU, analysis should be focused more on region-wide rather than national aggregates and policies. We agree that regional surveillance in the first sense deserves greater attention; and take up the case of the EU next.

9. The panel recommends that *surveillance of EU countries be carried out mainly at the EU level,* as is now being done for monetary policy for the EMU countries. We believe that surveillance for EU countries will move toward the EU level over the course of time, as other aspects of decision making move in that direction. Meanwhile, as we maintain country-level surveillance for EU countries, we need to consider whether too many resources are being devoted to that effort.

10. The panel recommends *quarterly publication of the World Economic Outlook (WEO).* We do not support this suggestion, which would be intensive in staff and Board time, preferring rather the approach taken so far of bringing out a special issue of WEO when needed. We could, however, support more frequent (than annual) publication of capital markets information, including possibly through expanding the quarterly report on capital flows sent to the Board by the Research Department. On the issue of WEO projections, we see great value in the present iterative process in which the area departments and the Research Department evolve towards a mutually acceptable view. (We note for the record the high regard for the WEO and *International Capital Markets* report shown by the evaluation group.)

11. *The review process.* This problem is discussed also in the evaluation of research. We have undertaken several internal reviews of the review process. The review process is an essential contributor to the creation of a coherent Fund position on issues. However, we do need to find a way of reducing the amount of resources devoted to it; that can be done in part by ensuring that departments concentrate on their own areas of expertise, with "no comment" becoming a fully acceptable and frequent comment.

12. *Role of the Board.* While this is by and large a matter for the Board to consider, we have the following three observations.

- In making the recommendation for a committee structure, the evaluators do not take account of the varying levels of participation of each chair at different meetings. The Executive Directors or their alternates tend to take part in the most important meetings, or those of particular interest; advisers and assistants take part in other meetings. This arrangement ensures the benefits of the committee approach, without removing the right of individual countries to take part in all discussions.

- For several reasons, most practically given time pressures, we would be reluctant to bring briefing papers to the Board for discussion; one way for the Board's concerns in a particular country consultation to be brought to the attention of the staff is for the Executive Director to ask colleagues before each mission whether there are issues that in their view deserve special attention, and then inform the staff.
- The experiments now under way to increase the efficiency of Board discussions could also help focus surveillance.

Staff Response to the External Evaluation of Fund Surveillance

1. The evaluators have produced a candid and comprehensive report. It is realistic about what surveillance can—and cannot—achieve, and it provides an historical overview of surveillance at the Fund that is informative even for knowledgeable readers.

2. The evaluators' main findings—summarized in their executive summary—have much in common with the views of Fund staff. Many of the prescriptions of the report—notably, better regional surveillance and a stronger international dimension to bilateral surveillance; and greater emphasis on financial sector and capital account issues, external vulnerability, policy transparency, and the dissemination of timely information—are already on the Fund's agenda. Staff broadly agree with the thrust of the recommendations in these areas.

3. Staff welcome the largely positive evaluation of the conduct of both bilateral and multilateral surveillance in core areas. Staff also appreciate the questions raised about the institution's capacity to deal adequately (in the context of bilateral surveillance) with nonfinancial structural issues and the related concern that the expanding coverage of these issues could detract from the overall effectiveness of surveillance. The focus of surveillance is an issue with which the staff have also been grappling, and we share many of the concerns raised by the evaluators. Improving work on nonfinancial structural issues, strengthening financial sector and capital account surveillance, and incorporating more of the various international and regional dimensions of a country's macroeconomic situation into the Fund's bilateral surveillance without reducing the quality of surveillance pose a major challenge—especially in light of the increasing demands on staff from other areas of work and stringent resource constraints. Nevertheless, most staff recognize the analytical necessity of the broadening of surveillance to cover certain areas that are critical to assessing member countries' situations. To focus bilateral surveillance solely on the exchange rate and directly associated macroeconomic policies, as the report recommends, risks missing important issues and misreads the needs and demands of the Fund's membership.

4. On methodology, many staff members would have liked to see more space devoted to the methodological underpinnings of the work leading to the conclusions and recommendations. Relatedly, there are comments and suggestions that arose from the interviews that staff found particularly thought provoking—for example, concerning the forecasting record of departments, the use of cross-country comparisons in bilateral surveillance, staff advice on fiscal consolidation, and the emphasis on first-best solutions. However, these were based on limited observations and it was difficult to gauge their relevance to the Fund's work more broadly. The points advanced in the report on these issues/merit more systematic examination, including in the context of the Fund's internal work.

5. On process, the staff read with interest many of the observations on the Fund's internal organization. Many of the proposals in the report, including those concerning a shift of the responsibility for WEO projections to the Research Department, the internal review process, and the role of the Board, have important implications for the Fund's internal processes and would need to be explored further before these proposals can be properly evaluated. This view is revisited in some of the sections below.

6. The response that follows focuses on several major themes and recommendations. The magnitude of the report dictates a need for selectivity in this effort. Thus, we touch upon issues related to narrowing the focus of surveillance; the conduct of regional surveillance; surveillance of the industrial countries and the euro area; shifting the responsibility for WEO projections to the Research Department (RES); the review process; the role of the Board; and transparency and Fund surveillance. A first annex provides extensive comments from RES on the WEO and the ICMR and the Department's analysis of capital flows; the staff in general associates itself with these comments. A second annex provides more factual and detailed comments from individual departments on a variety of other points.

7. This note does not comment on the interesting observations of the report on standards and the Contingent Credit Line: discussions on these issues con-

tinue at the level of the staff, management, and the Board; policy and practice are undergoing rapid change, and thus the report's observations, and staff responses, would almost certainly soon be out of date.

8. In general, the view of the staff is that the report of the evaluators provides an informed outside perspective that should serve as an important input to the Fund's deliberations on further strengthening surveillance.

The Focus of Surveillance

9. There has been much debate, including in the public domain, over the broadening of the surveillance agenda in recent years. The call for increased focus in the Fund's surveillance is not new and remains a challenge for the organization in light of the forces driving an expanding agenda. In its review of lessons from the Asian crisis for Fund surveillance, Executive Directors underlined that the focus of surveillance needed to extend beyond the core short-term macroeconomic issues, while remaining appropriately selective.[1] In this regard—bringing an appropriate focus to surveillance—there are important areas of agreement between the report and the proposals to bring more focus to surveillance presented in the 1998 staff paper "Lessons for Surveillance from the Asian Crisis" and agreed by the Executive Board:

- Surveillance should pay more explicit attention to capital account/financial sector/contagion issues and external vulnerability.
- Surveillance at the country level should pay greater attention to policy interdependence and the risks of contagion.

10. Notwithstanding the identification by the Fund's internal reviews of the need for more attention to these issues in Fund surveillance, we agree that implementation of these general principles has taken time. This can be explained, in part, by limited resources and, in some areas, expertise.

11. The staff find the demands arising from the sheer scope of surveillance issues to be challenging, particularly in areas necessitating new expertise. We are also well aware that the broadening focus of Fund surveillance has significant resource costs. However, the staff recognize the analytical necessity of the broadening of surveillance to cover certain areas if surveillance is to continue to be relevant. In this regard, the staff doubt very much that the Fund could be more effective by focusing on core macroeconomic and financial issues to the exclusion of structural issues. Selectivity, yes, but to focus only on macroeconomic and financial issues misreads the needs and demands of the Fund's membership.

12. As the report correctly points out, there is substantial pressure from the international community and shareholders to bring additional dimensions to the surveillance process. Following the Mexican crisis of late 1994–95, there were calls by the international community for more intensive treatment of members' financial sectors in Fund surveillance. In the immediate aftermath of the Asian crisis, the significance of transparency, data dissemination, financial sector stability and hence standards, and the need to extend beyond the core short-term macroeconomic issues have received increasing emphasis. While the report acknowledges the forces that have driven the broadening definition of "core issues" in Fund surveillance, it does not examine these forces squarely in coming to its recommendations on the focus of surveillance. A recent Board discussion on Mexico is illustrative in this connection for its heavy emphasis on progress in social policies over recent years, as is the June 1999 G-7 Communiqué calling on the Fund to pay greater attention to social sector issues.

13. Staff particularly emphasize the following points on the focus of surveillance:

- The report takes exception to the Fund's involvement in a number of areas that are considered to be outside the Fund's statutory mandate, including trade liberalization, labor markets, offshore banking supervision, tax reform, expenditure streamlining, military outlays, and income distribution. While staff would agree that the Fund should remain primarily a macroeconomic institution, the Fund's Articles of Agreement and decisions of the Executive Board[2] suggest a far broader mandate than the authors seem to have in mind.
- We believe that another key reason for the expanding scope of surveillance beyond traditional macroeconomic analysis is the realization by policymakers, international organizations, and the economics profession as a whole that there is a wider set of issues (microeconomic or structural in nature) that must be considered when analyzing the international monetary system, stabilization, medium-term sustainability,

[1]See IMF, *Annual Report 1998*, "Strengthening of the Architecture of the International Monetary System," Chapter 7.

[2]See Articles I and IV and paragraph 3 of "Principles of Fund Surveillance over Exchange Rate Policies" set out in Executive Board Decision No. 5392–(77/63), adopted April 29, 1977, as amended.

and growth—all key areas of Fund surveillance. Even if greater focus is achieved, a good macroeconomic analysis needs to view the macroeconomy in the broader context of the structural, social, political, and environmental setting. To be relevant in Western Europe, for example, Fund surveillance must be able to address labor market issues; in Central and Eastern Europe, privatization and enterprise restructuring; in Africa, civil service reform; and so on. Of course, the staff accepts that its attention to those areas should draw on the best work available outside the Fund.

- Relatedly, the Fund has come to learn the hard way that, over the longer run, the sustainability and viability of reform policies depend critically upon the large number of factors that affect growth. These include, among other things, governance, the composition of expenditures, and poverty. Many of these may not fall in the class of issues that the report would consider "directly relevant" to macro policies; yet, as experience shows, they can prove critical over the longer term.
- The Fund's membership covers a heterogeneous set of countries. What is a core issue may differ across countries. In a number of countries, structural issues outside the macroeconomic and financial areas, characterized by the report as "noncore,"[3] are nonetheless at the core of the problem. It would thus be odd if the Fund were to sidestep these issues.
- On the need for greater attention to capital account issues, the staff have been providing analyses of capital flows for many years, although attention intensified following the Mexican crisis and with the increasing integration of capital markets.[4] The staff, like others, have a learning curve.
- As the scope of surveillance has broadened, the staff are increasingly drawing on the expertise of other agencies where appropriate and feasible. Examples of this approach include the recent reliance on OECD work in framing certain elements of Fund advice to countries such as Korea and the recent initiatives to strengthen Bank-Fund collaboration in financial and social sector work. As the report acknowledges, in some noncore areas, the Fund has to step in, not so much as the chosen instrument, but rather the only presently available instrument. This issue has also come to the fore in the discussion of transparency reports, where some working knowledge on the part of Fund staff in noncore areas has been found desirable.
- The recommendation to focus on the "core" of surveillance, as the authors see it, leaves unanswered how this would affect the content of Fund-supported financial programs. If Fund staff did not have the opportunity to build their intellectual capital in "noncore" areas in the context of surveillance, would they still be expected to develop and apply conditionality relating to such issues in subsequent Fund-supported programs? How would "noncore" work currently carried out by the Fund be shared with other institutions?

14. For the reasons indicated above, and although we are in agreement on the appropriateness of containing the scope of Fund surveillance, it is not easy to see how a return to the traditional core areas could be accomplished in the current international context. Most staff believe that if surveillance is to continue to be relevant, its scope will need to change in response to the evolution in the world environment. What may be required is to sharpen the focus of surveillance in the individual case (avoiding a "shopping list" approach), allowing sufficient flexibility to mission chiefs to determine what are the core issues in each country within the Fund's broad and evolving interests. However, there are trade-offs in all of these approaches that might usefully be noted: a narrow focus on the "core" risks missing important issues; a "shopping-list" approach is a recipe for superficiality; and a country-by-country approach to focus raises issues of consistency of treatment across countries. In light of the above, the staff see the need for further examination of these trade-offs in the Fund's surveillance activities, including in internal reviews.

The Fund's Conduct of Regional Surveillance

15. The Fund's approach to regional surveillance emerges as an important theme, and staff agree that regional surveillance should receive greater emphasis. In this regard, the Fund has increased its involvement in regional surveillance in recent years, in part linked to initiatives among member countries themselves, and some additional aspects of this involvement are worth noting.

16. The Fund has devoted increasing attention to systematic participation in regional surveillance

[3]Apart from occasional references to poverty issues, the report does not specify what is meant by "noncore" structural issues; we have assumed the term refers to all structural issues other than those related to the financial sector and the capital account.

[4]Annex I provides instances from multilateral surveillance documents that were available to the public.

processes and to the development of these processes, not only in the euro area, but also in Asia, Africa, Latin America and the Caribbean, and the Middle East. In this regard, the report seems overly focused on Europe as a model for regional surveillance. As the report notes, the fact that other regions—such as Asia—are not as integrated as Europe, and will most likely remain so, suggests a different role—one being explored by the Fund—for regional surveillance as follows:

- Regional surveillance in Asia is implemented through a range of channels. The Managing Director participates in, and the staff prepare background information for, meetings of ASEAN Finance Ministers. The Fund has been designated as the technical secretariat of the Manila Framework Group that was established specifically to undertake macroeconomic surveillance. The staff also work with various arms of ASEAN and other regional groups. The establishment of the IMF's Tokyo office was an explicit recognition of the growing role of Asia, and working with various regional groups as part of surveillance is one of its major tasks.
- In the African region, the Fund has established periodic discussions with WAEMU, the BCEAO, and BEAC as a backdrop for bilateral consultation discussions with relevant members. Through the vehicle of cross-country initiatives, the Fund is playing an active role in assisting regional organizations in Eastern and Southern Africa to develop their capacity and policy focus in a harmonized way.
- Spillover effects of last year's crisis in Russia have been a focal point of most missions to transition economies in Central and Eastern Europe and the Commonwealth of Independent States (CIS) recently.
- The Fund has increased its involvement with the countries of the Gulf Cooperation Council (GCC) in the context of a regional framework. Recently, in the wake of the decline in oil prices, a framework of semiannual consultations with the GCC countries at the regional level has been established.
- Beyond the reference to the Fund's lead in September 1998 in convening Western Hemisphere finance ministers and central bank governors to discuss common issues, including contagion effects of the crises in emerging markets, staff have been exploring with member countries in Latin America ways of enhancing regional collaboration.
- Finally, surveillance of the Organization of Eastern Caribbean States in the Caribbean region includes a role for the Eastern Caribbean Central Bank—the regional monetary authority—again, as the backdrop for bilateral discussions with members.

17. The Fund's engagement in many of these areas is relatively new and to a degree experimental, and is increasingly seen as a means of coping with evolving regional arrangements. Staff agree that more needs to be done and that country surveillance should emphasize regional and spillover issues and bring to bear more of a cross-country perspective.

Surveillance of Industrial Countries and the Euro Area

18. The report proposes to reduce surveillance of smaller industrial countries, to shift euro area surveillance to the EU, and to focus more on the international implications of the largest industrial countries' domestic policies and correspondingly less on advice regarding domestic policies per se. While staff can see the merit of some reallocation of resources away from industrial countries generally, we have reservations about the implications of moving too far in this direction for the effectiveness of surveillance.

19. The introduction of a two-tier surveillance structure in which smaller industrial countries would be visited less frequently raises questions about the effectiveness of surveillance:

- The main effect of the shift to a two-year consultation cycle would be to reduce the Board's involvement—which runs against the evaluators' proposals elsewhere in the report to increase that involvement. At present, countries on two-year cycles often have interim discussions that resemble Article IV discussions, except with regard to the documentation prepared for the Board.
- Implementation of the recommendation that surveillance of individual participants in the euro area should largely take place at the euro area level and through EU institutions would, at this stage, detract from the quality of the Fund's surveillance of individual participants in the euro area. Indeed, the recommendation sits oddly with the report's earlier acknowledgment of the relative candor of bilateral discussions and the reluctance of countries to engage in frank exchange and criticism in regional forums. The proposal is also not consistent with members' obligations to collaborate with the Fund in the context of bilateral Article IV consultations, and would largely remove Fund sur-

veillance from the effective levers of policy. Talking about the euro area's fiscal policy would be to no avail in the absence of discussions about policies in individual countries.

- Similarly, we question the prudence of moving small and medium-sized industrial countries to two-year consultation cycles, as the proposal seems to assume that these countries will not have a crisis, or, if they do, they can take care of themselves. This proposal seems at odds with the report's emphasis on strengthening the role of surveillance in identifying vulnerabilities and risks of financial crises. If the Fund had adopted this recommendation earlier, it certainly would have put into this group some countries that have faced serious crises in the past decade. The experience of the Asian crisis is a reminder that today's star economic performers can become tomorrow's crisis countries.
- The fact that standard surveillance has not produced adequate warnings might be seen as an argument for strengthening, not weakening, consultation procedures. Published data and analyses complement (and provide important input for) the direct policy dialogue, but they are not a substitute. As the experience in some cases has shown, these sources can sometimes be quite misleading.

20. Staff are also skeptical about the scope for and desirability of cutting back resources for industrial countries, the room for savings in this area, and the suggestion that the focus of surveillance for the largest countries be mainly on the international implications of their policies.

21. Specifically:

- In the staff's view, the evaluators are unduly pessimistic with regard to the usefulness of the Fund's surveillance of industrial countries. The Fund's value added lies importantly in providing a disinterested outsider's analysis of national issues from a global perspective. Neither financial markets, the press, nor academic researchers provide this type of information, at least not on a regular basis. Examples include the analyses of German unification and the recent issues facing Japan.
- A policy of less frequent surveillance of industrial countries would need the endorsement of their authorities. Only a few such countries have made use of the voluntary option of a two-year consultation cycle, in the context of "selectivity" endorsed by the Board in April 1997 and made operational at the end of that year.
- The idea that the objectives of surveillance vary by type/size of country is contrary to the Fund's role as a global institution, and to the principle of uniformity of treatment that is essential to the Fund's relations with its members.
- It is not accurate that industrial countries never get into trouble and therefore have little to gain from "full" surveillance. The example of Japan is an obvious one, as are the periodic exchange rate crises in Europe in the last decade. We also believe that surveillance has helped intensify fiscal consolidation efforts in a number of countries, including Belgium, Italy, and Sweden.
- The evaluators recommend that fewer resources be devoted to industrial countries, but that the WEO be published more frequently; yet the latter would depend critically on more regular examination of developments in industrial countries.

Shifting the Responsibility for WEO Projections to RES and Publication of Quarterly WEO Forecasts

22. The report proposes to shift the ultimate responsibility for WEO projections to RES. Staff are concerned that the report downplays the complementarities that exist between bilateral and multilateral surveillance that would be weakened by such a shift. Staff also view bilateral surveillance as the bedrock of the Fund's work and the basis for multilateral surveillance. While we share some of the concerns of the evaluators about the ownership of the WEO forecasts, the report appears to have underplayed aspects of the Fund's internal processes—including informal as well as formal mechanisms to air and resolve differences of view in this area. However, while most departments feel that the interdepartmental mechanisms for coordinating the projections generally work well, the Research Department view is that in selected instances where significant differences between the staff of the Research and area departments have emerged, the process of resolving these differences has not worked as well as it should have.

23. The following specific issues were raised on this topic:

- Staff are concerned that if RES were to have final responsibility for projections, it would imply that the country desks would have no ownership of the IMF projections for their countries. Most staff see this as unworkable.
- To allow different country forecasts to be used in WEO, on the one hand, and in bilateral sur-

veillance and program work, on the other, would be confusing to the public and would limit the scope for country-specific knowledge to be incorporated into the WEO forecasts.

- Staff acknowledge, however, that the current ownership of projections needs to be clarified, as some departments view projections as forecasts of the area departments only, whereas other departments see them as forecasts of the entire organization—a situation that at times has led to conflicting presentations to the public.
- RES shares the concern of other departments that a full shift of responsibility would pose significant operational and other difficulties, including less careful preparation of forecasts by area departments if they no longer have the final responsibility; and the large resource implications of the proposal. However, RES also feels that there have been serious problems that have occasionally arisen with the WEO forecasts that deserve the attention of management and the Executive Board.
- On interdepartmental interactions, there is already much more consultation with RES than suggested by the report. The extent to which the Fund's policy assessment of the situation of the major industrial and developing countries is developed collectively, with input from functional as well as area departments, is underplayed.
- Most staff see a degree of tension in interdepartmental relations as an inevitable and healthy part of the multilateral surveillance process. While there may have been problems on occasion in the past, affecting capital markets work as well as the WEO, these are overstated in the report, and have not gone as far as a breakdown in communications. Moreover, where difficulties have occurred, considerable efforts have been made to ensure closer coordination between departments.
- Staff note the inevitable tension also between global assessments and forecasts underlying Fund programs, given the difficulty in assuming that Fund programs might fail, even though some inevitably will. Shifting the responsibility for forecasts will not resolve these tensions, which could be better dealt with through alternative scenarios analyzing downside risks.
- Staff of RES feel that the evaluators have missed some important points about how information about the Fund's forecasts is conveyed to the Executive Board. When there are significant differences between the Research Department and the area departments over the WEO forecasts, the Executive Board is usually informed of these differences, at least in qualitative terms, in the course of the WEO or World Economic and Market Development (WEMD) sessions.
- Finally, staff do not support a shift to quarterly WEO forecasts. Such a shift would imply a substantial increase in the staff's workload, potentially compromising the analytical content of these reports (which is a critical aspect of their comparative advantage). We also consider it important to retain some independence between the WEO and ICMR, and, when warranted by circumstances, ad hoc WEO/ICMR exercises could be produced to ensure that coverage of world developments is appropriately current (as was done in the early 1980s and also last year).[5]

Review Process

24. The evaluators provide some interesting observations on the review process. Staff recognize that the review process is resource-intensive, and that constant effort is required to manage it effectively. However, staff see this process of internal criticism and peer review as playing a critical role in enhancing the surveillance effort and improving the final product. Thus, most staff would like to see efforts first focused on addressing specific problems that have been identified and ensuring that the process is taken seriously, rather than unduly curtailing the resources devoted to internal review. On this issue, staff emphasized the following points.

- Most staff (including both functional and area departments) are not in favor of more informality in the review process. There is already a great deal of informal give and take that is undocumented. More generally, in our view, moving away from written to oral feedback might serve to lessen responsibility, impair institutional memory, and make for less-considered comments.
- While replacing formal comments with e-mails and phone calls may streamline the review process, it is important that all departments remain aware of each other's comments.
- Replacing formal comments with meetings would likely only increase the burden on reviewing documents: staff from reviewing de-

[5]See Annex I for an elaboration on these issues.

partments would still need to write comments to brief those participating in the meetings.[6] Also, from the recipient perspective, meetings are often much more time-consuming than written comments.

- Other reactions were also registered by staff, including that some of the criticisms of the review process are already being addressed by management guidelines; that cutting review resources would have to be balanced against the benefits of the process (such as better checks and balances and better integration of technical assistance activities with surveillance); and that effective solutions would require delving more deeply into the role of reviewing departments. This is an area to be pursued.

Role of the Executive Board and Proposals for Restructuring

25. Staff read with interest the proposed changes in the role of the Executive Board through the introduction of a two-step briefing process and of a committee structure. Although it was clearly understood by all that the Executive Board decides how to structure its work, in our view there are key aspects of the Fund's internal processes—and channels of interaction—that cumulatively and collectively raise issues to the Executive Directors in a timely fashion. We believe that there are important countervailing arguments, particularly concerning the resource implications of the report's proposals. The following specific comments elaborate on the general thrust of staff views.

- Effective procedures already exist for the Executive Board to express its views and provide guidance, for example through the regular consultation cycles and use of Fund resources meetings (whose policy conclusions are regularly referred to and followed up in subsequent Article IV discussions), country matters sessions, and WEO, ICMR, and WEMD sessions.
- The two-step briefing process potentially creates significant additional work both for the Executive Board and for the staff, especially if considered in conjunction with the proposals to implement quarterly WEO/ICMRs and more frequent and continuous surveillance.
- Resource savings, if any, from the committee approach would most probably come at the expense of the smaller countries, which would be the ones most likely to be discussed solely at the committee level, creating a "dual track" of surveillance that would undermine the global nature of the present system and tend to introduce bias against small states.
- The new regionally based committee structure might involve increased resource costs given the need for greater coordination between the Board, committees, and the staff. In addition, it is not unlikely that many countries would be discussed by the full Board.
- The new structure could tend to undermine the process whereby information is transmitted through Executive Directors to their capitals, and would require difficult and time-consuming balancing so that participation by Directors on committees was appropriately representative.
- Despite the safeguards proposed by the evaluators, pressures toward "clientism" and a "regional perspective" could only increase relative to the present system, amplifying and interacting with the preexisting biases that the evaluators identify as operating at the area department level.

Transparency and Fund Surveillance

26. On a final note, while supporting publication in general, we are somewhat less sanguine about the suggestion that "publication of staff reports should provide important support over time for greater frankness." The evaluators observe an opposite result in OECD reports and the danger that policy differences could be smoothed over in the final report is something that would need to be guarded against. While there are strong advantages to transparency and accountability in publishing, it is not enough simply to assume away the problem that publishing may reduce some country authorities' willingness to speak candidly about policies. In fact, the pilot project for the release of Article IV staff reports is intended to try to address this and other issues of concern to Directors, and the staff would not want to prejudge the outcome of this experiment.

27. Relatedly, staff are unpersuaded by the view that, because Article IV reports already circulate to some degree outside the circle of authorized users (a tendency that some thought the report exaggerated), they should be available to everyone. It is true that the general publication of Article IV reports might help to create a level playing field for

[6]As one department put it: "One of the virtues of the Fund, in contrast to other bureaucracies, is the relatively small amount of time spent in meetings. Certainly meetings can be important for significant and very controversial issues, but in our experience the balance seems about right."

all users; unauthorized leaks, even if widespread, allow unfair access to those benefiting from the leaks. However, the report's proposal—that the Fund publish the staff report for each Article IV consultation whether or not the relevant member consents—raises several legal issues, as the report acknowledges, that are not so easily tackled. First, the Fund may not publish a staff report disclosing confidential information without the member's consent. Second, even where confidential information would not be disclosed, the Fund's Articles permit the Fund to publish its views (e.g., on a member's policies) without the relevant member's consent only if they deal with "monetary or economic conditions and developments which directly tend to produce a serious disequilibrium in the international balance of payments of members." Finally, a special majority of the Fund's Executive Board (i.e., 70 percent of the Board's total voting power) must vote for publication of such reports.

Annex I Excerpts from Comments from the Research Department

The Role of the Research Department

The evaluators clearly express a generally favorable assessment of the Research Department's contributions to Fund surveillance, especially to multilateral surveillance, where RES has the lead responsibility. Of course, we appreciate this favorable evaluation. Nevertheless, we have two specific concerns about what the evaluators recommend and say in their report.

The WEO and ICMR

First, while we appreciate the implicit compliment in the recommendation for quarterly publication of a combined WEO/International Capital Markets report, we have grave reservations about this suggestion. An essential element of the value added of the ICMR is that it brings a "capital markets perspective" to important multilateral surveillance issues, meaning that its focus is on the role of financial market participants, institutions, and regulations. For example, the analysis of the ERM (exchange rate mechanism) crisis provided in Part I of the 1993 ICMR provides such a perspective on the factors involved in the ERM crisis—a perspective different from the macroeconomic perspective on the crisis that is presented in the WEO, focusing on the role of macroeconomic developments and policies. Neither perspective contains the whole truth; both are relevant and valuable. Similarly the ICMR perspective on the Asian/Russian/Long-Term Capital Management crises is different from, and adds considerable value to, the WEO perspective on these crises.

Especially in an institution that places heavy emphasis (some would say, excessively heavy emphasis) on macroeconomic analysis, combining the WEO and the ICMR on a regular basis would, we believe, tend to undermine the analytical independence of the ICMR and would, over time, undermine its unique value added. Moreover, an essential element in the preparation of the ICMR is the system of staff missions to key financial centers and to a variety of emerging market countries to gather information, analysis, and opinions (especially from private market participants) on the issues to be covered in the report. It would be very difficult and disruptive to attempt to make this system of missions conform to a quarterly schedule of publication, while still leaving time for the missions to be planned and executed and for the report to be thought out, written, reviewed, considered by the Executive Board, and published.

These concerns do not preclude the possibility of semiannual updates of the ICMR, perhaps sometimes combined with interim updates of the WEO. Last December's combined WEO/ICMR is a useful example of how this can be done, in consultation with the Executive Board, when developments in the world economy and global financial markets appear to warrant it. But the genesis of such reports would be best determined on an ad hoc basis. Beyond this, the plan is to expand gradually the analytical content of the quarterly private financing notes that are now distributed to the Executive Board (but not published) and to take up discussion of issues raised in these notes, as may be needed, in the WEMD sessions. This, of course, will not satisfy demands from outside the Fund for more frequent updates on international capital market developments and issues, but those folks are not paying the bills for the exercise.

Regarding the frequency and schedule for the WEO, it must be recognized that the WEO plays a central role in providing material for meetings of the Interim Committee and, correspondingly, the present semiannual schedule for the WEO reflects the schedule of meetings of the Interim Committee. Typically, there are nearly seven months between the late-September/early-October and the late-April meetings of the Interim Committee and, correspondingly, there are barely five months between the late-April and the late-September/early-October meetings. Given the usual schedule for preparation of the WEO, it is essentially inconceivable to think of an interim WEO during the summer. Even allowing for some compression of the normal WEO schedule (as suggested by the evaluators), an interim WEO presented to the Executive Board in late July or early August, followed by a full WEO presented in early

September, makes no sense. (As far as the Executive Board is concerned, the WEMD sessions can be used, and have been used, to fill in the gaps.) The fact is that the primary value added by the WEO, relative to information and forecasts produced in the private sector, is not rapid revisions in assessments of the outlook, but rather timely and relevant analysis of the economic forces shaping the outlook and of the risks to the global economy. Too high a frequency would destroy its fundamental value.

When something of global economic significance happens in the late summer or early autumn, it is feasible to produce an interim WEO in December or early January. This was demonstrated in the cases of the ERM crisis, which broke in mid-September 1992, as well as in the Asian and Russian/LTCM crises of 1997 and 1998. It would be possible to plan for a regular edition of an interim WEO or interim WEO/ICMR at every year-end. However, with pressures on staff resources already beyond the sustainable level, and with the need to plan, and think, and research to sustain the quality of both the WEO and the ICMR, we believe that it is better to address the issue of a year-end WEO/ICMR on an ad hoc, as-needed basis. Experience with this procedure, we believe, demonstrates responsible and constructive decision making.

Analysis of Capital Flows

Second, RES has important concerns about Box 3.2, in which the evaluators assess how the WEO and the ICMR dealt with the issues of capital flows and financial crises. This is clearly one area where published information provides evidence and substance to support an evaluation of the effectiveness of the Fund's work but where too little attention has been paid to the evidence contained in the Fund's reports. While we accept a number of the conclusions in this box as reasonable, or at least arguably plausible, we strongly believe that the evaluators go too far in three specific statements that are effectively contradicted by a fair reading of what was actually said in the WEO and by other information provided to the Executive Board (which has responsibility for the conduct of surveillance). The following statements, we believe, need to be reconsidered and significantly modified in light of the facts.

> . . . when doubts about the sustainability of capital flows were voiced—more frequently in the ICMR than in the WEO—*they did not put much emphasis on weakening financial systems* in the capital-importing countries. . . . [emphasis added]

> . . . the importance of *potential regional and international contagion* of currency crises was *given very little attention prior to the crisis, even in internal analyses.* [emphasis added]

> The overall impression of Fund multilateral surveillance as expressed through the WEO and the ICMR is that while these documents did make a number of pertinent observations on capital flows and financial crises that are helpful in understanding subsequent developments in Asia and elsewhere, *the risks were not forcefully presented.* [emphasis added]

The footnote attached to this last statement adds the following:

> In our interviews, staff suggested that such warnings were in fact present and indeed *couched in language that was quite strong*, in Fund terms. However, one well-informed and disinterested observer was of the view that the basic drafting strategy was *to say as little about risks as possible, while at the same time still being able to claim, if the risks did become reality, that they had been addressed*. [emphasis added]

The exposition of why we believe that these statements are not well supported and merit reconsideration and revision is detailed and extensive. We go into it not only because of its importance to the evaluators' assessment of the multilateral surveillance work of RES, which is overall quite favorable, but also because of the deficiencies that it suggests in the methodology that the evaluators have employed in reaching their broader conclusions and recommendations. The evaluators have relied, to a great extent, on the information gathered from their extensive interviews with a wide array of individuals who are knowledgeable, to a greater or lesser extent, about the Fund's work on surveillance and its effectiveness. In contrast, the evaluators appear to have spent much less time and energy on their own direct examination and evaluation of the Fund's surveillance work.

The evaluators' approach is surely efficient and, in many respects, the right approach. It is important for the evaluators not to base their judgments too heavily on their own assessment and prejudices, but rather to seek much wider views among people well informed about the Fund's surveillance activities. However, outside observers also have their prejudices, and it is important to countervail them with careful scrutiny of the documentary evidence. For much of the Fund's surveillance work, the documentary evidence—records of discussions with authorities, Article IV reports, minutes of Executive Board meetings, and so forth—is not publicly available. For the WEO and the ICMR, in contrast, the published versions are available. This makes it possible to compare the judgments and conclusions reached by the evaluators on this component of the Fund's surveillance work, based on their own judgments and the opinions gathered from informed outside observers, with the record of what was actually said in the WEO and the ICMR. Faced with the evidence, readers may be left to judge whether the conclusions of the evaluators are well-founded with respect to this specific area of Fund surveillance, and they may be allowed to make broader inferences about the basis for the evaluators' conclusions in other areas where the documentary record of the Fund's surveillance activities is not publicly available.

The fact is that on page 2 of the May 1997 WEO there is a quite explicit warning that two among the four key risks to global growth are those arising from disruptions in *capital flows to emerging market economies*, including the possibility of *contagion*, and from *fragilities in their banking systems*.

> Third, capital flows to emerging market countries. The surge in such flows in recent years reflects both the growing shift to a more open global financial system and the successful economic policies of many recipient countries. But caution is warranted since both the global availability of these flows and their cost are vulnerable to higher global interest rates and to adverse developments affecting systemically important capital-importing countries. While the aggregate global flows do not seem excessive, the reliance on capital inflows by some countries, and the associated narrowing of their interest rate spreads, may not be sustainable.
>
> Finally, the fragile banking systems are of concern in a broad spectrum of countries. These problems often stem from excessive credit expansions in the past under conditions of inadequate prudential supervision. In some emerging market countries, banking sector difficulties linked to significant exposure to foreign exchange risk have become more apparent following the reversal of capital flows from abroad. Among transition countries, bank loans have often allowed enterprises to delay restructuring, and as a result many firms have become increasingly unable to service their debt. Large portfolios of nonperforming loans, the erosion of banks' capital bases, and outright banking crises can affect countries' economic performance by obstructing banks' ability and willingness to lend, by constraining the operation of monetary policy, and because of the budgetary costs of rescuing and restructuring ailing financial institutions.

A similar warning is reiterated in the October 1997 WEO (p. 2), *before* the attack on the Hong Kong dollar signaled the general onset of the Asia crisis. On this occasion, the risk to the sustainability of capital flows to emerging markets, the possibility of contagion, and the problems of weaknesses in financial systems are all linked together as one of the three key risks to global growth.

> *Sustainability of capital flows to emerging market countries.* Several factors have contributed to record capital inflows into many emerging market countries and an associated compression of yield differentials in recent years, including the trend toward a more open global financial system and the increasingly successful economic policies pursued in many recipient countries. But the availability of these flows and their costs are also influenced by global cyclical conditions and are vulnerable to higher interest rates in world financial markets as well as to perceptions that large current account deficits—the counterpart to capital inflows—may not be sustainable in all cases. The crisis in Mexico late in 1994 and more recently the financial pressures that have affected Thailand and a number of countries in Southeast Asia underscore the importance of disciplined macroeconomic policies and robust financial sectors. They also have highlighted the risk and costs of potentially disruptive changes in market sentiment, including the danger of very strong reactions in financial markets and serious spillovers to other countries when critical policy weaknesses are not addressed in a timely manner.
>
> The rest of this chapter summarizes the IMF staff's near-term projections and policy assessments and identifies some key policy concerns that need to be addressed in order to strengthen medium-term economic prospects in all countries in accordance with the guidelines set out by the Interim Committee in its September 1996 "Declaration on Partnership for Sustainable Global Growth."[1] Other issues discussed include the prospects for EMU and its potential longer-term implications for Europe, lessons from recent exchange market crises and the trend toward greater flexibility of exchange rate regimes in developing countries, the challenges facing monetary policy in the transition countries in safeguarding progress toward macroeconomic stability, and the need for so-called second-generation reforms to sustain high-quality growth in all regions.

To provide the context and to show the prominence given to these warnings, the first three pages of the May and October 1997 WEOs are attached. Also attached are the relevant initial pages from the October 1996 WEO, which contain no similar warning. It is apparent that the warning clearly issued in the May 1997 WEO and reiterated in the October 1997 WEO was not just "boilerplate" that is commonly included in the WEO to protect against later accusations that some important risks, subsequently actually realized, were overlooked. The prominence and the clarity of the warnings in the May and October 1997 WEOs were upgraded over those in earlier WEOs in order to indicate rising levels of concern about a possibly imminent problem. Of course, not everyone reads the WEO in the same way. Some will not understand or appreciate a warning even when it comes in clear lan-

[1]See *World Economic Outlook*, October 1996, p. xii.

guage in a prominent location. Perhaps this is especially so for those who have a vested interest, or at least a psychological interest, in believing that they were not adequately warned because they continued to participate in the massive flow of capital to emerging market countries even after the May 1997 WEO warning that such flows might prove unsustainable. Is the unnamed individual quoted in the evaluators' footnote in this category? We don't know.

Nevertheless, we do assert that on a dispassionate reading, the May 1997 WEO does provide a clear warning of important risks to global growth from potential slowdowns or reversals of capital flows to emerging markets, possibly magnified by contagion, and from fragilities in their financial systems. If the evaluators disagree, as they clearly do in Box 3.2, then they should continue to assert their conclusions. However, the footnote disparaging the staff response to this box should have been deleted; it cites one anonymous source whose objectivity and motives may be suspect or who is unaware of the facts. Rather, in their report the evaluators should have quoted the entire text of the two relevant paragraphs providing the warning in the May 1997 WEO (and noted the reiteration of this warning in the October 1997 WEO), they should have noted the prominent position of these paragraphs in the WEO, and they should have emphasized the difference between this warning and what was said in earlier WEOs. The reader could then have been left to judge whether the warning provided was reasonable and, correspondingly, whether the judgment of the evaluators is entirely fair.

The above comments relate to publicly available information. However, Box 3.2 also refers to the preparation by the staff in late August 1997 of "a—broadly upbeat—memorandum to the Board on the risks of contagion in Asia [that] did not even mention Korea." In fact, this reading of the record ignores the fact that, in his presentation to the Executive Board on August 27, 1997, the Economic Counsellor clearly indicated that he saw the risks for a number of countries in Asia as being on the downside and that a realistic downward revision would probably lower the forecasts for some countries by 2–3 percentage points. He recommended against making such an adjustment at the time, in view of the concern that such action could exacerbate the crisis. However, some modest downward revisions were subsequently made to the forecasts for the published WEO, along with the inclusion of a more forceful discussion of the risks as indicated earlier.

Could and should the warning of a possible crisis affecting capital flows to emerging markets have been issued earlier? In the May 1994 WEO, before the "tequila crisis," a warning was given in the initial discussion of prospects and possible risks for developing countries (Chapter 1, page 7).

> . . . the surges in capital inflows and in stock market prices give cause for some concern about risk of overheating and the possibility of sudden changes in market sentiment. To minimize the risk of speculative bubbles in the emerging stock markets and a reversal of capital inflows, many of these countries will need to monitor developments carefully to avoid the buildup of imbalances; some countries may need to take corrective measures relatively soon. A number of countries may also need to strengthen prudential supervision of their financial systems and, in some cases, broaden and deepen financial market reforms.

This warning was reinforced in a more extensive discussion of equity flows to emerging markets and their risks (in Box 4, pages 26–27). Then, in the October 1994 WEO, the risks from a possible sharp slowdown of capital flows to some emerging markets were again noted (in the initial discussion of prospects and risks for developing countries, on page 6): "In a few cases, the rise in capital flows appears to have reflected the general enthusiasm for emerging financial markets, rather than well-founded confidence in economic prospects. For these countries, the risk of sudden changes in market sentiment is particularly serious." The main chapter on developing countries was devoted to "The Recent Surge in Capital Flows to Developing Countries," and provided a balanced assessment of the benefits, problems, and risks arising from such flows. To drive home the potential risks, the chapter concluded with an alternative scenario to the WEO baseline forecast that showed how a "sharp reversal of capital flows," together with policy slippages, in developing countries could have substantial and sustained adverse effects. The chapter concluded with the warning, "Despite the generally positive character of the large capital inflows, there are a number of countries where the confidence of foreign investors may not be warranted on a sustained basis."

Granted, these warnings were not quite as prominent as those presented in the May 1997 and October 1997 WEOs. Granted also, these warnings were not a forecast of the Mexican devaluation of December 1994 and of the "tequila crisis" that would follow in its wake. Nevertheless, someone who read the 1994 WEOs in any depth, especially someone who was interested in capital flows to emerging markets and read Box 4 of the May WEO and, especially, Chapter IV of the October WEO, would have recognized that there were significant risks that recent surges of capital flows were not sustainable for at least some emerging market countries.

With the onset of the tequila crisis in late 1994, capital flows to Latin America fell off sharply, with flow reversals experienced by Mexico and Argentina. Interest rate spreads shot up for Latin American borrowers. Other emerging markets generally felt only quite brief adverse spillovers, and net private capital flows to all emerging markets picked up in 1995 over 1994 levels, with substantial gains mainly for Asia. At this time, with an actual crisis affecting several emerging market countries, and with markets sensitized to risks, there seemed to be little point in stressing the possibility of an even deeper and more widespread crisis. Indeed, the perception in the Fund was that financial markets had overreacted to the true underlying weaknesses in Mexico and, especially, Argentina; and the effort of the international community was to help rebuild confidence in order to promote recovery in the countries directly affected and limit risks of a spread of the crisis.

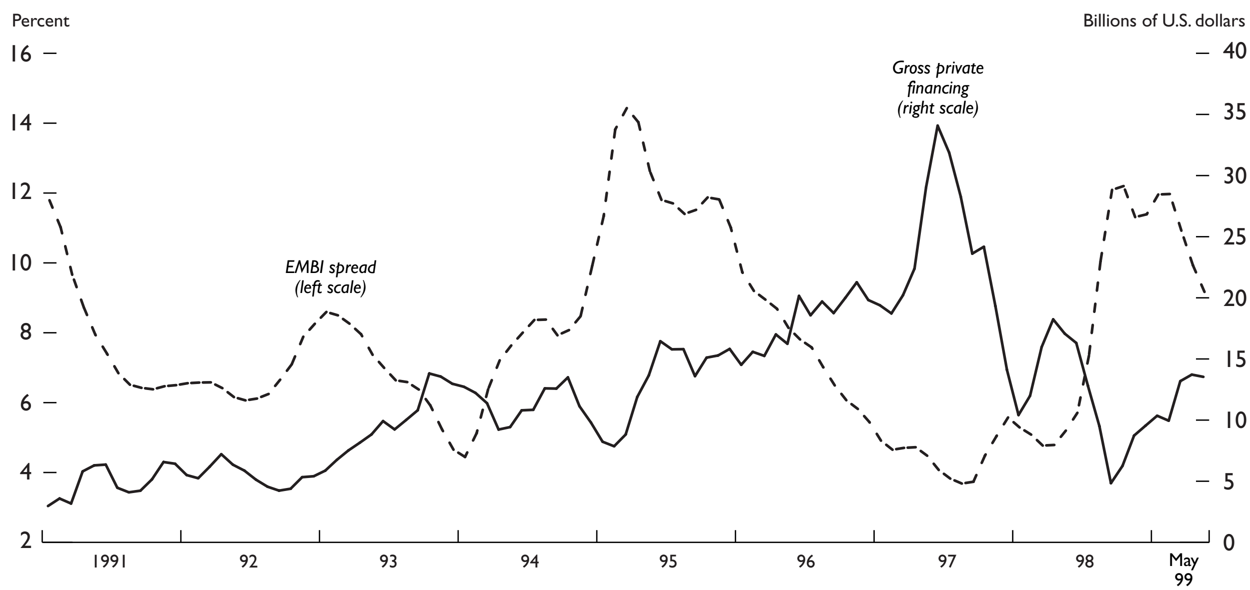
Nevertheless, the October 1995 WEO in Chapter IV, "Increasing Openness of Developing Countries—Opportunities and Risks," devoted considerable attention to the risks of capital flow reversals and emphasized both weaknesses in domestic banking systems and high volumes of short-term capital inflows as factors likely to aggravate such risks seriously. The message was largely one of important lessons to be learned from the tequila crisis, rather than a clear warning of imminent risks. In the concluding section of the chapter on "Implications of a Reversal of Capital Inflows," an alternative scenario was again used, as in the October 1994 WEO, to dramatize the adverse consequences of a possible future substantial slowdown of capital flows to emerging markets.

The revival of capital flows to Latin America, the continuing increase in gross private capital flows to emerging markets generally, and the narrowing of spreads in late 1995 and the first half of 1996 (see Figure 1) were generally regarded as welcome and healthy developments. By July 1996, when the October WEO was being prepared, the sharply rising volume of, and declining spreads on, capital flows to emerging market countries were pointed out, with a degree of concern about possible overexuberance, to the Executive Board in the WEMD session. At that time, however, there did not yet appear to be sufficient reason from global financial developments to express a clear warning about imminent risks concerning the sustainability of financial flows to emerging markets. The evaluators disagree but have not made clear the basis for their disagreement (other than hindsight).

By late 1996 (in the WEMD session of late November) and surely by early 1997 (in the WEMD session of mid-January), concerns about the healthiness and sustainability of capital flows to emerging markets began to rise as volumes of new gross private financing continued to increase, as spreads for emerging market borrowers continued to decline, and as more and more emerging market entities gained relatively favorable access to global financial markets. The Economic Counsellor raised these concerns with the G-7 deputies and with Working Party Three of the OECD in late 1996 and early 1997. Supporting views were expressed, particularly by central bank representatives. Thus, at the time when the May 1997 WEO was being prepared for Executive Board consideration (at end-March), there was a growing official consensus that there were important risks to capital flows to emerging markets. This concern was expressed publicly, and quite deliberately, in the WEO released to the press in late April and formally published in May.

Could and should the warning of a possible crisis have been more explicit? Until it actually happens, there is no way to be certain whether a financial crisis will occur or which countries it may affect. (For example, recent WEOs have continued to warn about the risks from a possible reversal of large gains in industrial country stock markets that has not materialized.) When the WEO was released to the press in April 1997, the Czech koruna was under pressure, but abandonment of the peg and depreciation of the currency did not occur until May. Slovakia also had large current account and budget deficits, and there were fears that its currency would also be pulled down. If so, other Central and Eastern Europe countries might come under pressure, especially if financial markets began to take a more skeptical view of the sustainability of Russia's public finances (see the May 1998 WEO, pp. 100–101). After reducing the federal funds rate by 75 basis points when the U.S. economy slowed during 1995 (partly due to spillover effects from the Mexican crisis), the Federal Reserve took an initial 25-basis- point step toward tightening in March 1997 on concerns that the U.S. economy might be moving toward overheating. In the spring and summer, financial markets were anticipating possible further tightenings. Although effects from the Asian crisis later helped to deter such moves, a relevant concern in May 1997 was that further Federal Reserve tightenings might, as in past such episodes, put pressure on capital flows to emerging markets, particularly on flows to Latin America. In such an event, Brazil was seen as vulnerable, and problems in Brazil were likely to affect Argentina. In Asia, the Fund had seen problems developing in Thailand at least since the second half of 1996. Malaysia, which also had a large current account deficit financed by buoyant private capital inflows, was also seen as vulnerable. Other Asian emerging market countries, most importantly Korea, were not perceived to be immune; but as the evaluators indicate, the risks for these countries were not rated as particularly great. Thus, the warning in the May 1997 WEO was a general warning of possible financing problems for a number of emerging market countries and of sufficient importance to be *a risk to the baseline scenario for global economic growth*, including through the phenomenon of conta-

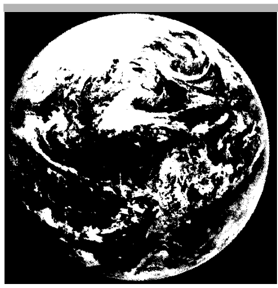
Figure 1. EMBI Spread and Gross Private Capital Flows



gion. The location of such financing problems, should they develop, was not—and arguably could not be—identified. A financial crisis of the scale and virulence that struck several Asian emerging market economies after the attack on the Hong Kong dollar in mid-October 1997 was not foreseen or warned about in the May 1997 WEO. But a clear warning about risks of global significance arising from disruption of capital flows to emerging markets and related to problems in their financial sectors was issued.

Were the risks potentially arising from weakness in emerging market financial systems given adequate emphasis in the WEO? Here, the evaluators have a more valid point, although overstated. The May and October 1997 WEOs do clearly emphasize that weaknesses in emerging market financial sectors, especially in an environment of potential disruptions of capital flows, were an important risk. The significance of this problem *for some individual emerging market countries*, however, was not broadly recognized in the Fund (outside of some staff in the Research Department's capital markets group), and the risks in this area for specific countries were not noted in the WEO. Korea, which is the focus of attention in Box 3.2, and Indonesia stand out in this regard.

What about contagion? In their paper on "The Role of the Fund" written for Executive Board consideration in the aftermath of the tequila crisis, Masson and Mussa emphasized the "monsoonal character" of disruptions of capital flows to emerging markets. In the debt crisis of the 1980s and in the tequila crisis of 1995, several countries concentrated in the same region were affected by the crisis. The caution in the May 1997 WEO that "the global availability of these flows [of capital to emerging market countries] and their costs are vulnerable to higher global interest rates and to adverse developments affecting systemically important capital-importing countries" conveys the notion of risks to global growth that would arise from something more than isolated instances of disruptions of capital flows to individual emerging market economies. The May 1999 WEO was clearly not the first instance in the recent crisis when serious attention was paid to potential regional and international contagion of currency crises. Beyond the warnings given in the May and October 1997 WEOs, the decision to produce the Interim WEO on the Asian Crisis (which was discussed at the annual meetings in Hong Kong in early October and made available immediately after the attack on the Hong Kong dollar in mid-October) was an emphatic recognition that contagion was not merely a potential concern; it was a fact for Asian emerging market economies and a clear risk for others. By late 1997, the financial media were already talking about "the Asian contagion." The main purpose of the discussion of contagion in May 1999 was not to emphasize risks of contagion that had already occurred on a global scale. It was to analyze the mechanisms through which contagion operated. The ICMR published in October 1998 and the Interim WEO/ICMR of December 1998 provide further detailed information on how contagion operated through global financial markets.



I

Global Economic Prospects and Policies

World economic growth quickened during 1996 following widespread deceleration of activity in 1995 (Chart 1). Economic and financial conditions are generally propitious for the global expansion to continue in 1997 and the medium term at rates at least matching those seen in the past three years (Chart 2). There are few signs of the tensions and imbalances that usually foreshadow significant downturns in the business cycle: global inflation remains subdued, and commitments to reasonable price stability are perhaps stronger than at any other time in the postwar era; fiscal imbalances are being reduced with increasing determination in many countries, which should help contain real long-term interest rates and foster higher investment; and exchange rates among the major currencies appear to be generally consistent with broader policy objectives.

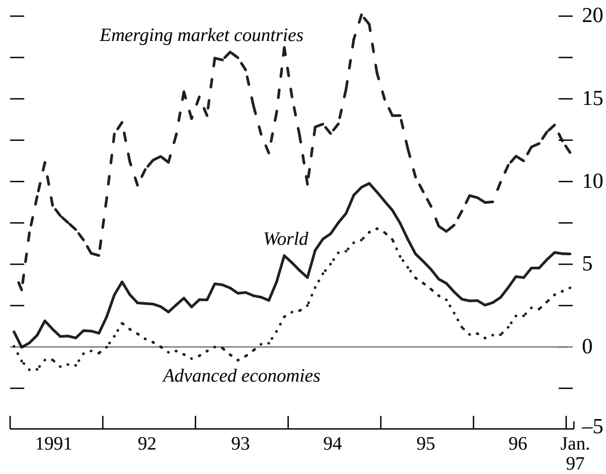
In many countries, structural reforms are enhancing the role of market forces and thereby strengthening the basis for sustained, robust growth. The process of trade integration continues to deepen and is being supported by growing liberalization of external payments. Also, changes in the role of the state through privatization and deregulation are raising efficiency and spurring private sector activity in a growing number of successfully managed economies in all regions.

The favorable global economic conditions are underscored by the continued robust growth performance with low inflation in the United States and the United Kingdom, the pickup in growth in Japan in 1996, and improved prospects for a strengthening of the recoveries in continental Europe and Canada. In many of the dynamic emerging market countries, there was a desirable moderation of growth and inflation in 1996, which should allow their expansions to be sustained in the period ahead. Growth has picked up in those developing countries in the Western Hemisphere that were particularly affected by the financial crisis in Mexico in 1995. Activity has also strengthened in the Middle East and Africa, while the transition countries, as a group, are expected to register positive growth in 1997 for the first time since the collapse of central planning.

Nevertheless, despite these grounds for optimism, it is important to recognize that contrasts in economic performance across countries have become starker in recent years. There are also a number of risks to the central scenario. First, in much of the European Union

Chart 1. World Industrial Production[1]
(Percent change from a year earlier)

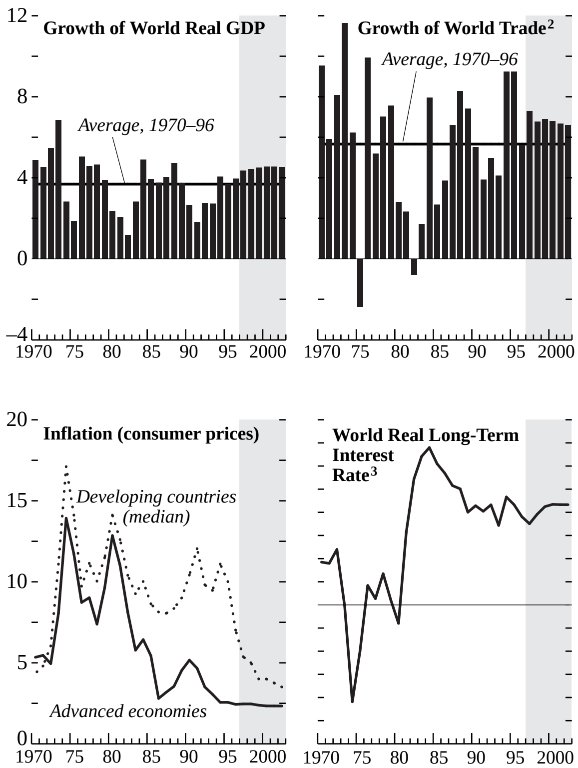
Following a marked slowdown in 1995, the pace of world industrial activity quickened during 1996.



[1]Data are for output in manufacturing in 30 advanced and emerging market economies representing 75 percent of world output; three-month centered moving average.

Chart 2. World Indicators[1]
(In percent a year)

The global expansion is expected to continue with the growth of world output and trade above trend, while inflation should remain contained in the advanced economies and slow further in the developing countries.



[1]Shaded areas indicate IMF staff projections.
[2]Volume of goods and services.
[3]GDP-weighted average of ten-year (or nearest maturity) government bond yields less inflation rates for the United States, Japan, Germany, France, Italy, United Kingdom, and Canada. Excluding Italy prior to 1972.

(EU), unemployment has risen further to new postwar peaks, and neither prospective growth nor the progress made with labor market reforms gives reason to expect any significant decline in joblessness in the near future. High unemployment and weak growth could make it difficult for EU members to fully meet the fiscal deficit targets associated with the plan for monetary union, affect expectations about the likelihood of the project going ahead on time, and lead to turbulence in financial markets.

Second, stock markets. The strength of equity prices in the United States and many other countries in the period up to early March was a reflection of investors' positive assessment of the business outlook. But recent declines in equity prices have underscored the risk of a more significant correction, especially if earnings expectations were to be downgraded or a reemergence of inflationary pressures were to require a marked rise in interest rates. The potential for a market correction large enough to contribute to a cyclical downturn depends partly on the extent to which the rise in stock prices has been an element in a broader buildup of demand pressures. In contrast to the run-up in asset prices in the late 1980s, especially in Japan but also in the United States and several other countries, a generalized overvaluation of asset prices, leveraged by increased indebtedness, does not appear to be present in most countries with strong stock markets. Nevertheless, a significant decline in stock prices could undermine confidence in some countries.

Third, capital flows to emerging market countries. The surge in such flows in recent years reflects both the growing shift to a more open global financial system and the successful economic policies of many recipient countries. But caution is warranted since both the global availability of these flows and their cost are vulnerable to higher global interest rates and to adverse developments affecting systemically important capital-importing countries. While the aggregate global flows do not seem excessive, the reliance on capital inflows by some countries, and the associated narrowing of their interest rate spreads, may not be sustainable.

Finally, fragile banking systems are of concern in a broad spectrum of countries. These problems often stem from excessive credit expansion in the past under conditions of inadequate prudential supervision. In some emerging market countries, banking sector difficulties linked to significant exposure to foreign exchange risk have become more apparent following the reversal of capital flows from abroad. Among transition countries, bank loans have often allowed enterprises to delay restructuring, and as a result many firms have become increasingly unable to service their debt. Large portfolios of nonperforming loans, the erosion of banks' capital bases, and outright banking crises can affect countries' economic performance by obstructing banks' ability and willingness to lend, by constraining the operation of monetary policy, and because of the budgetary costs of rescuing and restructuring ailing financial institutions.

* * *

It is becoming increasingly clear that the benefits of a favorable global economic environment do not accrue automatically to any country. In fact, remarkable differences persist in the degrees of success that countries have had in taking advantage of the opportunities for strengthening their economic performance.

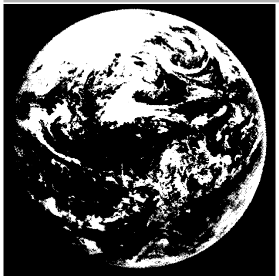
- Among the advanced economies, developments have been mixed and cyclical positions differ widely. Prospects for recovery have improved in continental western Europe following disappointing performances in 1995 and much of 1996. But unemployment is expected to remain at or near record levels in France, Germany, Italy, and several other countries. In Japan, growth was stronger than expected in 1996, and there is upside potential for activity in 1997 although there remains uncertainty in financial markets, in particular, as to whether the momentum of Japan's recovery will be maintained in the period ahead. The uncertain prospects and lack of confidence characteristic of these economies in recent years contrast with the favorable performance of the United States and the United Kingdom as well as a number of smaller countries including Australia, Denmark, Ireland, New Zealand, and the Netherlands. These contrasts reflect both cyclical and structural factors, including policies.
- An increasing number of developing countries in all regions are reaping the benefits of the steadfast pursuit of sound financial policies and outward-oriented, market-based structural reforms. This is reflected in large inflows of foreign direct investment, rapid expansion of both exports and imports, and solid growth prospects. But some countries have experienced setbacks and others are vulnerable to changes in investor sentiment. While economic conditions have clearly been improving in a growing number of low-income countries, many of the poorest countries have continued to fall behind, facing the risk of marginalization from the mainstream of global economic progress.
- Among the transition countries, the contrasts in performance have also widened between some of the early, relatively successful reformers and countries that have started adjustment and reform later and with less determination and consistency. Between these two extremes, which, to be sure, also reflect widely different starting conditions, there are wide ranges of policy effort and economic success.

Motivated in part by these contrasts, the Interim Committee in its September 1996 "Declaration on Partnership for Sustainable Global Growth" set out a range of broad policy principles to promote the full participation of all economies in the global economy. These principles stress the need to implement sound macroeconomic policies that consolidate success in bringing inflation down, strengthen fiscal discipline, enhance budgetary transparency, and improve the quality of fiscal adjustment; to foster financial and exchange rate stability and avoid currency misalignments; to maintain the impetus toward trade liberalization and current account convertibility; to tackle labor and product market reforms more boldly; and to ensure the soundness of banking systems and promote good governance in all its aspects. The complementary and mutually reinforcing roles of macroeconomic and structural policies were given particular emphasis.[1]

The uneven performance across countries and uneven distribution of rewards within them are frequently linked to the phenomenon of *globalization*—the rapid integration of economies worldwide through trade, financial flows, technology spillovers, information networks, and cross-cultural currents. There is no doubt that globalization is contributing enormously to global prosperity. At the same time, however, public debate often focuses on perceived negative aspects of globalization, including the effects on employment and real wages, especially of the low skilled, in the advanced economies. Globalization, like any form of technological or structural change, may adversely affect the living standards of some in the short run. However, it does not seem to be the principal force behind the unfavorable developments in employment and income distribution observed in some advanced economies.

Another widespread perception is that globalization may, at some cost, limit the autonomy of policymakers at the national level. It is argued in this report that while it does appear that globalization increases the costs of economic distortions and imbalances, policy related or otherwise, it clearly enhances the rewards of sound policies. In this way, globalization may be contributing to the apparent polarization between successful countries and those that are falling behind in relative, and sometimes even absolute, per capita income positions. Globalization is not, however, a zero-sum game with some economies winning at the expense of living standards and employment elsewhere. If policies are adapted to meet the requirements of integrated and competitive world markets, then all countries should be better able to develop their comparative advantages, enhance their long-run growth potential, and share in an increasingly prosperous world economy.

[1]See *World Economic Outlook,* October 1996, p. xii.



I

Global Economic Prospects and Policies

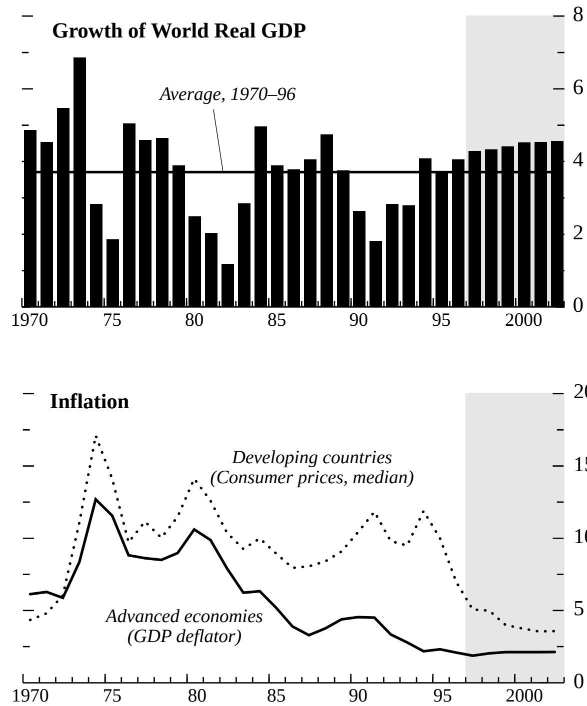
With world output expected to expand by some 4¼ percent in both 1997 and 1998, the strongest pace in a decade, the global economy is enjoying the fourth episode of relatively rapid growth since the early 1970s (Figure 1). The expansion is underpinned by continued solid growth with low inflation in the United States and the United Kingdom; a strengthening recovery in Canada; a broadening of recovery across continental western Europe, notwithstanding persistent weakness in domestic demand in some of the largest countries; robust growth trends in most of the developing world, particularly in China and much of the rest of Asia even though some countries are likely to experience a setback associated with recent turmoil in financial markets in Southeast Asia; and evidence of an end to the decline in output, and perhaps a beginning of growth, in Russia and in the transition countries as a group. It is worth recalling, however, that each of the three previous episodes of relatively rapid growth was followed by widespread slowdown and even recession in many countries. Taking account of this earlier experience, is there a danger that the present expansion may soon run out of steam and give way to a new global downturn?

Although a moderation of world growth is indeed likely to occur at some point, there are reasons to believe that the current expansion can be sustained, possibly into the next decade. First, there are relatively few signs of the tensions and imbalances that have usually presaged significant downturns in the business cycle: global inflation remains subdued and commitments to safeguard progress toward price stability are perhaps stronger than at any other time in the postwar era; fiscal imbalances are being reduced with increasing determination in many countries, which is helping to contain inflation expectations and real interest rates; and exchange rates among the major currencies, taking account of relative cyclical conditions, are generally within ranges that appear to be consistent with medium-term fundamentals. Second, cyclical divergences have remained sizable among the advanced economies, and there are still considerable margins of slack to be taken up in Japan and continental Europe. Stronger growth during the period ahead in these countries should help support global demand and activity as growth slows to a more sustainable pace in those countries that have already reached a mature stage in their expansions, especially the United States,

Figure 1. World Output and Inflation[1]

(Annual percent change)

The expansion of world output is expected to continue above trend, while inflation should remain contained.



[1]Shaded areas indicate IMF staff projections. Aggregates are computed on the basis of purchasing-power-parity weights unless otherwise indicated.

the United Kingdom, and several of the smaller advanced economies. Third, the recovery that is in progress in the transition countries seems likely to continue to strengthen at the same time as the growing number of successful economies in the developing world are also providing both new markets and increased production capacities; these developments are stimulating trade and growth worldwide while helping to dampen price pressures. Taking into account the combination of the strong catch-up potential of the developing and transition countries and the beneficial effects on productivity of technological advances and increasing globalization, the sustainable rate of world output growth may now in fact be somewhat stronger than in the quarter century since the first oil shock. This view is embodied in the IMF staff's medium-term scenario, which points to a trend growth rate of world GDP of about 4½ percent between 1996 and 2002 compared with an average rate of expansion of 3¾ percent since 1970.

This generally positive assessment of the global outlook should not lead to complacency because there is a wide range of risks and fragilities that confront individual countries and may affect regional and world economic and financial conditions. The main areas of concern relating to prospects over the short to medium term include the following:

- *Risks of overheating*. Although world inflation has subsided to the lowest rates seen since the early 1960s, inflationary pressures could reemerge, especially in countries that have reached high levels of resource use. Effective policy to prevent inflation rising requires vigilance not only against overheating in product and labor markets but also in asset markets, and it requires preemptive action when warning signs appear. Problems stemming from large swings in asset prices emerged in the late 1980s and the early 1990s in a number of countries, most notably in Japan but also in Australia, Sweden, the United Kingdom, and the United States, with repercussions on the soundness of financial systems in some cases. More recently, several emerging market countries, especially in Southeast Asia, have experienced similar difficulties in their real estate sectors. Despite some correction in August, there is also reason for concern about the strength of world stock prices, which may to some extent be based on unrealistic expectations about prospects for future profit growth and low interest rates. A more substantial correction in stock prices, were it to occur, could adversely affect confidence and economic activity.
- *Uncertainties about the Economic and Monetary Union (EMU) in Europe*. The marked convergence of interest rates among the prospective members of the monetary union seems to suggest that financial markets expect the project to go ahead in accordance with the agreed timetable, which calls for the new currency, the euro, to be in place by January 1999. Investor sentiment may still change, however, if the feasibility of the timetable was perceived to be threatened. In that case, interest risk premiums might again widen for some countries, while the currencies of others might be subject to unwelcome upward pressure. Also, should growth prove insufficient to permit progress in reducing record levels of unemployment in much of Europe, confidence would remain weak; in some cases there might be a risk of resort to counterproductive fiscal policies incompatible with the requirements of EMU.
- *Sustainability of capital flows to emerging market countries*. Several factors have contributed to record capital inflows into many emerging market countries and an associated compression of yield differentials in recent years, including the trend toward a more open global financial system and the increasingly successful economic policies pursued in many recipient countries. But the availability of these flows and their costs are also influenced by global cyclical conditions and are vulnerable to higher interest rates in world financial markets as well as to perceptions that large current account deficits—the counterpart to capital inflows—may not be sustainable in all cases. The crisis in Mexico late in 1994 and more recently the financial pressures that have affected Thailand and a number of countries in Southeast Asia underscore the importance of disciplined macroeconomic policies and robust financial sectors. They also have highlighted the risk and costs of potentially disruptive changes in market sentiment, including the danger of very strong reactions in financial markets and serious spillovers to other countries when critical policy weaknesses are not addressed in a timely manner.

The rest of this chapter summarizes the IMF staff's near-term projections and policy assessments and identifies some key policy concerns that need to be addressed in order to strengthen medium-term economic prospects in all countries in accordance with the guidelines set out by the Interim Committee in its September 1996 "Declaration on Partnership for Sustainable Global Growth."[1] Other issues discussed include the prospects for EMU and its potential longer-term implications for Europe and the world economy, the critical need for labor market reforms in Europe, lessons from recent exchange market crises and the trend toward greater flexibility of exchange rate regimes in developing countries, the challenges facing monetary policy in the transition countries in

[1]See *World Economic Outlook*, October 1996, p. xii.

safeguarding progress toward macroeconomic stability, and the need for so-called second-generation reforms to sustain high quality growth in all regions.

Advanced Economies

The high degree of price stability remains an impressive achievement shared by almost all of the advanced economies. In 1996, the rate of consumer price inflation averaged 2½ percent, and only four countries experienced inflation above 5 percent; measured by GDP deflators, a broader measure of the price level, average inflation was just 2 percent. In terms of output and employment, the picture is much more mixed as underscored by sharp divergences in labor market performance in recent years. Whereas a number of economies including the United States, the United Kingdom, and several of the smaller advanced economies are operating at relatively high levels of resource use, the three major continental European countries have suffered protracted economic weakness that has been accompanied by a dramatic rise in unemployment to postwar record levels. Conditions for recovery have gradually improved, but few forecasters expect the upswing to make more than a modest dent in unemployment. In Japan, the recovery has also proven quite hesitant, as discussed below and in Chapter II in greater detail.

The unsatisfactory economic performance of the three major economies of Germany, France, and Italy cannot be blamed on the external environment. In fact, external markets have been expanding strongly and exports have been the main source of stimulus in recent years. Thus, between 1992 and 1997, the real foreign balance is estimated to have improved by 1¼ percent of GDP in Germany (most of this occurring in 1996 and 1997), 3½ percent of GDP in France, and 5½ percent of GDP in Italy. This clearly indicates that the sources of weakness have been internal, and in fact domestic demand has expanded by less than 1 percent a year in these three countries combined over the past five years.

There are at least four sets of factors that need to be considered in explaining this exceptional sluggishness.

(1) *Fiscal consolidation*. Since 1992, there has been a substantial effort in many countries to reduce fiscal imbalances that had reached unsustainable levels; although beneficial for growth in the longer run, those efforts have tended to weaken aggregate demand in the short run notwithstanding offsetting effects from lower interest rates and exchange rates. In continental Europe as a whole, however, fiscal policy (measured by changes in cyclically adjusted balances) has not been substantially tighter than in the United States or the United Kingdom. Differences in fiscal stance therefore clearly cannot by themselves explain the differences in growth performance.

(2) *Labor market rigidities*. The lack of flexibility of continental European labor markets has undoubtedly exacerbated the weakness of economic activity at the same time as product market rigidities may have impeded the private sector's adjustment to the withdrawal of fiscal stimulus. Some labor market measures, such as work sharing and early retirement, which were intended to reduce open unemployment, may actually have served to dampen growth by reducing the supply of skilled labor and increasing tax burdens and labor costs.

(3) *Confidence factors*. Although such influences are difficult to assess in isolation from other forces, delays in addressing the root causes of structural unemployment and fiscal imbalances may well have affected business confidence, while labor shedding in response to high labor costs has increased job insecurity and undermined consumer confidence. Excessive reliance on revenue increases to reduce fiscal deficits rather than reform-based reductions in expenditures may also have discouraged both investment and consumption. Recurrent uncertainties about the feasibility of the timetable for EMU have probably added to hesitation in business investment.

(4) *Monetary policy*. The progressive easing of monetary conditions in Germany and the rest of Europe during 1993 and early 1994, and generally declining risk premiums in long-term interest rates, played a significant role in the first phase of recovery in 1994. As this initial pickup failed to turn into a self-sustained expansion, owing in part to the effects of an overly strong deutsche mark in early 1995, official interest rates were reduced further during 1995 and early 1996. However, while the stance of monetary policy since the latter part of 1993 has supported demand, a somewhat faster and ultimately more pronounced easing of monetary conditions would have helped put the recovery on a stronger footing without jeopardizing price performance. The timing of such easing was constrained by the rise in long-term interest rates in 1994, but an easier monetary stance was justified subsequently by the absence of inflationary pressures, the prevalence of significant cyclical unemployment, the large withdrawals of fiscal stimulus, and depressed levels of consumer and business confidence. As of August 1997, with the further weakening of the currencies participating in the European exchange rate mechanism (ERM) vis-à-vis the U.S. dollar and the pound sterling providing additional stimulus, monetary conditions in continental Europe appear to be sufficiently supportive of the emerging recoveries.

Movements of major currency exchange rates since the spring of 1995 have corrected earlier misalignments, and the present configuration is generally helpful and appropriate in view of relative cyclical positions. Specifically, the present relatively strong values of the currencies of the United Kingdom and the United States in comparison with the currencies of flexible than other policy instruments. Most capital-importing countries have not explicitly employed fiscal consolidation as a response to inflows, but as part of medium-term adjustment programs. More problematically, fiscal consolidation may also encourage capital inflows by easing concerns about possible future liquidity problems.

It is, therefore, not surprising to find that in addition to altering monetary, fiscal, and exchange rate policies in response to large swings in international capital flows, many counties have employed measures that discourage capital inflows or seek to influence their character. These measures are often generically referred to as “capital controls.” In fact, such measures range from prudential controls on the banking system, to market-based measures, all the way to quantitative controls on inflows and outflows (Box 1). In particular, these measures have included imposing or tightening prudential limits on banks’ offshore borrowing and foreign exchange transactions (Indonesia, Malaysia, and the Philippines), as well as taxing some types of inflows by requiring non-interest-bearing reserve deposits against foreign currency borrowing by firms (Brazil, Chile, and Colombia). For example, in Chile, the measures have taken the form of non-interest-bearing 30 percent reserve deposits placed at the Central Bank for a period of one year on direct foreign currency borrowing by firms.

In some instances, measures have taken the form of quantitative restrictions. For example, Colombia restricts foreigners from investing in the domestic bond maket. Malaysia responded to the inflow of speculative short-term bank deposits with the imposition of several quantitative measures. The most successful of these measures was the prohibition on domestic residents selling short-term money-market instruments to foreigners. In this case, abandoning the sterilization of foreign exchange intervention and imposing capital controls appear to have been successful in reducing domestic interest rates and short-term inflows. A number of countries particularly Asian developing countries, have restrictions on foreign borrowing by domestic companies and some have maintained prudential restrictions on financial institutions, such as restrictions on the open foreign exchange positions of banks.

It is dangerous to draw general conclusions about the consequences of “capital controls” without reference to the nature of such measures and the circumstances under which they were employed. On the one hand, comprehensive and detailed restrictions on capital inflows and outflows can have highly distorting effects, and such restrictions tend to erode over time. As the effectiveness of controls becomes weaker, authorities may be tempted to intensify them, increasing their distortionary effect.

Table 4. Reserve Accumulation and Capital Inflows
(Changes in reserves as a percent of the balance in the capital account)[1]

Country	First Year	Second Year	Third Year	Fourth Year	Fifth Year	Average
Argentina (1991)	82	42	46	12	. . .	46
Chile (1990)	77	167	86	22	110	92
Colombia (1991)	263	13,261	9	4	. . .	3,384
Indonesia (1990)	48	63	23	–9	. . .	31
Malaysia (1989)	92	126	18	67	121	85
Mexico (1990)	43	34	12	21	–159	28[2]
Philippines (1992)	13	9	17	. . .	. . .	13
Sri Lanka (1991)	17	29	37	59	30	34
Thailand (1988)	75	34	39	41	47	47

Sources: International Monetary Fund, *International Financial Statistics,* and *World Economic Outlook.*

[1]The year in parentheses next to each country respresents the first year of the surge in inflows. A minus sign indicates reserve losses.

[2]Does not include 1994.

On the other hand, measures to discourage excess short-term, foreign currency denominated borrowing by banks, such as increased reserve requirements, can be justified on prudential grounds—bank failures can have significant real effects, as well as fiscal consequences, when deposits are de facto guaranteed. Such measures also tend to have a more permanent effect. Some strong measures, such as taxes on short-term capital flows and bans on the purchase of particular types of securities, may be justified only as temporary measures until domestic financial markets and institutions become well established and resilient, while some other types of prudential measures and reserve requirements can be justified as more permanent features of the regulatory framework.

For example, a review of the Chilean and Malaysian experiences reveals that, in the short run, the volume of inflows was reduced by capital controls during episodes of higher exchange rate volatility and little or no sterilization, in 1991 and 1994, respectively. Furthermore, capital controls were undoubtedly less important than sound fundamentals in explaining the long-run success of several countries cited above in dealing with capital inflows.

In this regard, it should be noted that both Hong Kong and Singapore have managed large capital inflows without recourse to capital controls. Therefore, although capital controls may be helpful at times, they are not the distinguishing feature characterizing countries that have dealt successfully with capital inflows and outflows. Imposing capital controls on outflows during a crisis is interpreted as a measure of despair and hence is counterproductive. Furthermore, market participants tend to view the control of capital outflows as a confiscatory measure, which can be expected to increase future borrowing costs,

Box 1. Restrictions on Capital Inflows and Prudential Requirements[1]

Brazil (1992)

October 1994. A 1 percent tax was imposed on foreign investments in the stock market. It was eliminated on March 10, 1995.

The tax on Brazilian companies issuing bonds overseas was raised from 3 percent to 7 percent of the total. Eliminated on March 10, 1995.

The tax paid by foreigners on fixed interest investments in Brazil was raised from 5 percent to 9 percent, and reduced back to 5 percent on March 10, 1995.

The Central Bank raised limits on the amount of dollars that can be bought on foreign exchange markets.

Chile (1990)

June 1991. Nonremunerated 20 percent reserve requirement to be deposited at the Central Bank for a period of one year on liabilities in foreign currency for direct borrowing by firms.

The stamp tax of 1.2 percent a year (previously paid on domestic currency credits only) was applied to foreign loans as well. This requirement applied to all credits during their first year, with the exception of trade loans.

May 1992. The reserve requirement on liabilities in foreign currency for direct borrowing by firms was raised to 30 percent. Hence, all foreign currency liabilities have a common reserve requirement.

Colombia (1991)

June 1991. A 3 percent withholding tax was imposed on foreign exchange receipts from personal services rendered abroad and other transfers, which could be claimed as credit against income tax liability.

February 1992. Banco de la Republica increased its commission on its cash purchases of foreign exchange from 1.5 percent to 5 percent.

June 1992. Regulation of the entry of foreign currency as payment for services.

September 1993. A nonremunerated 47 percent reserve requirement to be deposited at the Banco de la Republica on liabilities in foreign currency for direct borrowing by firms. The reserve requirement is to be maintained for the duration of the loan and applies to all loans with a maturity of 18 months or less, except for trade credit.

August 1994. Nonremunerated reserve requirement to be deposited at the Banco de la Republica on liabilites in foreign currency for direct borrowing by firms. The reserve reserve requirement is to be maintained for the duration of the loan and applies to all loans with a maturity of five years or less, except for trade credit with a maturity of four months or less. The percentage of the requirement declines as the maturity lengthens; from 140 percent for funds that are 30 days or less to 42.8 percent for five-year funds.

Indonesia (1990)

March 1991. Bank Indonesia adopted measures to discourage offshore borrowing. It began to scale down its swap operations by reducing individual banks' limits from 25 percent to 20 percent of capital. The three-month swap premium was raised by 5 percent.

October 1991. All state-related offshore commercial borrowing was made subject to prior approval by the government and annual ceilings were set for new commitments over the next five years.

November 1991. Further measures were taken to discourage offshore borrowing. The limits on banks' net open market foreign exchange positions were tightened by placing a separate limit on off-balance-sheet positions.

Bank Indonesia also announced that future swap operations (except for "investment swaps" with maturities of more than two years) would be undertaken only at the initiative of Bank Indonesia.

September 1994. Bank Indonesia increased the maximum net open position from 20 percent of capital to 25 percent, on an average weekly basis. Individual currency limits were no longer applied.

Malaysia (1989)

June 1, 1992. Limits on non-trade-related swap transactions were imposed on commercial banks.

January 17, 1994–August 1994. Banks were subject to a ceiling on their non-trade- or non-investment-related external liabilities.

January 24, 1994–August 1994. Residents were prohibited from selling short-term monetary instruments to nonresidents.

February 2, 1994–August 1994. Commercial banks were required to place with Bank Negara the ringgit funds. . .

[1]The year next to the country name denotes the first year of the surge in inflows.

whereas preannounced taxes on short-term inflows avoid this stigma.[25]

In sum, shifting international capital flows can represent large shocks to small open economies, occasionally amounting to more than 10 percent of GDP in one year. The policy response to large and volatile capital flows may require multiple instruments, including measures that seek to discourage capital inflows or change their character, and coordination of policies, monetary, fiscal, and exchange rate, to ensure that recipient countries can derive benefits without incurring much of the costs.

[25]For further discussion of capital controls, see the background paper "Controls on Capital Flows: Experience with Quantitative Measures and Capital Flow Taxation," pp. 95–108.

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 IMF, 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.[1] 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 multiyear 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 fultill its mandate. It will keep members' efforts at achieving the common objectives of this strategy under review.

[1]See the October 1994 *World Economic Outlook*, page x.

Annex II Other Comments

Comments on Selectivity and Presentational Issues

1. A general comment on the report concerns its selectivity in reporting criticisms of the Fund's approach to surveillance, and at times the substance of Fund policy advice. It is unclear what weight should be given to such criticisms, for example, the reference to "an academic observer's" Criticism of the Fund's line on currency boards (Chap. III, para. 21).The observer is cited as noting that the Fund had "bitterly opposed" a currency board in Indonesia while effectively "imposing" one in Bulgaria, without adequate explanation in his view. In fact, the Fund had explained to the authorities in considerable detail the reasons for the inappropriateness of a currency board in Indonesia in early 1998 (including shortage of foreign reserves, likely encouragement of capital flight, and the urgent need for extensive bank and corporate restructuring). It had also been made clear to the authorities that some form of fixed exchange rate arrangement could become appropriate at a later stage. This could have been acknowledged in the report.

2. In several instances the report refers to a complaint by officials that IMF staff "were seen as coming with a preconceived framework" and with a "one-size-fits-all" approach (Chap. III, para. 6; Chap. IV, para. 15). The report notes that the impact of Fund advice was enhanced when missions were able to "adapt the advice to the particular situation" (Chap. IV, para. 15). It would have been useful for the report to elaborate on this and provide concrete examples that describe the circumstances in which Fund staff recommended a set of policies that did not take into account country-specific situations.

3. The report does not delve sufficiently into the treatment of statistical issues and the role statistics play in the context of the surveillance exercise. This is relevant in the context of the views expressed by some small states that "too much time was devoted to data issues rather than policy advice" (Chap. III, para. 46). The report could usefully have provided some general background information for a balanced discussion of statistical issues that have a bearing on surveillance. This is particularly important given the Board's assessment that "the effectiveness of surveillance depend[s] critically on the timely availability of accurate information" and major institutional initiatives in this area in light of the crises in Mexico and the Asian countries.[1]

The Focus of Surveillance

4. The paragraph headed "Scope and Coverage" (Chap. III, para. 41) states that, in addition to traditional macroeconomic demand-side topics, surveillance has become involved in microeconomic and supply-side matters such as trade liberalization. This is a misunderstanding of trade liberalization *as addressed in Fund surveillance*, which is based on establishing and sustaining an outward, market-oriented policy environment consistent with an appropriate macroeconomic framework. This is fundamental to the macroeconomic and trade performance of the great majority of Fund members. Article I of the Articles of Agreement suggests that this is central to the Fund's purpose. In fact, the language of Chapter V (para. 29) seems to confirm this view and contradict the earlier statement. The same argument would apply also to the statements on tax policy and expenditure in the same paragraph.

5. The report's references to the discussion of military spending in Fund consultations (Chap. I, para. 25) might usefully have taken note of the limitations that the Board has placed upon the extent to which these issues can be discussed in the context of Article IV consultations.

6. The discussion of the Fund's evaluation of equilibrium exchange rates (Chap. I, para. 32) does not take into account the considerable work done in recent years by the Coordinating Group on Exchange Rates (CGER), reported, for example, in the Occasional Paper on exchange rate assessment by Isard

[1]See IMF *Annual Report 1998*, "Strengthening the International Architecture," p. 35.

and Faruqee.[2] While not wishing to oversell the role of CGER, the Fund's evaluations of exchange rates have been used as a basis for specific policy recommendations and public statements.[3]

7. The statement that there is "no attempt by the Fund itself to develop a comprehensive set of policy recommendations" in the context of the WEO is not accurate. Since 1993, the first chapter of each WEO has contained a comprehensive overview of policy issues and recommendations akin to the staff reports for Article IV consultations.

8. Our perspective is that the policy assessments provided through bilateral (Article IV) and multilateral (WEO, G-7 notes) surveillance are closely coordinated, with the Surveillance Committee chaired by management playing the deciding role when there are differences in view between area and functional departments (Chap. II, para. 6). Moreover, the Surveillance Committee meets regularly to review both Article IV briefs and staff reports, but also the main multilateral documents, not just on an ad hoc basis as earlier suggested.

9. With respect to the proposal that the Fund discontinue its work in the area of bankruptcy legislation (Chap. III, para. 39), our experience demonstrates that the development of an effective bankruptcy regime is critical to the Fund's efforts to strengthen members' financial systems and involve the private sector in the resolution of members' balance of payments difficulties. On the operational level, the need for effective bankruptcy legislation has been recognized in a growing number of Fund-supported programs. On the policy level, the importance of the Fund's work in this area has been recognized in the communiqués of the Interim Committee and in the decision establishing the Fund's policy on contingent credit lines.

Mission Frequency and the Reduction of Workload

10. We find the report overly optimistic about the potential for a reduction of the scope of surveillance activities in order to relieve the workload on the staff (Chap. V, para. 70). We are skeptical that the recommendation to better focus the surveillance process will have any significant effect on the overall workload. In a world in which many factors affect macroeconomic policy, the list of topics that might be seen to be "directly relevant" (Chap. V, para. 29) may be a long one in any given case. Although further progress can undoubtedly be made in collaborating with other international institutions and in more clearly delineating the respective areas of responsibility, this progress is likely to be incremental. Thus, the recommendations of the report relating to more frequent and/or continuous surveillance, more regional surveillance, more discussion of capital account issues, more focus on policy priorities and tradeoffs, etc., would likely have significant implications for staff resources that would not be offset by savings in other aspects of the surveillance process. These resource implications of the report's recommendations should have been assessed and presented to the Board.

Role of the Executive Board and Proposals for Restructuring the Executive Board

11. On the Board Committee proposal, it is not evident that committees would save (rather than use up) Directors' time (Chap. V, para. 110). In particular, the proposal for committee reports would certainly be labor intensive for someone. There would be an efficiency gain at the end—that is, when the full Board meets—only if at that stage Directors refrained from extensive, prepared, presentations. But this idea has been floated before, and even adopted, but never actually implemented. The two-step briefing process could similarly lead to further demands on an already stretched Board and staff, and, if not strongly managed, it could lead to a proliferation of topics for the mission, rather than a narrowing.

12. The proposal that the Board approve the set of topics to be discussed by missions would be a significant departure from the current division of responsibility between management and Board (Chap. V, para. 32), and would create an anomalous situation where policy issues facing a country would be discussed with the Board before they are discussed with that country's authorities.

Legal Issues

13. The report should not have referred to surveillance as a form of technical assistance or development aid (Chap. I, para. 8). Surveillance is distinct from the provision of technical assistance, and is not a form of development aid.

14. It should also be noted that Fund missions may meet with nongovernmental representatives in member countries only with the consent of the relevant authorities (Chap. V, para. 83).

[2] Peter Isard and Hamed Faruqee, eds., *Exchange Rate Assessment*, IMF Occasional Paper No. 167 (Washington: IMF, 1998).

[3] See the chapter by Kahn and Nord in Isard and Faruqee, eds.

Staff Recruitment

15. Coming on the heels of the external evaluation of research in the Fund, we note some interesting differences in views on what the Fund's priorities should be in recruiting staff (Chap. II, para. 47 and Chap. V, paras. 86 and 87). Not surprisingly, the evaluation of research stressed the importance of recruiting staff with strong interests in research. On the other hand, one of the recommendations of this evaluation is that the Fund should place more emphasis on recruiting staff with policy experience, and less on academic qualifications, at all levels. This seemingly contradictory advice points to the importance of the Fund setting priorities and organizing itself against the background of a strategic vision of its role in the international community. Evaluations—both internal and external—that focus too closely on one particular activity may lose sight of this. In our recruitment of experienced economists, who account for well over half the Fund's hiring of economists, the emphasis is on policy experience already. The suggestion to place more weight on policy experience in the recruitment of Economist Program participants is simply not realistic: the average age of Economic Program entrants is 29; it is very difficult to have substantial relevant policy experience by that age.