Helping the Global Economy Stay in Shape

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The IMF adopts a new framework for monitoring countries' economic performance

FROM AN economic perspective, no country is an island. The policy decisions of one country often have consequences for neighboring ones. And when it comes to the policies of large countries, an entire region or even the whole world may be affected. This is more true today than ever. Trade links have increased, and capital markets are now able to magnify and transmit shocks across borders at extraordinary speed. Often, these dynamics are benign. But in the late 1990s, the Asian crisis showed us how powerful economic forces have the ability to wreak havoc across borders, with a crisis in one country spreading like wildfire to other economies that had been perceived as sound until then. Although awareness of these global dynamics is growing, national policymakers are inherently ill equipped to deal with them.

This is where the IMF comes into the picture. The IMF was set up in the wake of the Second World War—an event that many historians consider rooted, in part, in the Great Depression—to help ensure global monetary stability. The founding fathers were particularly keen to avoid competitive devaluations, which had worsened the crisis and helped make it global. While this basic goal remains the same today—exchange rates have again become the subject of often-heated international debate—the way the IMF goes about promoting global economic stability has evolved in response to the new landscape of international trade and finance.

In recent decades, the IMF was often seen as a global financial firefighter or aid catalyst. But providing financial assistance to countries in need has always been a means to an end. Today, the IMF's business model is undergoing a wide-ranging reexamination to ensure that it can continue to fulfill its core mandate of promoting international financial stability.

A universal code of conduct

In 1945, the emphasis was on avoiding the competitive devaluations that had marred the 1930s. Under the Bretton Woods system, this objective was achieved through fixed but adjustable exchange rates—a key pillar of the original code of conduct that countries were encouraged to follow when they joined the IMF. Changes in exchange rate parities exceeding 10 percent could take place only with the IMF's approval. When the United States broke the dollar's link to gold in 1971, this system broke down. As a result, a new code of conduct had to be agreed upon. The

outcome of those deliberations was a revision of Article IV of the IMF's Articles of Agreement, which became effective in 1978 and is still in force.

Under the revised Article IV, countries pledged not to run their policies in blind pursuit of their own short-term interests, disregarding the effects of their policies on neighbors or indeed on their own longer-term stability. In particular, the new code of conduct encouraged member countries to promote economic growth while maintaining reasonable price stability and orderly financial conditions. It also directed member countries not to manipulate their exchange rate for balance of payments purposes, for instance to gain an unfair competitive advantage, and called on them to pursue exchange rate policies that were compatible with domestic and external stability.

As for the IMF's own obligations, the revised Article IV mandated the organization to assess whether country policies were consistent with the code of conduct and to provide advice on economic policy. This process has come to be known as country, or bilateral, surveillance, and it applies to all member countries regardless of size and economic health. Article IV also requires the IMF to oversee the functioning of the international monetary system to ensure its effective operation—a mandate known as multilateral surveillance.

Targeted policy advice

Through surveillance, the IMF provides an expert assessment of economic conditions in member countries and identifies risks to stability and growth. This analysis is packaged into policy advice delivered in high-level discussions with policymakers in each member country and in written reports, most of which are accessible on the IMF's website. Of course, there are many other sources of assessment and advice, but the IMF has distinct comparative advantages. These include access to economic policymakers and all the data needed for thorough economic analysis; a perspective free of national, political, or commercial bias that reflects the interests of the international community as a whole; and the ability to draw on a vast stock of knowledge, comprising not only a bird's-eye view of global economic and financial conditions but also the accumulated experience of 185 member countries in figuring out which policies work best in what circumstances.

The process of surveillance has the added benefit of giving all 185 member countries—represented by 24 Executive Directors that sit on the IMF's Executive Board—the opportunity to comment on each other's economic policies. The views of the Board are communicated to the country's authorities after the meeting.

Surveillance in the spotlight

The IMF's surveillance work has generally attracted much less public attention than its external financing packages and the sometimes-controversial policy conditionality attached to its loans. But in recent years, countries' external financing needs have receded, putting surveillance in the spotlight. The resulting scrutiny has led to a recognition that IMF surveillance faces significant challenges to its effectiveness. Some of these are long-standing whereas others are more recent.

Persuasion. Surveillance is based on persuasion through dialogue and peer pressure, not on penalties. Thus, it lacks the "teeth" that policy conditionality gives to IMF-supported programs. This has led many observers to ask whether surveillance can be effective at all when it lacks a proper enforcement mechanism. This is a long-standing challenge, inherent in the modus operandi of surveillance.

Leverage. The IMF has also suffered from a perception that it has more leverage over some member countries than others—reflecting differences either in the likelihood of countries having to resort to IMF financing down the road or in countries' sensitivity to opinions voiced by the IMF about their future access to financial markets. A related concern is a perception that the IMF may not be as candid with its larger members as with the smaller ones. Regardless of whether such perceptions are valid, the fact that these views are out there is in itself a challenge to the institution's effectiveness.

Higher expectations. The world has changed in ways that raise the bar for IMF surveillance to add value. For example, the IMF can no longer claim a monopoly in providing macroeconomic analysis and advice. Every day, financial institutions flood markets—and policymakers—with new analysis of economic developments, and an array of experts are on hand to offer advice. And although 20 years ago many countries had to rely on external advice on macroeconomic matters, most have now developed their own talent. Moreover, there is an ever-growing number of regional and international organizations—including the European Union and the OECD to mention but two—that allow countries to tap many different sources of multilateral policy advice. Finally, the world economy itself has changed significantly, the most striking development being the enormous expansion of international capital markets and the subsequent increase in cross-border capital flows. Although the global economy presents countries with a host of new opportunities, it has also created new risks to stability. These risks often elude clear diagnosis because of their complexity and a lack of data, and are therefore difficult to contain.

Taking action

All these challenges have increased the urgency of adapting surveillance to the new realities of the 21st century. Making surveillance more effective is a key goal of the IMF's Medium-Term Strategy (MTS), launched by Managing Director Rodrigo de Rato in April 2005. The MTS encompasses ambitious reforms in areas ranging from governance to lending. Reforms pertaining to surveillance have centered on seeking clearer goals, better advice, and better delivery.

Clearer goals. The idea behind the first set of reforms mirrors the one behind public sector reforms introduced in recent years in many countries—namely, that clearly spelling out the objectives expected to be achieved will improve effectiveness and accountability in two ways: first, by focusing on what is critical; second, by allowing various stakeholders to monitor progress. In the case of surveillance, this clarification is taking place at several levels.

- At the highest level, the IMF has just completed a major update of its policy framework by adopting a new Decision on Bilateral Surveillance to replace one that for 30 years, together with Article IV, provided the main legal foundation for surveillance (see box). As a result, the IMF now has, for the first time, a clear and detailed statement, endorsed by its membership, of what constitutes best practice in surveillance.
- One level down, the IMF has been considering the introduction of a statement of time-bound surveillance priorities (a three-year horizon has been mentioned as one possibility) that would help focus its work, clarify responsibilities, and better integrate bilateral and multilateral surveillance. These priorities would include both operational objectives (such as improving the IMF's analysis of exchange rate issues) and economic objectives (such as contributing to the reduction of current global imbalances).
- At the country level, the IMF recently introduced surveillance agendas, a list of priority objectives that surveillance will promote over the next three years for each member country, and a work plan for achieving these objectives.

Better advice. The second set of reforms aims at improving the quality of IMF analysis in core areas, including exchange rate policies and developments, cross-country spillovers, financial sector surveillance, and the assessment of vulnerabilities in emerging market countries. A number of initiatives are under way.

The main area of emphasis has been exchange rate analysis. A recent study by the IMF's Independent Evaluation Office (IEO) identified an effectiveness gap in this crucial area during 1999–2005. The IEO pointed to insufficient analysis of exchange rate levels, scope for greater clarity in discussing de facto exchange rate regimes, and inadequate attention to spillover effects and coordination issues. The MTS also focused on improving exchange rate analysis. In fact, the IMF had already begun to strengthen exchange rate surveillance in the very areas identified by the IEO as needing improvement when that report was published.

Many efforts are under way, but a particularly noteworthy change has been the strengthening of analytical tools to assess exchange rate misalignments. In particular, a growing set of countries benefit from assessments of their exchange rates performed in a multilateral analytical framework (see chart).

New ground is being broken in other areas as well. Analytical tools are increasingly being applied to capture cross-country spillovers—how one country's policies may inadvertently affect other countries. Tools are also being developed to better integrate financial sector and capital

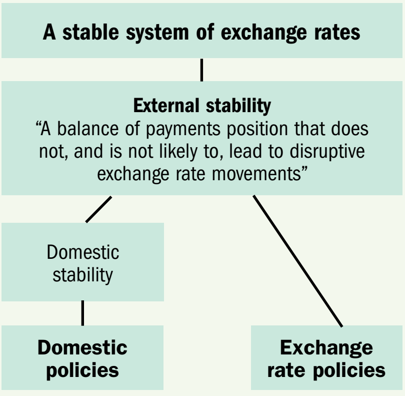
A new framework for surveillance

As part of a number of initiatives to strengthen its surveillance framework, the IMF's Executive Board approved in June 2007 a new Decision on Bilateral Surveillance, replacing its predecessor adopted 30 years ago.

The new decision is the first comprehensive policy statement on surveillance. By clarifying expectations about the best practice of surveillance, it will ensure that the policy dialogue between the IMF and its member countries is more focused and more effective. It provides an up-to-date and comprehensive framework for the regular "health checks" of national economies and encourages candor and evenhanded treatment of all countries. It reaffirms that country surveillance should be focused on assessing whether countries' policies promote external stability (see box chart). And it spells out what is and what is not acceptable to the international community in terms of how countries run their exchange rate policies, including by defining what is meant by exchange rate manipulation and indicating the type of situations when discussions with the country may be in order.

Clarifying the goals

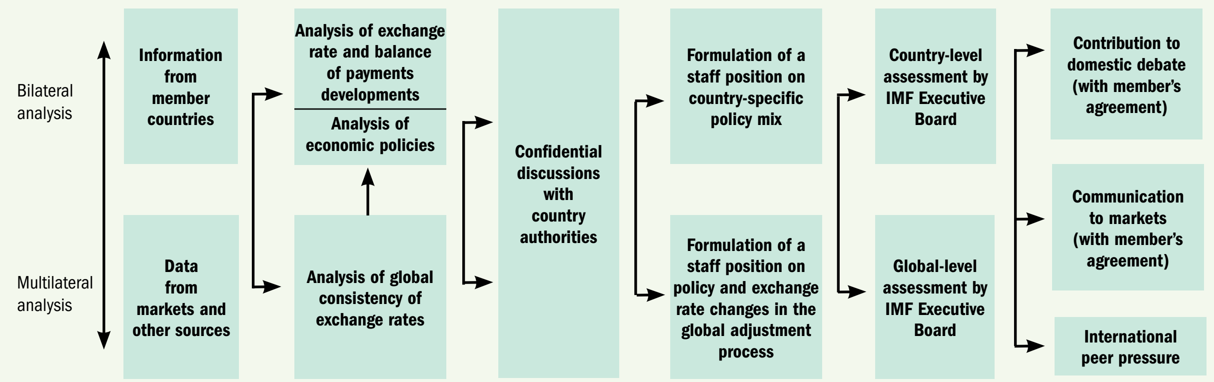
The new decision on surveillance spells out how countries should run their economic policies.



Source: IMF staff.

How it works

The IMF's analysis of its member countries' policies takes into account global as well as country-specific factors.



Source: IMF staff.

markets analysis into macroeconomic assessments. These new approaches will put the IMF in a better position to assess the impact of the financial sector on the economy as a whole and will enable it to assess the multifaceted risks that may originate from this increasingly important sector. The methodology used by IMF staff to assess underlying vulnerabilities and crisis risks in emerging markets has also been revamped.

Better delivery. The third set of reforms relates to the IMF's interaction with policymakers. The most far-reaching of these reforms is the introduction of multilateral consultations. The IMF has long had tools for multilateral surveillance, including its biannual *World Economic Outlook* and *Global Financial Stability Report*, but these are based mainly on IMF research and do not involve detailed policy discussions with countries. However, some problems—and their solutions—involve many countries at the same time.

The multilateral consultations provide a new forum for discussing issues of global or regional interest among the countries that are most directly affected by them. The talks further a common understanding of what the problems are and provide a platform to address them. The role of the IMF in this exercise is essentially to facilitate the discussions and provide analytical input, including by identifying any synergies or inconsistencies between the policies of different member countries. The first multilateral consultation started in 2006. It covered the issue of global payments imbalances and involved China, the euro area, Japan, Saudi Arabia, and the United States. The discussions resulted in a public statement in April 2007 in which each of the participants committed to a set of policies that will help reduce imbalances. The IMF will follow up on implementation in its regular surveillance work.

Additional reforms are under way—more mundane but no less important in practice, given that they affect the delivery of surveillance throughout the IMF's membership. Looking beyond closed-door interactions with officials, the IMF is enhancing its outreach and communications efforts to make sure the messages of surveillance inform the domestic policy debates in the broadest possible way. And more focused consultations have been introduced for countries for which only a few issues need to be discussed, allowing for a more thorough analysis.

In sum

Multifaceted reforms are under way to adapt surveillance to the current realities and ensure that the IMF continues to deliver on its mandate of supporting global monetary stability. Will these reforms enable surveillance to fix all the problems in the world economy and guarantee everlasting stability? Of course not. No matter how sophisticated its advice and analysis, the IMF does not control the policy levers that ultimately determine economic policies around the world. But there is no doubt that these reforms are timely—the global economic environment remains benign, providing the IMF with a great opportunity to step back and rethink the way it operates.

What is going to be the effect of all these reforms? It is too early to tell with any certainty, but change is perceptible already in the way the IMF goes about its work. Ultimately, the hope is that these reforms will help ensure that the IMF's advice remains highly relevant and sought after, and that its voice is both heard and heeded. Provided the IMF adjusts to the demands of the global economy and keeps chasing the highest standards of analysis and communication, surveillance can make a unique and critical contribution to helping the global economy work better. In so doing, it will give member countries reasons to keep believing in the spirit of multilateralism—the force that was behind the creation of the IMF. ■

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