The IMF's 'Surveillance': How Has It Changed since the Global Financial Crisis?

Emily Poole*

The International Monetary Fund (IMF) is mandated by its members to oversee the international monetary system. One of the key ways it does this is through bilateral and multilateral 'surveillance' – monitoring, analysing and providing advice on the economic and financial policies of its 188 members and the linkages between them. This article discusses three broad issues identified with the IMF's pre-2008 surveillance by the IMF and IMF watchers – analytical weaknesses (though these were not confined to the IMF alone), ineffective communication of key surveillance messages in public reports, and governance issues and practical constraints – and examines the steps taken by the IMF to address them. Significant improvements have been made in addressing analytical weaknesses, and efforts to improve the effectiveness of the IMF's communication are ongoing. However, issues around governance remain unresolved, which risks reducing the credibility and influence of IMF surveillance.

Introduction

At its most basic level, surveillance provides information on economic developments and the outlook for growth in individual countries and the global economy. But the higher-level aim of surveillance is to influence the decisions of national policymakers in a direction that fosters stability by exposing them to external scrutiny. This ongoing influence would ideally make countries and the global economy more resilient to economic and financial shocks (Krugman 2014). In practice, the extent to which surveillance prompts the desired changes in domestic policy decisions depends on factors such as the strength of the established global policy consensus, the quality and appropriateness of recommendations, the effectiveness of communication to both policymakers and the public, and the degree of trust between the government and the surveillance entity (Pisani-Ferry, Sapir and Wolff 2011; IEO 2013). Of course, there may be a strong case for policymakers to resist external policy advice – national authorities are likely to be better informed about the economic and political constraints facing their country and, as stated by Mussa (1997, p 28), 'policy advice is limited by the accumulated wisdom of the economics profession, which is continually advancing and being revised'.

The IMF has a special role among the many entities conducting various types of surveillance. With 188 members it has near-global membership, and a condition of membership is regular consultations on domestic policies known as Article IV consultations. This combination, plus the technical expertise of the IMF's staff in conducting surveillance, gives the IMF the potential to be a powerful forum for discussing and influencing members' policies. While questions have been raised over the extent to which this potential has been realised for the policies of advanced and large emerging economies, low-income and smaller emerging market economies typically view the quality and effectiveness of the IMF's surveillance and technical assistance more favourably (Lombardi and Woods 2007; IEO 2009).

* The author is from International Department.

Surveillance by the IMF

The IMF's Articles of Agreement set out the obligations of the IMF and its members, with Article IV providing the basis for the IMF's surveillance activities.[1] In summary, members have agreed that:

- The IMF has general oversight of the international monetary system to ensure its effective functioning and 'firm' surveillance over the exchange rate policies of members.
- Individual members will seek to undertake policies that foster orderly economic and financial conditions. This includes avoiding the manipulation of exchange rates that would prevent effective balance of payments adjustments or give them an unfair competitive advantage.

Countries' observance of these obligations is assessed through both bilateral and multilateral surveillance. Bilateral surveillance refers to the regular, typically annual, Article IV consultations between IMF staff and relevant stakeholders in member countries. The aim of these consultations is to identify risks and vulnerabilities that may threaten domestic (and potentially global) stability and provide advice on policy adjustments. These consultations culminate in a staff report prepared for discussion by the IMF's Executive Board.[2] With the permission of the government, this report is then released to the public along with a summary of the Executive Board's discussion. The scope of policies covered by these reports has shifted over time as views have evolved on the role that various economic and financial policies play in fostering domestic and global stability.

The IMF's bilateral surveillance is a key source of policy advice for low-income countries and for those emerging market countries with constrained local policymaking capacity and where alternative information sources tend to be limited (Lombardi 2005; IMF 2014c). The IMF's significant cross-country experience in providing policy advice, capacity building and financial assistance to countries facing similar macroeconomic and financial challenges puts it in a unique position to support macroeconomic and financial stability in these countries. IMF policy advice is also sought outside of the Article IV cycle, with a 2014 survey conducted by the IMF finding that nearly 90 per cent of low-income country respondents and 60 per cent of emerging market respondents had approached the IMF for ad-hoc advice over the past three years, compared with 40 per cent of advanced economy respondents (IMF 2014c).

Members also engage in other types of consultations with the IMF aimed at complementing the Article IV process. For example, following the Asian financial crisis, members agreed to voluntary assessments of the stability of their financial sectors (the Financial Sector Assessment Program (FSAP)) and their observance of selected international standards (the Report on the Observance of Standards and Codes (ROSC)).[3] Following the global financial crisis, FSAPs every five years were made mandatory for jurisdictions with systemically important financial sectors (including Australia), with the aim of better safeguarding global financial stability.

Multilateral surveillance aims to identify trends, risks and vulnerabilities at the regional or global level. It focuses on the interlinkages between systemically important countries at the global or regional level and the spillovers of these countries' policies to the rest of the world. The IMF uses a constantly evolving

1 The current version of Article IV was incorporated into the Articles of Agreement in 1978 following the collapse of the Bretton Woods system of fixed (but adjustable) exchange rates in the early 1970s.

2 The Executive Board is responsible for overseeing the day-to-day business of the IMF. Composed of 24 Executive Directors, who are appointed or elected by member countries or by groups of countries (known as constituencies), the Executive Board is chaired by the IMF's Managing Director and usually meets several times each week. Australia is in a constituency with 14 other countries, including Korea and New Zealand.

3 The IMF has the sole responsibility for the FSAPs of advanced economies, while the FSAPs of emerging and developing market countries are the joint responsibility of the IMF and World Bank. The 12 areas of the ROSC are related to policy transparency, financial sector regulation and supervision, and institutional and market infrastructure.

set of reports and tools to conduct multilateral surveillance. Examples of publicly available multilateral surveillance reports currently produced by the IMF include the biannual *World Economic Outlook* (WEO) and *Global Financial Stability Report* (GFSR) and the annual *Spillover Report*. The IMF also conducts a number of confidential internal and external exercises aimed at identifying and informing policymakers of risks and vulnerabilities and ideally influencing them to act to mitigate these risks.[4]

The IMF's Response to Issues Identified in its Pre-crisis Surveillance

The IMF has openly acknowledged that it provided few clear warnings about the build-up of risks and vulnerabilities in the global financial system leading up to the global financial crisis – although it is important to note that it was not alone in this (IEO 2011, 2014a; IMF 2011). According to various internal and external reviews, insufficient attention was paid to vulnerabilities in advanced economies amid the strong belief that their financial institutions were in a strong position and that financial markets were fundamentally sound. Contagion and spillover risks were overlooked, and any warnings that were made were too scattered and unspecific to generate a policy response. The IMF has subsequently put significant effort into overhauling its surveillance activities and recognises that this is an ongoing process (IMF 2014a).

This article groups the issues with IMF surveillance identified in these and earlier reviews into three main types – analytical weaknesses, ineffective communication of key surveillance messages, and governance issues and practical constraints. Of these, significant progress has been made by the IMF in addressing analytical weaknesses since the crisis, arguably at the expense of some conciseness in public communication. However, long-identified governance and practical constraints on the IMF's surveillance remain.

Strengthening the IMF's analysis

The global financial crisis exposed widespread analytical weaknesses across the economics profession and surveillance entities (such as the IMF, the Organisation for Economic Co-operation and Development (OECD) and Bank for International Settlements). Analytical weaknesses identified by the IMF as being particularly important include knowledge gaps around the interaction between the macroeconomy and the financial sector ('macrofinancial' linkages), the lack of a global risk assessment framework, and insufficient analysis and discussion of spillovers and low probability but high impact ('tail') risks. Data gaps were also a constraint. According to the IMF's Independent Evaluation Office (IEO), 'silos' within the IMF further hampered its staff's ability to develop a complete picture of the key risks and vulnerabilities facing the global economy (IEO 2011).

In response, the IMF has introduced several new publicly available multilateral reports and confidential internal exercises aimed at facilitating the identification and discussion of baseline and tail risks and spillovers. New multilateral reports include the annual *Spillover* and pilot *External Sector* reports, and the biannual *Fiscal Monitor*. To strengthen the early identification of risks, the IMF's staff regularly updates an internal global risk assessment matrix and the existing confidential exercise aimed at identifying vulnerabilities in emerging markets was expanded to cover advanced and low-income countries. To facilitate the discussion of tail risks to the global economy by finance ministers and central bank governors, a semiannual presentation is put together by the IMF and the Financial Stability Board (FSB). According to the IMF, efforts have also been made to break down internal silos and foster more interdepartmental collaboration.

Gaps in the IMF's legal framework around surveillance have been addressed through the

4 The WEO was introduced in an internal background paper in 1969, and was first released publicly in 1980. The GFSR was introduced in 2002 (replacing the annual *International Capital Markets Report*), and the *Spillover Report* was introduced in 2011.

adoption of the Integrated Surveillance Decision (ISD) in July 2012.[5] Prior to the ISD, the bilateral Article IV consultations were legally restricted in their ability to discuss spillovers from a member's policies and the scope and modalities of multilateral surveillance were not defined. The ISD gives the IMF the ability to discuss spillovers arising from the policies of individual members that may undermine global financial or economic stability as part of Article IV discussions. For example, recent Article IV reports for the United States include discussions on potential negative spillovers from the unwinding of the US Federal Reserve's unconventional monetary policy to vulnerable economies. While the IMF may suggest alternative policy actions, the ISD does not give the IMF the power to require that a member change its policies. In addition to greater discussion of spillovers, all Article IV reports now include risk assessment matrices and the framework for debt sustainability analysis was reformed.

These changes have improved the IMF's processes around identifying risks and examining potential spillovers. Remaining priorities identified by the IMF in the 2014 Triennial Surveillance Review include continuing to improve the integration between bilateral and multilateral surveillance, integrating macrofinancial analysis into Article IV discussions, strengthening the surveillance of macroprudential policies, expanding policy advice to cover selected structural issues, reviving 'balance sheet analysis' and strengthening the assessment of external balances (IMF 2014a, 2014b). Significant work remains to be undertaken by the global academic and policymaking community in developing the models and economic theory to underpin this analysis. The debate over the size and type of spillovers from unconventional monetary policy is an example of where theory is currently lagging behind practice. In addition, even as the models and tools available to examine interconnections and spillovers become more sophisticated, it will be important to keep in mind the limitations of data and technical analysis and for IMF staff to be open to alternative views. It will also be important to draw on their experiences of past crises to keep an eye out for vulnerabilities affecting multiple countries that are being generated by distorted incentives, such as moral hazard.

Improving the communication of key surveillance messages in public reports

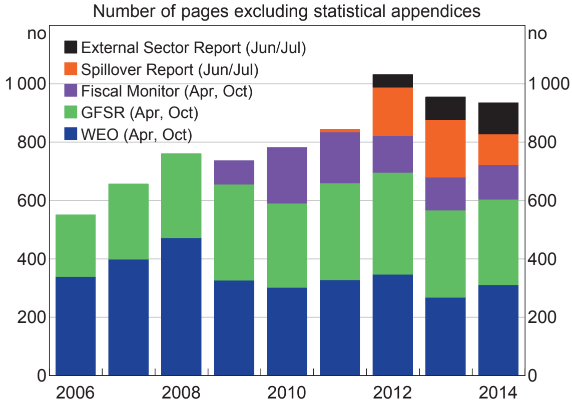
In order to gain traction with policymakers, key surveillance messages need to be clearly communicated. Communication can take place behind closed doors during Article IV discussions and subsequent IMF Executive Board discussions, and also publicly through the published Article IV and multilateral surveillance reports. While it is not possible to judge the candour and effectiveness of the IMF's bilateral discussions with policymakers from the outside, the published surveillance reports have been criticised both before and since the financial crisis for lacking clarity, having weak links between policy recommendations and the analysis presented, suffering from insufficient follow-up on previously identified risks or recommendations, and providing a laundry list of risks rather than highlighting the risks of most concern (IEO 2006; IMF 2014b).[6] The new multilateral reports introduced since the financial crisis have further increased the amount of information for policymakers to absorb

5 The Articles of Agreement are operationalised through 'decisions' taken by the IMF's Executive Board. This has allowed the IMF's approach to implementing its mandate to evolve over time. Prior to the ISD, the IMF's surveillance activities focused on members' obligations under Article IV, section 1 – 'to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates'. In order to expand the scope of IMF surveillance beyond bilateral surveillance, the ISD drew on the obligation of the IMF under Article IV Section 3(a) to 'oversee the international monetary system in order to ensure its effective operation', which it was agreed is only possible in an environment of global economic and financial stability.

6 As discussed in the next section, some of these criticisms may reflect self-censorship by IMF staff, with countries having to agree to the public release of their Article IV report. It is also possible that the report may be less candid on risks than in discussions with policymakers for fear of precipitating a market response. According to the IMF, 90 per cent of countries agreed to the publication of their Article IV reports in 2013.

and digest, with complaints expressed in the 2014 Triennial Surveillance Review that the volume of IMF reports are 'overloading' policymakers. A simple page count of the main text of the IMF's multilateral reports shows that the total volume of material has increased by around one-third since 2006, with key surveillance messages now also spread over more reports (Graph 1). The IMF has also acknowledged that the increase represents a challenge for ensuring consistency across reports.

Graph 1
Length of the IMF's Multilateral Reports
Number of pages excluding statistical appendices



Source: IMF

In response to these challenges to effective public communication, improving the cohesion and clarity of published policy advice in both bilateral and multilateral surveillance has been identified as a priority by the IMF. In particular, from April 2015, the main views on the global outlook, risks and vulnerabilities, and key policy messages from all the multilateral reports will be summarised in a single report, the 'Managing Director's Global Policy Agenda'. Also, Article IV reports will now explicitly discuss the policy mix rather than discussing various policy measures in separate sections. These changes should help improve the clarity and consistency of the Fund's public communication of key surveillance messages, but a more fundamental streamlining of the number and length of multilateral reports seems worth considering in the future. IMF staff will also seek to strengthen the bilateral policy dialogue with member countries through staff visits and other less formal channels than Article IV missions, as well as aim to deliver more candid and practical advice.

Governance issues and practical constraints on surveillance

As a member-owned and financed global organisation, the IMF faces practical constraints related to surveillance of its members. These issues are longstanding and are mostly not within the power of IMF management and staff to address. First, the IMF does not have the power to compel its members to change their policies. Attempts by IMF staff to push for reforms in this direction over the past decade have been firmly resisted as a threat to members' sovereignty (Legg 2013). Second, the credibility and influence of surveillance is intertwined with perceptions of even-handedness in the IMF's treatment of members and the governance structure of the IMF. Third, members may have a different view from IMF staff on the risks and benefits of publicising vulnerabilities that may precipitate market volatility.

Regardless of the quality and clarity of the IMF's surveillance messages, under the IMF's current legal framework national authorities can still choose to ignore them; or in the words of Fischer (2008, p 382), '[s]ometimes advice is valued less for its quality and more for its agreeableness, and this is simply a fact of life with which the IMF has to contend'.[7] Members do have some legal obligations under the IMF's Articles of Agreement, such as the provision of data (Article VIII) and avoiding the manipulation of exchange rates to gain an unfair advantage over other members (Article IV), but the enforcement mechanisms for even these few obligations are weak. The IMF's Executive Board must agree to enforce any breach and members have historically been quite unwilling

7 Even countries in IMF programs subject to conditionality are not legally required to adjust their policies. However, a failure to comply with the agreed package of policy measures is likely to lead to the IMF suspending payments due under the program and a potentially negative reaction from financial markets.

to expend the required political capital.[8] Calls to strengthen the IMF's power to compel members to change their policies meet strong resistance, as this would effectively undermine members' sovereignty.

A persistent criticism of the IMF by some members is that it has not treated members with similar circumstances in a similar manner – that is, it has not been 'even-handed' in its surveillance and lending activities. IEO (2014b) identifies three areas of asymmetric treatment of members – asymmetry in analysis, asymmetry in the influence of members (where political influence was exercised in a non-transparent way) and asymmetry in the candour of surveillance. Some of these are of more concern than others. The existence of asymmetries in analysis does not necessarily mean that the IMF is not being even-handed; for example, more analytical resources should be devoted to the more systemically important countries. However, justifications for asymmetries in influence and candour are less clear. On candour, the IEO raised concerns over self-censorship by IMF staff, reporting that 'many staff members believed that there were limits as to how critical they could be regarding policies of the largest shareholders' (IEO 2011, p 20). Perceptions of a lack of even-handedness in influence and candour have the potential to undermine the credibility of Fund surveillance and members' willingness to engage in policy discussions with IMF staff. This risk is heightened when combined with concerns about the continued under-representation of emerging market countries in the IMF. Reforms agreed to by members in 2010 that would have shifted more than 6 per cent of voting and quota shares and two Executive Board seats away from advanced economies towards dynamic emerging market economies are yet to be completed, with the United States, which has an effective veto power, failing to ratify them.[9]

This self-censorship also reflects a deeper problem with IMF surveillance identified by James (1995). As an institution owned by, and responsible to, member governments, the IMF sometimes faces challenges in openly discussing risks and vulnerabilities when governments are fearful that acknowledging the existence of these vulnerabilities will trigger a self-fulfilling market response. A counterargument to this is that a government may, on occasion, want the IMF to expose risks and vulnerabilities in order to provide the government with a political mandate to address them rather than allowing them to continue to build.

Recognising the threat to the credibility, legitimacy and effectiveness of the IMF and its surveillance posed by the continued delay in completing the 2010 reforms, IMF management remains publicly committed to advancing quota reforms, while most of the Executive Board changes have already been agreed voluntarily. In late January 2015, a resolution was submitted for agreement by the IMF's Board of Governors calling on the Executive Board to agree on interim steps towards the outcomes of the 2010 reforms by 30 June 2015, while also stressing that any agreed interim step is not a substitute for the 2010 reforms, the ratification of which remains the highest priority for member countries. In the meantime, the IMF is addressing concerns over even-handedness in its surveillance, including by increasing the

8 A member deemed not to be fulfilling its obligations under the Articles of Agreement may be declared as ineligible to use the resources of the IMF, and at the extreme can be required to withdraw from membership. Czechoslovakia is the only country to have been expelled from the IMF (in 1954 for failing to provide required data), although several other countries have withdrawn from IMF membership at various points in time. Czechoslovakia was readmitted in 1990, with the Czech Republic and Slovak Republic succeeding Czechoslovakia's membership in 1993.

9 The key elements of the 2010 quota and governance reforms include: a doubling of IMF quotas to SDR476.8 billion, which facilitates a shift in quota shares to under-represented, dynamic emerging market economies of more than 6 per cent while preserving the voting shares of the poorest members; advanced European members agreed to reduce their representation on the Executive Board by two seats after the quota increase comes into effect (this shift has already substantially come into effect via voluntary actions); and the five appointed Executive Director positions will be abolished, meaning that the Executive Board will consist of 24 elected Executive Directors. Although the 2010 reforms were agreed in December 2010, they do not come into effect until they are ratified by members and require 85 per cent of the voting shares. The US voting share is currently 16.75 per cent, giving the US effective veto power over the 2010 reforms.

transparency of how decisions are made regarding inputs into surveillance and establishing a process for investigating and reporting on even-handedness concerns raised by members. Delivering more candid and practical advice, particularly to systemic countries, has also been identified as a priority by the IMF.

One potential way for the IMF to mitigate some of these constraints is through harnessing their interactions with international groups, such as the G20, and other international organisations, such as the FSB, OECD and World Bank. It becomes more politically difficult for domestic policymakers to ignore surveillance messages when similar warnings are being issued by several international organisations with a reputation for quality analysis and policy advice. The G20 is potentially a particularly powerful forum for peer pressure, with representatives of countries collectively accounting for around 85 per cent of global GDP sitting around a table with a range of invited international organisations. Since the crisis, the IMF, along with the OECD and World Bank, has played a key analytical role in supporting G20 members' assessment of each other's policies through exercises such as the Mutual Assessment Process and peer review of members' growth strategies. At the same time, the IMF must be careful that it continues to represent the interests of all its members, not just those involved in forums such as the G20.

Conclusion

As acknowledged by the IMF, the IMF's bilateral and multilateral surveillance suffered from analytical weaknesses and deficiencies in communication prior to the global financial crisis. These gaps were compounded by longstanding constraints around the IMF's ability to influence domestic policymakers. Since then, the IMF has put significant efforts into improving its capacity to identify and discuss risks and vulnerabilities facing member countries. These efforts are ongoing, with the IMF's 2014 Triennial Surveillance Review identifying a number of areas for continued improvements, including the communication of key surveillance messages. However, since the power of the IMF's surveillance lies in its ability to convince domestic policymakers to adjust their policies, these efforts risk being undermined by concerns over the IMF's governance and the even-handedness of its advice. Given this, discussions in 2015 aimed at progressing the stalled quota reforms, as well as ongoing efforts to ensure that IMF advice is even-handed, will be crucial. ✠

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