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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/37

10:00 a.m., April 4, 2002

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**Executive Board Attendance**

H. Köhler, Chairman  
 A. Krueger, Acting Chair  
 E. Aninat, Acting Chair

**Executive Directors**

S.M. Al-Turki  
 A. Barro Chambrier  
 I.E. Bennett

M.J. Callaghan

K. Bischofberger  
 P.C. Padoan  
 D.I. Djojosebroto

V.L. Kelkar  
 W. Kiekens

P. Duquesne

A. Mirakhor

T. Scholar

M. Portugal

A.S. Shaalan

Wei Benhua

J. de Beaufort Wijnholds  
 K. Yagi  
 A.G. Zoccali

**Alternate Executive Directors**

A.A. Al-Nassar, Temporary

N. O'Murchú  
 P.H. Whitehall, Temporary  
 I.- K. Cho, Temporary  
 W. Szczuka  
 N. Davletov, Temporary

R. von Kleist  
 H. Vittas  
 Low K.M.

M.P. Bhatta, Temporary  
 R.A. Jayatissa  
 J. Prader

I. Abel, Temporary  
 B. Andersen  
 B. Gulbrandsen, Temporary

M. Lundsager  
 P.A. Dohlman, Temporary

S. Boitreaud  
 B. Couillault, Temporary

T. Hadded, Temporary  
 A. Lushin

Y. Lissovolik, Temporary  
 E. González-Sánchez, Temporary  
 P. Moreno, Temporary

M.A. Brooke  
 D. Merotto, Temporary

R. Junguito  
 A.A. Tombini, Temporary

I. Usman  
 M.B. Chatah  
 N.H. Farhan, Temporary

Wang X.  
 A.Y.T. Wong, Temporary

M. Faulend, Temporary  
 T. Komatsuzaki, Temporary  
 D. Vogel, Temporary

S.J. Anjaria, Secretary  
 A. Linde, Acting Secretary  
 S. Maxwell, Assistant  
 M. Schulte, Assistant

**Also Present**

IBRD: A. Abrantes, F. Perrot, J. van Houtte, Africa Regional Office. A.M. Diouf, Office of the Executive Director. African Department: J. Clement, D. Donovan, C. Kende-Robb, N. Kirmani, G. Moser, T. Roy, M. Zejan. European I Department: A. Leipold. External Relations Department: W. Camard, L. Mboto-Fouda. Independent Evaluation Office: M.S. Ahluwalia, Director; T. Tsikata. International Capital Markets: P. Dattels. Legal Department: P. De Boeck, C. Ogada. Monetary and Exchange Affairs Department: M. O'Brien, A. Ouannes, S. Wajid. Policy Development and Review Department: T. Geithner, Director; L.J. Lipschitz, Deputy Director; D. Desruelle, K. Hviding, S. Kashiwagi, H. Lankes, A. Matzen, Y Metzgen, J. Rahman, M. Schulze-Ghattas, Y. Sobolev, M. Walsh, Q. Wang. Research Department: K. Rogoff, Economic Counsellor and Director; D. Robinson. Secretary's Department: C.M. Watson, Deputy Secretary; L. Hubloue, P. Ramlogan. Western Hemisphere Department: L. Breuer. Office of the Managing Director: A.A.E. Bertuch-Samuels, Special Advisor; C. Salmon, Personal Assistant; J.T. Boorman, S.B. Brown, A. Mazarei, R. Moghadam. Advisors to Executive Directors: M.A. Ahmed, J.A. Costa, S.S. Farid, P.R. Fenton, N. Guetat, A.R. Ismael, Liu F., A. Muganda, E. Nyambal, Y. Patel, S. Rouai, F. Vermaeten, M. Yanase, F. Zurbrugg. Assistants to Executive Directors: M. Abbing, D. Baasankhuu, V. Bhaskar, G.M. Campos, N.J. Davidson, N. Epstein, F. Haupt, N. Joicey, C. Josz, R. Manivat, T. May, T.P. Nguema-Affane, M.L. Nikitin, K.S. Oo, E. Pinto Moreira, P.R.D. Prasad, T. Segara, B. Siegenthaler, Wei X., N. Yeritsyan.

**1. BIENNIAL REVIEW OF IMPLEMENTATION OF FUND SURVEILLANCE  
AND OF 1977 SURVEILLANCE DECISION—OVERVIEW; AND  
EXTENSION OF DEADLINE FOR REVIEW**

Documents: Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Overview (SM/02/82, 3/14/02; Sup. 1, 3/15/02; Sup. 1, Cor. 1, 3/18/02; Sup. 2, 3/15/02; Sup. 2, Cor. 1, 3/18/02; and Sup. 3, 4/3/03)

Staff: Lipschitz, PDR; Schulze-Ghattas, PDR; Desruelle, PDR

Length: 3 hours, 40 minutes

Mr. Portugal submitted the following statement:

Surveillance has appropriately grown to become one of the major functions of the Fund. In an ever more integrated and complex international economy, the positive and negative externalities on other members of domestic economic and financial policies of individual countries have become increasingly more relevant, enhancing the importance of a structured process for exercising cooperative international peer pressure. Moreover, prevention is always better and less expensive than cure. I welcome this opportunity to review the Fund's surveillance activities and thank staff for the well-written set of papers.

**Purposes and Coverage of Surveillance**

There has been, and probably there will continue to exist, debate and some tension in defining the purposes and coverage of surveillance. Among other reasons, this results from the ambiguity of the text of Article IV, which seems to be more encompassing when it defines the purposes of the international monetary system and the obligations of members with respect to their domestic economic and financial policies, than when it defines the extent of coverage of Fund surveillance.

While Article IV Section 1 mandates members to direct their economic and financial policies to foster orderly economic growth with price stability, to avoid erratic disruptions of these policies, and to avoid manipulating exchange rates, it also seems to limit the scope of the obligation to cooperate with the Fund and with other members to the narrower field of exchange arrangements and exchange rates. Section 3 (a) empowers the Fund to oversee the effective operation of the international monetary system and each member's compliance with the obligations of Section 1. But Section 3 (b) seems again to limit the coverage of surveillance to exchange rate arrangements, as it specifically says that, in order to exercise the functions of Section 3 (a), the Fund shall exercise firm surveillance over exchange rate policies. This

limitation seems also to be reflected in the very title of Article IV, which defines its coverage as referring to obligations regarding exchange rate arrangements.

The coverage and the framework of surveillance, through explicit decisions and accepted practice, has been gradually expanded and, as the staff observes, surveillance is currently implemented in a substantially different manner from what prevailed at the time of the Second Amendment to the Articles of Agreement and the 1977 Surveillance Decision. While the surveillance framework has evolved, its main purposes should not change. It needs to be circumscribed by the purposes envisaged in Article IV and address the realm of economic and financial policies there specified. It is also important that decisions to extend the coverage of surveillance or to introduce new tools and modalities be explicitly approved by the Board.

In general, the changes and evolution of the framework have been appropriate and positive, and to a large extent inevitable, given the need to maintain the effectiveness of surveillance by adapting it to a rapidly changing world economy, marked by increasing economic integration in trade and finance. This evolution, however, has greatly increased the difficulties of maintaining the quality of surveillance, which is the most important aspect for its effectiveness and impact and, as acknowledged by staff, has also increased the challenges for keeping the focus on issues that are critical for macroeconomic stability, as well as the difficulty for selectively integrating the various issues into a coherent overall macroeconomic and financial assessment.

While most of the changes that have occurred in the surveillance process have been driven by the need to adapt it to a changing global economic and financial environment, it is and will continue to be important to guard against the tendency of member countries of trying to use the process of Fund surveillance to address international problems that are beyond the Fund's purposes, mandate, and expertise. This tendency needs to be resisted, even when the objectives themselves are meritorious, as it would overburden further Fund surveillance, compromising its quality, and undermining its legitimacy.

As staff observed, a main catalyst in broadening the framework of surveillance has been the occurrence of external crises. This could be expected for basically two reasons. First, crises tend to be very costly, especially for the country concerned, and reach the headlines, galvanizing immediate attention. Second, external crises by definition occur in economically weaker member countries. Hence, there might be greater acceptance by the more powerful shareholders to broaden surveillance especially in this direction.

Less visible economic and financial developments and policy decisions in member countries that have systemic importance to the world economy did not seem to have functioned as a catalyst for changes in surveillance framework, even if those events engendered costly consequences to the global or regional economy. This was the case, for instance, of prolonged recession and deflation in major countries, of misalignment and sharp swings in the exchange rates of major world currencies, of the behavior of highly leveraged financial institutions that operate on an international scale, and of adverse developments in sectors or market segments of major countries that, while not causing an external crisis in the country where they happened, have generated nevertheless significant negative externalities for other countries.

I welcome and support the broadening of the surveillance framework to try to better prevent external crises. I wish, however, that improvements and expansion in bilateral, regional and global surveillance be also driven by, and be responsive to, these types of developments in the major industrial countries that can have repercussions on the global or regional economies. The global and regional impacts of policies of the major industrial countries need to be placed high in the hierarchy of concerns to be addressed by Fund surveillance, being accorded equal priority as external vulnerability.

Expanded coverage has created major challenges for maintaining the quality of surveillance and, as staff has emphasized, for appropriately integrating the various issues in a coherent macroeconomic assessment. I agree with staff that there is still room for greater selectivity in applying the existing framework. I would advocate that an approach similar to the agreement reached by the Board with respect to the coverage of conditionality also be applied with respect to the coverage of surveillance. The main focus of surveillance, with respect to areas to be covered, should be on exchange rate, monetary and fiscal policies, the financial sector, and assessment of external vulnerabilities, while structural policies and institutional issues would be covered when they are critical for macroeconomic and financial stability of the country concerned, or relevant in terms of externalities to other countries. With respect to trade issues, I agree with the staff suggestion that they are selectively included in the case of countries with serious trade distortions that hamper macroeconomic prospects and in large advanced economies whose trade policies have adverse implications for developing countries' market access. In addition, surveillance should also address domestic trade-distorting subsidies and other non-trade barriers that limit market access.

#### Uniformity and Evenhandedness of Treatment

An aspect not explicitly covered in the staff papers is the issue of uniformity and evenhandedness of treatment in surveillance to which

Executive Directors have attached high importance in previous discussions. I would suggest that this issue be explicitly covered in future biennial reviews.

Given the cooperative nature of the Fund and the considerable expansion of the surveillance framework beyond what is envisaged in the Articles, I believe that uniformity and even-handedness of treatment are paramount aspects to be monitored. Obviously, this does not mean treating all countries equally. Uniformity of treatment means treating similarly countries that have similar circumstances. There is one form of differentiation that is unavoidable and, indeed, required. Article IV instructs the Fund to pay due regard to the members' circumstances. The Fund has also to respect the social and political policies of member countries.

### Quality of Surveillance

Quality of surveillance is another area this biennial review could have covered with a more systematic and detailed approach than what has been presented in the papers. Quality of the policy advice is, in my view, the single most important factor to enhance the effectiveness and impact of surveillance.

The definition of quality obviously centers on an up-to-date and solid theoretical treatment and a sound empirical analysis of the economic and financial issues confronting the member country, with a clear indication of the linkages of the various issues in a consistent model. But it should go beyond that. It should also involve a workable and politically feasible strategy for addressing the various issues. In most cases, what is important is not so much what needs to be done, which the authorities may be aware of, but how to do it, given existing constraints. Adequate sequencing, gradualism, and innovative approaches may be of the essence of high quality policy advice. Policy advice that does not take these aspects into consideration is likely to have less impact, and may even be ignored by the authorities as sterile lecturing or criticism, rather than taken as workable solutions.

I would now turn to some issues of quality of coverage raised by the staff. I agree with staff that coverage of financial sector issues would have to attain greater depth to measure up to other areas. Staff argues that participation in FSAPs seems to have been the most important factor accounting for uneven coverage of financial sector issues. However, surveillance is conducted annually, while FSAPs have a longer cycle. Also, participation in the FSAP is and should continue to be voluntary, while surveillance is a mandatory exercise. ROSCs also have an indirect role in supporting surveillance as their periodicity is higher than annual, and they should continue to be voluntary exercises. I agree, however, that it is desirable to increase the voluntary participation both in FSAPs and ROSCs.

I agree with staff that coverage of medium-term debt sustainability has been inadequate. The staff suggests greater attention to sensitivity analysis with respect to exchange rate and interest rate assumptions. I agree, and would add to the list, the assumptions about GDP growth rate, inflation, and international market conditions. The staff also complains about lack of data on private sector debt and private sector balance sheet. However, analyses have been inadequate even for public sector debt where the data is more readily available. I would suggest that staff should, first, improve assessments for that part of debt for which data is available, before requiring countries to provide costly and difficult to collect data on private sector debt and balance sheet. If eventually required in the future, this type of data should not be limited to emerging markets, as has been suggested in an earlier staff paper, but should encompass also industrial countries due both to uniformity of treatment and analytical considerations.

While agreeing with staff that candor has been an important factor affecting the quality of treatment of exchange rate regimes in many countries, I wish to point out that there is a trade-off between candor and disclosure with respect to these sensitive issues. This trade-off would have to be addressed before greater candor can be achieved. Also, this is a case where, as important as candor of treatment may be, what seems to be even more relevant is the presentation to the country concerned of a workable strategy to deal with the problem, with the appropriate financial backing, if one wants policy advice to be implemented.

#### Multilateral Surveillance

The growing interdependence among countries has increased the importance of multilateral surveillance and of better integrating it with bilateral surveillance. The semi-annual WEO discussions are important to address common and cross-country issues, the inter-linkages among countries, and the systemic impact of policies and developments in major advanced countries, although the latter should also be covered in greater detail in bilateral surveillance. The WEMD discussions have been important vehicles to discuss key economic and financial market developments and systemic risks emanating from financial market events. The recent effort to spell out more clearly in these documents the policy implications of the analysis is welcome, but needs to be deepened.

The recent merging of the annual ICM with the quarterly Emerging Markets Financing Reports into the new quarterly Global Financial Stability (GFS) report has begun to bear fruits. The first GFS report has been of a very high quality, attesting to the appropriateness of the decision to create the new International Capital Markets Department. Of particular value was the emphasis given in the GFS report to developments in mature financial markets, and their potential spillovers to other countries, including emerging



markets. An example was the in-depth analysis of the market for credit transfer instruments in industrial countries, which was not only opportune, but also quite relevant to assess potential developments in credit markets with repercussions far beyond national financial systems.

One aspect that deserves greater attention is a more systematic incorporation of the conclusions of these various forms of multilateral surveillance into bilateral surveillance, and especially into program design and review.

### Bilateral Surveillance

As the staff observes, current policies with respect to Article IV consultations already provide flexibility with respect to frequency, mission size, background documentation, and consideration on a lapse of time basis. Considering the information provided in the paper, reliance on longer consultation cycles and consideration of reports on a lapse of time basis did little to reduce work pressure. As Box 4 indicates, these policies had been periodically introduced and abandoned in the past and, perhaps, consideration could be given to discontinuing them once again. Background documentation, which still remains substantial, may offer more prospects for reducing work pressure. I agree with the staff suggestion to encourage flexibility on the Selected Issues Papers, which in some instances may not be needed, as well as with the proposal for flexibility with Statistical Appendices, which could be discontinued when the information for the country concerned is readily available to the public.

### Surveillance in Program Countries

I am not convinced that the conduct of surveillance in program countries raises significant concerns about its effectiveness. A key issue is what is the definition of effectiveness. The staff analysis seems to equate effectiveness with coverage in the Article IV report, regardless of whether the policy advice has had a real impact on policy outcomes or not. If effectiveness of surveillance were to be measured by its impact on the policies ultimately adopted by the country concerned, maybe the opposite conclusion could be reached, namely that surveillance is more effective in program countries. Another issue is whether industrial countries should have been excluded from the sample. If the objective is to compare the conduct of surveillance in program countries and non-program countries it is not obvious that industrial countries should have been excluded. If industrial countries were included in the sample, again, maybe the opposite conclusion could be reached.

The interpretation of some of the features highlighted by the analysis as shortcomings of combined reports is also problematic, as staff acknowledges. For instance, the fact that a description of the views of the

authorities and the staff is not presented may be due simply to the fact that there is less to report in this area, since a program represents an agreement between the staff and the authorities on policy issues. In other cases, the alleged deficiency of coverage may be justified. For instance, not emphasizing the risks to the short-term outlook in cases of programs whose objective is to restore market confidence, especially given the possibility of publication of the report, a point also acknowledged by the staff. Nevertheless, there were some combined Article IV reports that provided adequate coverage in this area, as the examples mentioned in Box 3 of Supplement 2 indicate.

I do not share the view that surveillance needs greater independence from program activities. While it is true that not all objectives of surveillance and Fund supported programs are the same, both share many common broad objectives such as the maintenance or restoration of macroeconomic viability and external viability. Fund programs should be temporary events. During this period, given the importance of restoring market confidence and of solving the acute problems which led to the program, maybe the opposite could be argued, namely that program activities need to have precedence over surveillance. The problem of a broader and independent scrutiny of the overall strategy and of the policies followed under the program is adequately dealt with in our current structure by the independent review function performed by PDR. When necessary, changes in the strategy and policy may be considered during the review process and program reviews.

Establishing an “institutional firewall” between program and surveillance activities by having different groups or different mission chiefs dealing with each issue, as the staff pointed out, could lead to significant efficiency losses, create problems of coordination, and substantially increase staff numbers. Having two separate sets of assessments by Fund staff for the same country during the same period of time would create confusion for the authorities, market participants, and the public in general. In addition, the proposed separation of staff teams would not completely achieve the objective of ensuring independence between surveillance and programs, as management and the Board approving these policies would be the same for both activities. Pushed to its logical consequences, proposals for an “institutional firewall” would, indeed, require splitting the Fund into two organizations, one in charge of surveillance and another in charge of financing.

While there have been problems with inadequate program design and programs going off-track, as well as problems of prolonged use of resources and repeated programs, these are not surveillance problems. They are program problems that would have to be dealt with as such. I am not inclined to support the guidance suggested by the staff in the second and fourth bullets of paragraph 45, although I can accept the staff recommendations in paragraph 46 of SM/02/82.

Monitoring during program implementation is quite frequent, pays greater attention to detail, and is more specific and effective with respect to recommendations. As such, it can function as a temporary substitute to regular surveillance. I agree, therefore, with the staff proposals in paragraphs 47 and 48 of SM/02/82 to move members with Fund arrangements to a 24-month surveillance cycle.

#### Staff-Monitored Programs

The use of Staff Monitored Program (SMP) seems to require a closer examination and, perhaps, deeper changes than suggested in the staff papers. The use of the same instrument to achieve two completely distinct objectives—establish a track record towards a Fund arrangement and increase private creditor confidence seems to be inadequate.

The use of formal LOIs and MEPs, quantitative targets, structural benchmarks and a monitoring framework that resembles formal programs have increased the likelihood of misinterpretation between SMP and formal Fund programs. It is not clear whether the additional disclosure suggested by staff will help to solve or to aggravate the problem. While a format resembling the targeted arrangement may be useful for track-record SMPs, it may be less desirable for market signaling SMPs, as for the latter it is important to emphasize mainly medium-term external viability and to avoid confusion with a regular Fund program. On the other hand, the suggestion that public statements explicitly indicate the program's informal nature and the fact that it does not imply Board endorsement tends to detract from the main objective of signaling SMPs.

While it is difficult to draw firm conclusions on the strength of track-record SMPs after the introduction of the new guidelines, so far no improvement is apparent in relation to the earlier 1992-98 period. I also think that the understanding reached by the Board with respect to streamlining structural conditionality in programs should, with more reason, be applied to SMPs. In particular, the use of prior action for starting a SMP that is itself considered a kind of extended prior action and which involves no Fund resources is clearly an exaggeration. The use of prior actions in SMPs should be discontinued.

The staff should guard against requiring a SMP as a precondition for Fund programs when this is not specifically required in Board decisions. The delay associated with a SMP may be costly for the country concerned, while the benefits in terms of providing indication of good implementation in the future are inconclusive, as suggested in a recent conditionality paper. The marked upward trend in the number of SMPs during the last three years need to be monitored.

Preferably distinct instruments should be used for the different objectives establishing a track record and market signaling. One idea could be to keep SMP for the cases of establishing a track record, which represent three-quarters of this type of monitoring device, and to re-establish the use of the enhanced surveillance mechanism for the purpose improving private creditor and market confidence. For the reasons discussed above, I would prefer not to endorse the staff proposals to strengthen performance reporting and disclosure requirements for SMPs, until a deeper examination of these issues is undertaken.

#### Post program monitoring

Since the purpose of PPM is to provide early indication of problems in the capacity to repay the Fund, it is important that all PPM reports clearly establish a potential causal link between eventual vulnerabilities and repayment capacity. When the impact of the vulnerability cannot be quantified, staff should at least indicate how such vulnerability could affect the repayment capacity. Issues that are not linked to the capacity to repay should be covered in normal Article IV reports and not in PPM reports. In paragraph 73 of Supplement 2, the staff suggests that PPM reports should address progress on structural policies started during the previous arrangement. In my view, this goes beyond what was agreed during the PPM Board discussions. Only structural policies that have a bearing on the external capacity to repay could be covered in PPM reports.

#### Next steps

The staff indicates that a short follow-up paper containing a draft decision to conclude the 2002 biennial review of surveillance will be presented prior to the Annual Meetings. While agreeing with this approach, I wish to emphasize the importance of moving in parallel with the a draft decision revising the 1979 Conditionality Guidelines, whose review process seems now mature for reaching conclusion.

Extending his remarks, Mr. Portugal supported Mr. Padoan's suggestion that Article IV consultations should contain an assessment of the impact of previous policy advice on policy implementation, and Mr. Mirakhor's call for further research to find ways of eliminating the apparent asymmetry in surveillance between different types of issues and countries. Mr. Mirakhor's suggestions for ways to gain the willingness of countries to follow the advice provided by the Fund was also useful. The quality of the staff's advice remained, however, the decisive ingredient in that effort. It would be useful to develop an incentive structure that motivated countries to implement the surveillance initiatives. In that context, it would be worth exploring a pre-qualification approach and making the CCL more attractive.

The suggestion by Mr. Callaghan to discuss, at a separate meeting, the issue of how effectively to use the work of other organizations to enhance Fund surveillance was of great

value, Mr. Portugal continued. That issue was more complex than it seemed. When the respective other organization had the same membership as the Fund and operated in a similar way and in a similar field, there was not much of a problem. An example of such an institution could be the WTO. However, cooperation would probably be more difficult, with organizations with widely different memberships, work methods, and areas of expertise, such as the OECD or the Financial Stability Forum—both mentioned in the staff paper and in other Directors' statements. Membership in those organizations was much smaller than in the Fund, which could favor views on certain issues that differed greatly. There were also some organizations that relied more strongly on negotiated assessments with members, which also differed from the type of assessments made at the Fund and the World Bank.

While the use of work done by other organizations with a focus outside the Fund's area of expertise seemed to be a good idea, Mr. Portugal considered that there were clear limitations to such an approach. Given that peer judgment delivered by the Board was one of the most important elements in Fund surveillance, it was not clear how the Board could realistically provide those inputs in areas considered outside its own expertise. Utilizing a research paper produced by another organization in such a way would imply that the Board had to accept the conclusions without being able to subject them to the appropriate critical analysis. Given those complications, such issues should be discussed separately, as had been proposed by Mr. Callaghan.

Mr. Portugal clarified that he agreed with Mr. Wijnholds regarding the overall quality of Fund surveillance, with the caveats mentioned in his preliminary statement. Rather than intending to be critical, the objective was to follow the staff's view according to which there was no room for complacency.

Mr. Callaghan submitted the following statement:

#### Key Points

We need to assess all the factors that influence whether countries follow Fund policy advice, for policy action is the ultimate test of the effectiveness of surveillance.

The failure of governments to adopt Fund advice may not be all the fault of the governments - it may also represent shortcomings in the nature of the advice, how it is delivered, and its persuasiveness.

Staff may not always be focused on the 'end game'. Missions may not judge the success of their efforts in terms of the extent Fund advice is followed by governments, but how their reports are received in Washington.

The Board could lead by example with a critical look at what it could do to enhance the effectiveness of surveillance.

Greater selectivity in the coverage of surveillance is appropriate, but this should not compromise uniformity of treatment.

More needs to be done to integrate multilateral and bilateral surveillance and greater efforts are needed in making cross-country comparisons. This should be the Fund's strength.

There should be a separate discussion on how to use the expertise of other agencies, including private sector bodies, to enhance Fund surveillance.

Efforts to date to introduce greater flexibility into the surveillance process have been limited, they need to be reinforced via a more formal process of setting priorities and intervention by management.

Management should be alert to the need to introduce a 'fresh pair of eyes' in joint Article IV/program missions, however, creating 'institutional firewalls' would be counterproductive.

The rationale for 'signaling' SMPs needs to be reviewed.

#### Improving the Effectiveness of Surveillance Goes Beyond the Biennial Review

The staff has produced a comprehensive set of papers for the biennial review of surveillance. We particularly appreciated the frankness and self-criticism in the areas of monitoring SMPs and Article IV reports on program countries.

It is not a criticism, for we appreciate the large amount of work that has been undertaken in preparing the biennial review, but the nature of this exercise and the focus of the papers has a significant procedural component involving an assessment of the coverage, scope and modalities of surveillance. Such assessments are important, but they are only one input into addressing the fundamental issues which the Managing Director raised informally with Directors last week, namely, what can we do to improve the effectiveness of surveillance, both in terms of preparing better policy advice and having a greater impact.

The issues the Managing Director has raised are not new, nor will they ever be fully resolved. We face a constant task of having to continue to refine and improve the Fund's surveillance activities to ensure that they are appropriate to an ever-changing world.

Responding to the Managing Director's challenge to turn the lessons from the past into a comprehensive strategy to make Fund surveillance a more effective vehicle will require broadening the scope of the biennial review. In

addition, it may be useful to have frequent and informal mechanisms (say, semi-annually) to assess how we are approaching/adapting surveillance as country cases come up. The ultimate objective should be to assess the effectiveness of surveillance against the objectives laid out in paragraph 9 of SM/02/82 - namely: (i) to endeavor to direct economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability; (ii) to seek to foster orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions; and (iii) to avoid manipulating exchange rates to prevent effective balance of payments adjustment or gain an unfair competitive advantage.

Pursuing these objectives should not simply involve a critique of staff and requests for additional work by the staff. We should start by looking at the role, contribution and effectiveness of the Board in the surveillance process. In fact, the Board should set an example for staff in terms of undertaking a frank, self-critical look at its leadership and contribution to the task of surveillance.

At the heart of Fund surveillance is policy advice, which we hope will translate into policy action. The gathering of information, analysis of economic trends and issues, and assessment of vulnerabilities are all directed towards identifying needed policy responses. The ultimate test of the effectiveness of Fund surveillance is whether it contributes to governments taking policy action which resulted in achieving the objectives of surveillance outlined previously. This will in turn depend on whether Fund surveillance: (i) concentrates on the right issues; (ii) provides appropriate policy advice; and (iii) is sufficiently persuasive.

Are we focusing on the right issues and do we offer the right policy advice?

The papers prepared for the biennial review address the coverage of surveillance. The conclusion is that while the scope of surveillance has broadened, it has not lost its focus, although there perhaps should be greater selectivity. It is hard to disagree with the desirability of selectivity, or pursuing a hierarchy of concerns - for surveillance should be adapted to a country's needs and we should avoid any perception that we follow a rigid template or "one size fits all" model. For example, the approach to vulnerability analysis is sometimes overly formulaic, with undue attention paid to simplistic ratios and insufficient regard to the underlying vulnerability of an economy. In addition, it would clearly be inappropriate to apply the same approach to surveillance in a very small developing economy as it would in a large industrialized country.

Greater ‘selectivity’ should not compromise uniformity of treatment

Operationalizing greater “selectivity” in surveillance, while maintaining uniform treatment among members, is no easy task. In terms of whether there is uniform treatment among members in surveillance, we pose the following questions:

is there the same recognition of domestic political constraints and the need to build consensus in support of reform efforts in developing as developed countries;

is there the same treatment of privatization issues in developed countries as there is in developing countries;

does the candor of the discussion of the appropriateness of exchange rate regimes vary among countries; and

is the coverage of trade issues, production subsidies and income support mechanisms the same for all members.

We support greater selectivity in surveillance, but there should always be good reasons why issues are approached differently in different countries.

In terms of the coverage of surveillance, one specific thought we would offer is that Article IV consultations should regularly cover such matters as the use (or non-use) of collective action clauses in sovereign issues.

Coverage of financial sector issues

While recognizing the desirability of strengthening the coverage of financial sector issues in regular Article IV processes, the underlying structures that make a financial system fundamentally sound or otherwise may not change substantially from year to year. This is in contrast to some of the key macroeconomic factors, such as the stance of fiscal and monetary policy. On this view, the longer assessment cycle entailed in FSAPs and ROSCs might be sufficient for financial sector issues and coverage in Article IVs to the same depth as the other key elements might not be necessary.

Do we sufficiently integrate multilateral with bilateral surveillance?

The papers outline the innovations in the conduct of multilateral surveillance, and note that the integration of multilateral and bilateral surveillance has evolved significantly. However, when it comes to Article IV consultations, it is sometimes not evident that the international backdrop affecting a country’s economic outlook is adequately taken into account. Towards this end, some specific points we need to consider include:



do we sufficiently understand the nature of the inter-linkages between economies, particularly the non-trade linkages;

do we regularly refer to international developments being fundamental to the outlook for a particular economy without fully understanding how developments in the world economy will actually impact on that economy; and

do we sufficiently take into account the aggregation effects of the policy advice recommended to individual countries - for example, in the context of advising individual countries to contract domestic demand and depreciate their exchange rates?

Greater effort is needed in making cross-country comparisons.

The comparative strength of the Fund, with its near universal membership, should be in providing advice on the policies and experiences in other countries facing similar policy challenges. Being able to draw on cross-country experiences should also help in convincing countries to take the policy advice offered by the Fund. However, the extent of cross-country comparisons in Article IV consultations seems to be something of a hit-and-miss affair, with a lot depending on whether a staff member happened to work on another country facing similar issues.

Drawing on the expertise of other agencies

The Managing Director has suggested there is a need for better ways to reach out to other institutions for their input and expertise so as to enhance surveillance. For example, we should increase our interaction with the OECD on structural issues in the developed economies, the WTO on trade matters, BIS on financial sectors, and the ILO on labor issues. The Fund should also draw on the input of private sector bodies, including NGOs, although there will always need to be a selective and critical assessment as to the extent we can rely on outside expertise. We cannot delegate our responsibilities for surveillance.

It would be desirable if we had a separate discussion covering the extent of interaction with other agencies that takes place now and how we can effectively utilize their work in enhancing surveillance.

Is our policy advice sufficiently persuasive?

As the Managing Director has noted, not only should we do everything possible to enhance the quality of Fund policy advice, we also have to ensure that it is heard and has impact. This is the challenge that every domestic policy adviser faces, and it is a very different world from academia.

In the case of non-program countries, whether the advice of the Fund is accepted or not will depend on its quality, its responsiveness to the country's circumstances, and its persuasiveness. Certainly, there is a role for peer and public pressure which the Fund can help bring to bear, although this raises the issue of transparency which we will be considering at a later date.

The failure of governments to embrace the policy reforms advocated by the Fund may not, however, simply be the fault of the governments concerned—it may say something about how the Fund approaches its policy advising task. With this in mind, we pose the following questions:

Does staff measure the success of an Article IV consultation by the extent to which they have an impact on a country's economic policies, or how the staff report is received in Washington? We fear in many instances it is the latter. The 'client' should always be the country and not management or the Board.

Do Ministers of Finance or Central Bank Governors read staff reports? We would suggest that in many instances, the key to the success of a mission depends on the extent of the dialogue, the interaction with the authorities that takes place when the mission is in the country and not what is written when the mission returns to Washington. As such, much depends on the rapport and confidence that mission leaders can establish with the authorities.

Do mission leaders adequately understand and appreciate the constraints facing the authorities, particularly the political situation? The Managing Director has noted that we have to recognize that crises have a lot to do with political factors, and he asks whether the Fund is well equipped for political analysis. This is an area where improvement is clearly necessary. If the Fund is to have an impact with its policy advice, it has to be in tune with the political situation a country faces.

Do we spend too much time on advising what policy changes are required and not enough time in advising how the changes can be achieved? It is one thing to say what policy measures should be adopted, it is another to advise on how the policy changes can be successfully implemented. In many instances the authorities know what has to be done, but the challenge they face is building the necessary support to implement the needed reforms. With this in mind, focusing on the costs and benefits of reform and the merits of alternative options, as well as drawing on the experiences of other countries, may prove to be influential in helping countries adopt recommended policies and build a domestic consensus in support of reform.

Do mission members and mission leaders change over too frequently? It takes time to understand a country and for the staff to establish sufficient

respect within a country such that Fund advice may be heeded. This is particularly an issue for the smallest members of the Fund, who often face a completely new mission for every Article IV consultation.

In addition, if advice is to be persuasive and ultimately useful to the authorities, it is important that it be timely. In this regard, we wonder if there is scope to reduce the time between the mission visit and the conclusion of the consultation by the Executive Board.

#### Greater Flexibility in Article IV consultations is required

The proposal put forward in the paper is to stick with the current policy in respect of lapse of time conclusions of Article IV consultations, mission size, scope of staff reports and Selected Issue Papers, but to encourage greater flexibility. We would certainly endorse the need to apply greater flexibility with respect to all these factors. However, if the quest for greater flexibility with respect to Article IV consultations has not been successful to date, why should it be more successful in the future? There is perhaps a need for a more formal process of establishing surveillance priorities and actively pursuing flexibility. For example, with respect to Selected Issues Papers we have the impression that the staff feel obliged to produce such papers regardless of whether they add to the Article IV analysis in a substantive way. Perhaps staff should be required to justify the production of each Selected Issues Paper.

As to the frequency of Article IV consultations, the impression given in the paper is that the move to a 24-month cycle has not been a great success. However, where does this leave those countries currently on a 24-month cycle? We would note that of the 18 countries still on a 24-month cycle, 7 are in this constituency. These are very small economies, but they face enormous economic challenges. In many cases, communications are poor and it is difficult to undertake ongoing monitoring. Moreover, these are the economies who face a completely new Fund mission team with every consultation. We are not suggesting that we eliminate the 24-month consultation cycle altogether, but special efforts are needed to maintain ongoing contact with many of the countries on the 24-month cycle. The Fund needs to do more in this regard.

#### Surveillance in Program Countries

There is clearly a danger that program missions may lose perspective with respect to a country. They may become too immersed with the details of a program, and lose the capacity to step back and take a critical look at any shortcomings in the program itself as well as problems with its implementation. Article IV consultations have the potential to provide an objective view. We therefore support efforts for a greater degree of

independence between program and Article IV missions, but this should not be at great resource cost. We also think the notion of 'institutional firewalls' is inappropriate, since this implies no flow of information between the Article IV and the program processes.

Perhaps what is also required is more active oversight by management of each program and a greater preparedness to introduce a 'fresh pair of eyes' if required. This may involve separating the Article IV from the program mission in some cases, or alternatively in a joint program/Article IV consultation, incorporating a senior staff member who has not been part of the program team.

As for moving Article IV consultations to a two-year cycle for program countries, this should be addressed on a case-by case basis. The qualifications outlined in paragraph 48 should only be seen as a guide in terms of applying flexibility with respect to the consultation cycle.

#### Staff-Monitored Programs

The problems identified with the monitoring and transparency of SMPs are essentially questioning the role of 'signaling' SMPs. We agree with this questioning, for while we see a clear rationale for an SMP to build a track record leading to a program, the rationale for a signaling SMP, and its relationship with the Article IV process, appears less clear cut. Rather than establishing new guidelines for reporting on signaling SMPs, we suggest that their whole rationale be examined.

Extending his remarks, Mr. Callaghan emphasized the need for better mechanisms to bring cross-country comparisons to bear in the context of surveillance. That had already been an element of the Fund's response to crises, and some organizational steps had been taken to bring the experience gained in various crises together so as to find responses to a particular situation. It appeared that cross-country comparisons were often better structured in OECD country surveys than in Fund surveillance reports. The former Director of PDR had, at some stage, also considered that this was an area of surveillance that could be strengthened.

Mr. Zoccali and Mr. Le Fort submitted the following statement:

We thank staff for the lucid set of papers for the Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision, a subject that lies at the very core of the Fund's responsibilities. At the outset, we very much favor a broadened framework for Fund surveillance, where crisis prevention in individual countries is only one objective, within the wider focus of the promotion of a stable global macroeconomic environment conducive to stability and growth for the membership at large. In this regard, adequately addressing systemic problems is a prerequisite for the success of the surveillance process.

The need for a global approach for assessing systemic issues thus points to the important role of regional and multilateral surveillance exercises in the identification of systemic risks. Within this broadened framework for surveillance, the criterion of macroeconomic relevance should continue to be the central one for selecting particular concerns that may be relevant to this process. However, within the broadened approach, the assessment of macroeconomic relevance should refer not only to the effects of policies or other issues on the originating country, but also on its international repercussions. Particularly important in this respect are trade distortions including subsidies, and financial regulations or conditions in large advanced countries that could generate significant macroeconomic impact particularly in developing countries. We concur that concerns affecting the sources of growth and the global impact of policies in individual countries should be placed high on the hierarchy of surveillance concerns.

Surveillance should thus be part of a process that helps countries to define an all-encompassing medium-term policy strategy coherent with stability and growth objectives. As such, this process should not only point to the risk to external sustainability, but also help countries to define a medium-term policy framework that would foster both national prosperity and positive externalities throughout the membership. Better policy advice framed in this fashion is more likely to have a greater impact. Regrettably, the leverage of the Fund to make its surveillance more effective is not only weak, but also asymmetric. While developing countries in actual or potential need of Fund resources have direct incentives for maintaining an open dialogue with the Institution at the highest decision-making levels in other members that are not expected to make use of Fund financing, in particular the largest industrial countries there appears to be only a limited capacity for Fund advice to influence these countries' policies. The limitations on the effectiveness of Fund surveillance are thus not derived from issues of opportunity or frequency of policy consultations, but rather of incentives. It is necessary, in our view, to develop incentives schemes that could help reduce or overcome the asymmetries to increase the overall effectiveness of the surveillance process through positive incentives, such as merit lists or automatic and publicized access to facilities that would reinforce the private sector perception of low risk, or even negative incentives in the form of name and shame lists in cases where national policies entail particularly unfavorable global externalities.

We consider it important to further clarify the current procedures governing Article IV consultations, and see room for additional simplification. On the one hand, we see merit in not focusing on the issue of opportunity of the consultation, but rather it is the clarity of the message and the quality of the policy dialogue that matters. Simplification and streamlining appear to be desirable, for example, when it comes to defining the need to produce Statistical Appendices in countries that are subscribers to the SDDS. More synergy with the SDDS design could in turn allow for the production of the

relevant tables. Similarly the frequency of individual Article IV consultations in some low-risk countries appear to be excessive, keeping in mind the upgraded process both formal and informal of multilateral surveillance.

Capital account issues have rightly become a central part of the surveillance concerns. On the one hand, the volatility of external financing imposes significant risks for emerging market economies, and the assessment of the vulnerability of their current external positions should be a central feature of crisis prevention and a first priority for Fund surveillance. On the other hand, the structural reforms related to the liberalization of the capital account and the appropriate sequencing for advancing towards complete integration in globalized financial markets are critical elements for good management of external risk. Appropriate Fund surveillance should go beyond identifying the conditions and risks for external sustainability and include in addition to the diagnosis, the elements underlying the solution for the member's policy dilemmas.

There can be no general prescriptions for an appropriate sequencing to international financial integration, nor is it reasonable to expect an immediate and unconditional liberalization of all restrictions. Nevertheless, the final objective is both generally applicable and clear: all countries should aspire to become integral parts of a global system of trade and finance. In this regard, the sequencing of the integration process should be approached keeping in mind the general lessons drawn from past experiences, with due consideration given to the particular risks and structural conditions faced by each country. The development of adequate institutions is central to the definition of the appropriate sequencing among them the development of adequate monetary and financial institutions including the framework for prudential regulatory oversight and markets. This points to the importance of technical assistance to ensure that better Fund advice can have its intended impact, namely good policy implementation for sustained growth. Institutional reforms at the level of the individual country level should also be complemented by the development of the relevant global institutions, regulations and markets.

An effective multilateral assessment of financial risks should include the entire membership with exposure or participation in international financial markets. The focus on recipient countries without also considering the conditions prevailing in the suppliers of funds is self defeating. We consider, therefore, that Fund surveillance is uniquely placed to provide a comprehensive assessment of financial risks, not just specific or unconnected details concerning the different financial industries or markets. In addition to contributing to the diagnosis and with the best policy advice for individual country problems, the Fund and other specialized institutions also have a particularly important didactic role to play in helping market participants to better assess policy risks and limitations. ROSCs and FSAPs may serve as snapshots on relevant issues affecting individual country surveillance. However,

these should not be seen as sufficient to pass or fail a country, but rather as one element in the assessment of risks for the purposes of surveillance.

To avoid confusion and misinterpretation it is important that a clear differentiation be made between countries with SMP and with active Fund arrangements, and that this differentiation should be made transparent. For the purposes of surveillance, SMP countries should be treated as other non-program countries, whilst program countries should be considered special cases. Program discussions and reviews should already focus on these countries' relevant concerns, and for these a full surveillance exercise appears redundant. At the same time, focusing surveillance on the issues and conditions likely to surface beyond the program time frame, or on core aspects not included in the Fund-supported program could indeed add value to the process of defining adequate policies.

On balance, we do not see a justification for independent surveillance in the case of program countries. On the one hand, this would put further stress on limited Fund resources and on the other, independent surveillance may end up sending conflicting signals from the Fund to policy makers. Fund policy advice should be unambiguous and not lead to different interpretations. The independence of the Fund's assessment should be guaranteed by the participation of the relevant departments in program design and review and by the timely involvement of the Executive Board at critical stages of discussions with country authorities.

Lastly, the Fund has, in the exercise of its surveillance responsibility, an obligation to strike the right balance between transparency and candor. Privileging its role of confidential advisor is deemed critical if Fund policy is to have the greater impact on policy correction and confidence building that is generally expected from the surveillance exercise.

Mr. Shaalan and Mrs. Farid submitted the following statement:

The papers prepared for today's discussion demonstrate that Fund surveillance has generally adapted well to the rapidly changing global environment of the past decade. In response to growing global integration, particularly through massive and volatile cross border capital flows which have significantly increased member economies' vulnerabilities and heightened the risks of contagion. Fund surveillance has been strengthened by widening its coverage and modifying its modalities.

#### Broadened Coverage

Over the past decade, and particularly in response to a series of crises, Fund surveillance has been broadened from its traditional focus on exchange rates and external, fiscal and monetary policy issues to cover broader financial

issues, including in particular, conditions in the financial sector whose soundness has a strong bearing on the vulnerability of economies to exogenous shocks. The coverage of exchange rate issues has also been deepened, and greater emphasis has been placed on exploring the linkages between the financial sector, the capital account, external debt issues and exchange rate policies. External debt sustainability analyses have also received considerable attention and are now a regular feature of consultation reports. International capital markets are also being monitored more closely than ever before. These are welcome developments. Nevertheless, we note three particular concerns that are highlighted by the staff:

First, despite the increased emphasis on financial sector issues, the staff paper indicates that adequate coverage of the financial sector is still lacking outside the FSAP framework. While the last surveillance review had recommended reinforcing Article IV mission teams with financial expertise, it is apparent that progress in this area has been slow. We would venture to suggest that staffing constraints are at the root of this shortcoming, but would appreciate staff views on the difficulties faced in achieving this important objective. In our view, upgrading the quality of financial sector surveillance in Article IV consultations in countries not participating in FSAPs should be accorded a high priority. As an important aside, it must be noted that identifying problems in this sector must lead to the provision of technical assistance. Again, staff constraints are an issue which, in our view, is not adequately addressed.

Second, it has been recognized that weaknesses in the non-financial corporate sector could aggravate financial sector problems and constrain the ability of countries' to adjust policies in the face of a crisis. Staff point out that in many cases it is difficult to assess the vulnerabilities of the non-financial corporate sector due to a general lack of information. The subtle implication seems to be that maybe the role of ROSCs would need to be changed in order to address this information constraint. Here, we would caution that changing the voluntary nature of ROSCs would not be the solution and we would be firmly opposed to it. The correct response is to encourage member countries to collect such information with the help of the World Bank. The difficulties involved, however, should not be underestimated. It is well to note here that in the last biennial surveillance review, Directors called on staff to intensify collaboration with the World Bank in the analysis of corporate sector vulnerability, with a view toward identifying useful operational indicators. We would appreciate staff elaboration on what steps have been taken in this direction. This area should remain the responsibility of the World Bank.

The third concern raised in the paper, also in connection with the coverage of members' vulnerability to crises, is the less than adequate coverage of medium-term sustainability issues. We would concur with the recommendation that all balance of payments scenarios be subjected to



sensitivity analyses and alternative growth assumptions in order to make the analysis more useful.

Still on issues of coverage, a heightened appreciation of the importance of structural and institutional issues on economic performance has also broadened the range of potentially macroeconomically relevant issues covered by Article IV missions. We must distinguish here between structural and institutional issues that lie in the core areas of the Fund, like central bank independence, financial sector regulation and fiscal transparency, and those that lie outside the core areas. It is essential that a high degree of selectivity be applied when dealing with issues outside the Fund's core areas of competence and expertise. Selectivity should continue to be guided by the criterion of macroeconomic relevance, as was reaffirmed in the summing-up of the last biennial surveillance review. Explicit justification for coverage of non-core areas, by demonstrating macroeconomic relevance, should also be consistently provided in staff reports.

On the specific question of trade coverage, while we welcome the recently increased attention that has been accorded to trade issues in advanced economies, particularly the larger ones, more needs to be done. A higher priority needs to be accorded to issues of trade protection, particularly when they have a significant global impact.

#### Implementation challenges

Notwithstanding the generally satisfactory application of the Fund's surveillance over the past two years, serious difficulties in implementation have no doubt accompanied the expansion in coverage. The first difficulty has to do with the risk of losing the proper focus of Fund surveillance by an excessive broadening of our efforts into non-core areas. This would clearly undermine effectiveness. A closely related risk is the possibility of weakening the analytical rigor of the Fund's assessments, in view of resource and staffing constraints. Staffing shortages, which we have witnessed lately, could well lead missions to cut corners in order to cover all the areas that they are increasingly being asked to cover, thereby undermining the excellence of the Fund's macroeconomic analysis. If this were to happen, it would lead to a loss of credibility which, once lost, would be difficult to regain, as we have so often warned our member countries. Our decisions back and forth on the frequency of Article IV consultations, alternating between strict adherence to annual consultations to assure continuity of surveillance and greater flexibility in timing to reduce work pressures, are an obvious reflection of the challenge posed by an expanded workload in the context of serious resource limitations and our reluctance to address the issue squarely. Our current drive to eliminate as much background material as possible in connection with Article IV consultations is yet another manifestation of these constraints, which have necessitated a reallocation of resources. Of course, a reordering of priorities

based on changing conditions and evolving requirements of surveillance is a healthy and necessary exercise. However, as we do so, we should not lose sight of our purpose and our mandate.

Another implementation challenge posed by the expansion in coverage has been how to draw effectively on the expertise of other international institutions, like the World Bank, in areas beyond the Fund's traditional areas of competence when they are macroeconomically relevant. We would simply note here, that despite the best intentions and our traditionally close relationship with the Bank, we continue to face difficulties in integrating our work with that of our sister institution. We should, to the greatest extent possible, maximize our cooperation with the World Bank, whose work is complementary to ours in many ways, rather than expend scarce resources trying to reach out to institutions whose work is not closely related to ours as the Bank.

A related concern arises from the question of whether to accord "growth" a higher priority on the hierarchy of issues to be covered in surveillance. We do not see the benefit to doing so. While no one can deny that the ultimate objective of all policymakers is to achieve high sustainable growth, we all know that this involves a host of areas and policies that go beyond the Fund's mandate and expertise. Placing an even stronger emphasis on growth than is the case at present would only serve to dilute the focus of our surveillance. We should also guard against encroaching on the sovereignty of our members by straying into non-economic areas, which we are neither mandated nor equipped to address.

#### Integration of multilateral and bilateral surveillance

We welcome the progress made in improving multilateral surveillance in response to the increasing global trade and financial linkages. The expansion in the surveillance of financial markets, which was made possible by the establishment of the International Capital Markets Department is particularly commendable, and should impact Fund surveillance positively. Progress has also been made in the integration of our multilateral surveillance with bilateral surveillance with regard to emerging market countries, most notably with the new vulnerability assessment framework. For the larger industrial countries, such integration should lead to a greater emphasis in Article IV reports on the global impact of policies. We need to encourage staff to make stronger progress in this area. More efforts are also needed to integrate multilateral and bilateral surveillance in the case developing countries that are not classified as emerging markets. Integration here still takes place in an ad hoc manner that is not very effective. What is needed is a more structured framework that would systematically integrate the work of these area departments with the work of the Research and Capital Markets Departments.

#### Article IV consultation procedures and documentation

We continue to believe that Article IV consultations remain central to the Fund's surveillance. Frank and candid discussions between the Fund and country authorities lie at the heart of surveillance, particularly for assessments of exchange rate policies. It is imperative that we do not in any way jeopardize this candor, which is essential for the Fund to effectively perform its central role of confidential advisor to its members.

We are concerned by the decline in total staff resources devoted to Article IV surveillance and by the increased delays in the conclusion of consultations, which have effectively meant that consultation cycles have lengthened further in 2000-01. More information on what was being eliminated by this decline in staff resources would be appreciated. Reducing staff resources at a time when financial sector surveillance needs are not being met is particularly disturbing.

As to the proposed clarification of the current streamlined consultation procedure, we have the following comments:

While we agree to the proposed flexibility on Selected Issues Papers, we feel that our new policy on REDs, which is closely related, may require some modification. Specifically, according to current policy, information previously provided in REDs would now, if needed, be folded into the Selected Issues paper. However, this does not address the cases where it is decided that a Selected Issues paper is not needed (or staff constraints do not permit it), but an RED is desirable. Apparently, current policy does not take account of such an eventuality. According to current policy, if there is no Selected Issues paper then there can be no RED coverage. We have just come across such a case in our constituency. This situation should be remedied.

On Statistical Appendices, we continue to believe that the information in these documents is essential for effective surveillance. This information should be readily available at country desks in area departments. Continuing to make it available to the Board and, of course, to the country concerned, should not be too resource intensive. Asking Directors to navigate the Web to find this information is impractical and inconvenient. As Mr. Kiekens has noted on previous occasions, the potential resource savings to be expected with the elimination of Statistical Appendices are minimal and do not justify such a change.

#### Surveillance in program countries

The paper on surveillance in program countries is built on the premise that concerns have been raised with regard to the effectiveness of Fund

surveillance in a program setting. This came as a surprise to us. Although the paper goes to great lengths in its attempt to provide evidence that would justify such concerns, it fails to make a convincing case that a systemic problem exists. We are not convinced that the existence of a program hinders the “independence” of surveillance in that country. If anything it reinforces surveillance and improves its focus. At the same time, we find that staff have generally been doing a good job of looking beyond program targets and of modifying programs as circumstances changed. Those who raised the ‘independence’ concerns may have had specific cases in mind where surveillance may have been less than optimum in a program context. If that is the case, then we should identify these cases and address them individually. We should also find out what role resource constraints play when surveillance is judged to have been less than adequate.

Since we are not convinced of the existence of a systemic problem, it goes without saying that we would have serious reservations to radical approaches like building an institutional firewall between program and surveillance activities. Having said that, we see no harm in having Board provide clear guidance to staff on the conduct of combined Article IV consultation. However, like Mr. Portugal we are not inclined to support the second and fourth bullets of paragraph 45. As to the proposed guidance on the timing of the Article IV consultation with program countries, we support the staff proposal as presented in paragraphs 46–49 of the overview paper.

#### Staff-monitored Programs

We agree that clearer guidance should be given to staff on the inclusion of progress under SMPs in Article IV staff reports, since the quality of such reporting appears to have varied widely. However, we do not agree to the proposal to have a presumption of publication of the authorities’ MEFP and staff performance assessments. This is inconsistent with our policy on the voluntary publication of consultation reports and would blur further the distinction between a SMP and a Fund-supported program.

Additionally, an operational distinction between an SMP and a so-called precautionary arrangement is called for. All Stand-By Arrangements are precautionary arrangements and the country chooses whether to draw or not. As such there is no facility that can be termed a precautionary arrangement. Having said that, the discussion in the paper indicates that the rationale for the use of SMP’s as a signaling mechanism needs to be reviewed.

To conclude, let us guard against the culture of attempting to address all economic issues facing a particular country or the global economy. The Fund is not equipped, nor should it be, to assume that role. Doing so can only reduce the credibility and effectiveness of the institution.

Extending his remarks, Mr. Shaalan pointed to a discrepancy between Supplement 1 of the staff paper currently before the Board (SM/02/82, Sup. 1, 3/15/02) and the paper on Intensified Work on Anti-Money Laundering and Combating Financing of Terrorism (SM/02/97, 3/27/02). He agreed fully with the language in Paragraph 96 of SM/02/82, Sup. 1 on the Framework and Conduct of Surveillance in 2000-01, which referred to “the coverage of systemic initiatives such as efforts to combat money laundering or the OECD anti-foreign bribery initiative. While it might be argued that the Article IV process—which is the most regular formal mode of interaction between the Fund and national authorities—is a convenient channel to address issues of broad interest in the membership as a whole, this consideration must be weighed against the danger of overloading the Article IV process and diluting its focus”. However, Paragraph 25 of SM/02/97 conveyed a different message on the same subject by saying: “The biennial review of the implementation of the Fund’s surveillance (SM/02/82, Supplement 1) notes that coverage of systemic initiatives—like AML/CFT—in the Article IV process, which is the most regular mode of interaction between the Fund and national authorities, is a convenient channel to address issues of broad interest to the membership as a whole. This consideration must be balanced against a danger of overloading of the Article IV process”. That language suggested that the decision had already been made, whereas the paper on surveillance gave a more balanced presentation. Unless that discrepancy could be explained, it would be difficult for his chair to go along with either of the documents.

The Chairman noted that staff from two different departments were working on those issues, and that only the paper on surveillance was currently under discussion. The other paper would be discussed during the following week, and should, therefore, not be an obstacle to the current Board discussion. Mr. Shaalan’s point relating to the issue of Anti-Money Laundering and Combating Financing of Terrorism efforts could be addressed early in the following week.

Mr. Duquesne thanked Mr. Shaalan for pointing out that paragraph in the paper on Fund surveillance, although he would draw conclusions from it that were different from those that Mr. Shaalan had presented. In fact, the wording of Paragraph 96 of SM/02/82, Sup. 1 was disappointing in view of the fact that, at an earlier Board meeting, there had appeared to be broad consensus that this area should be included in Fund surveillance. The French chair had even argued that it should be included in conditionality—a position which had, however, not been widely supported.

The Chairman suggested that the issue of how Anti-Money Laundering issues should be treated within the context of Article IV consultations should be addressed at a later stage.

Mr. Kelkar submitted the following statement:

#### Key Points

A broadened framework surveillance must be seen against a hierarchy of concerns unique for each country (Para 2).

The surveillance process should not only be directed at crisis prevention, but also at sources of growth within a country and in case of major industrial countries, the spillover effect on other countries in both the regional and global context (Para 3).

Focus on trade issues should be strengthened (Para 4).

Discussion on exchange rate issues should be more forthright and incorporate cross-country effects (Para 5).

While the FSAP/FSSA reports are extremely valuable in the surveillance process, resource constraints must be kept in mind while considering expansion of their coverage (Para 7).

We would like to see a greater integration of multilateral surveillance with bilateral surveillance and into both program design and conditionality (Para 8).

Guidelines need to be framed for issue of the Selected Issues paper (SI). The Statistical Appendix should be retained (Para 9).

A brief description of the policy debate within the country would add value to documentation (Para 10).

The Fund should interact with legislative bodies as part of the surveillance exercise (Para 11).

Periodic external evaluation of surveillance output would be useful (Para 12).

Surveillance in program countries should be improved within the existing framework. The aggregate number of Board discussions—formal program reviews and the Article IV consultation for a country should not normally exceed three per year (Para 13).

We should not tighten standards for signaling SMPs (Para 15).

We wish to thank staff for a set of comprehensive and insightful documents, which trace the evolution of Fund surveillance against the background of the rapidly changing global environment, and candidly analyze the conduct of surveillance since the last review. While it can be argued that in the past, the Fund has been reactive and new initiatives in surveillance have been primarily driven by crises, the changes made in the coverage and tools of surveillance do demonstrate the flexibility and resilience of this mechanism. We are pleased that increasingly, the Fund has been proactive with its focus on crisis prevention through initiatives like the improved coverage of ROSCs

and FSAPs, the development of policy guidelines on public debt and reserve management, and the increased interaction with capital markets.

#### Coverage and Focus of Surveillance

With the remarkable increase in global trade and capital flows, surveillance has become a more complex exercise with coverage beyond the conventional “core concerns”. Given that priorities would be different for each country, we agree that a hierarchy of concerns needs to be developed, unique for each country with exchange rate policies, balance of payments, financial sector and cross country issues ranking high in this ordering. Selectivity needs to be maintained in respect of other areas, but the exercise of selectivity would be dependent upon the country concerned and its stage of development. For example, given the growing importance of wealth effects on macro economic development we would like to see a greater emphasis on asset markets, including the housing market, in the surveillance of industrial economies. In some countries, the energy sector is similarly relevant to macro economic development and should receive specialized attention. We welcome staff comments.

We see the Article IV surveillance process as a framework not only directed at crisis prevention through addressing short-term issues, but also as a platform to suitably highlight significant medium term issues which have the potential to erupt as crises. An important issue would be the identification of the sources of growth in an economy and the policy action required at national and international level to actualize this potential. We also feel that in case of the industrial countries, the Article IV consultations should look at the ‘externalities’ of their policies i.e. the spillover effect on other countries in both the regional and global context.

#### Trade

We strongly support the staff suggestion to strengthen the focus of trade issues in surveillance. This has also been mandated by the IMFC. The Fund should be at the forefront in advocating and promoting trade liberalization on a multilateral basis. This would require regular attention to trends and issues in the global trading system, including the impact of large country policy actions on the rest of the world. Restrictive trade policies and practices in the major economies and the spillover effect it has on other countries would require a clearer exposition in staff papers. This has been seen in some consultations—e.g., the lucid box in the Brazilian 2001 Article IV consultation document describing the trade barriers faced by Brazilian exports in industrial country markets. We would like to see the extension of such coverage to the reports of other countries. Staff could also place greater emphasis on the impact of preferential trade arrangements in place, particularly on countries, which are affected by, but are not members of the

arrangement. In this regard, staff should explore the possibilities of incorporating inputs from the WTO's Trade Policy Review into the framework of multilateral surveillance. We welcome comments.

### Exchange Rate Issues

We note that while attempting to balance candor with the need to avoid adverse market reactions, staff have tended not to question exchange rate regimes in some economies resulting in conclusions that 'have typically been less than explicit'. We support the suggestion that discussions on exchange rate issues could be franker. While the member's choice of a particular exchange rate regime should be respected, this should not prevent a candid staff analysis on the sustainability and overall economic impact of the exchange rate regime in all cases, including currency boards and other hard pegs. It will be difficult to do so while simultaneously maintaining the confidentiality of market sensitive discussions, but not doing so will affect the credibility of the surveillance process.

As with trade issues, during multilateral surveillance, we would like to see a discussion on the impact of exchange rate policies of industrial countries on the rest of the world, particularly on developing economies.

### Financial Sector Assessment

While the analysis of the financial sector does rank high in the hierarchy of surveillance concerns, we note that an adequate coverage is dependent upon the availability of prior studies of the sector or the participation in the FSAP. The FSSA is a very useful vehicle to outline risks emanating from the financial sector. A strong focus on OFCs/HLIs is needed to highlight stability issues, wherever relevant. As part of this initiative, we could encourage member countries to increasingly assume ownership of the FSAPs as well as the responsibility to update them regularly. While aiming for these objectives, resources may prove to be a constraint. This limitation needs to be addressed, through careful deployment of the existing resources, and consistent with a prioritization process discussed during the FSAP review last year. Simultaneously, we suggest a deliberate emphasis on the use of information technology in this process. Offsite data collection and monitoring and the use of video conferencing, could reduce the pressure on staff resources, given that a significant amount of staff surveillance time is spent on travel.

### Multilateral Surveillance

We commend the initiatives taken for strengthening multilateral surveillance, including establishment of the ICM department and the CMCG, as well as the improved efforts at dissemination of information. While we note



the efforts being taken in this direction, we would like to see a greater integration of multilateral surveillance into bilateral surveillance and into both program design and conditionality. This would be an important measure of the impact of surveillance—how much its findings are internalized within the Fund.

#### Bilateral surveillance

While we agree to the proposal on flexibility on Selected Issues Paper, we strongly urge that staff be given the maximum leeway in the production of this useful document- which often buttresses the arguments made in the Article IV document and enhances understanding about the economy. We understand that the lack of guidelines for producing a SI paper often clouds decisions in this regard, and we urge that relevant guidelines for issue of SI papers be framed. We are more uncomfortable with the proposal to introduce flexibility in the production of the Statistical Appendices, even though this will be subject consultation with (and not consent of) the concerned Executive Director. Such appendices provide valuable information often necessary for the enhanced appreciation of the Article IV document. Staff would in any case have prepared these tables during the course of the consultations, and the incremental use of resources for publishing them; would at best be marginal. For a significant number of countries, Statistical Appendices remains the only source of reliable information. Other countries, which do publish their statistical data on the web, may not provide convenient and costless access to time series data. We therefore strongly feel that the Statistical Appendices should be retained.

Staff point out that in some consultations, there is no account of the policy dialogue between staff and the authorities on key policy issues. This would be useful, but we would suggest going a bit further. Given the significance of political factors on policy formulation, we would like to see, wherever relevant, a box in the staff documents outlining the debate within the country on issues relevant to the reform, and what the different shades of opinion are on the policy initiatives suggested. Staff comments would be welcome.

#### Enhancing the Impact of Surveillance

As the staff documents point out, the issue of the fundamental asymmetry in Article IV consultations with developed countries and those with developing countries has been a point of discussion in the Board for a considerable period of time. The need for surveillance to be effective on systemically important economies is pressing, and yet apart from the efforts at transparency no other formal steps seem to have been taken to address this long-standing issue. One reason for the lack of effectiveness could be that the Article IV consultation process is mostly directed at the executive branch of

government- and that too with a focus on the Treasury and the Central Bank. In only a few cases, is the legislature- the primary fount of policy making in democracies consulted. If surveillance is to be more effective in advanced economies, the Fund should seek to systematically interact with the relevant parliamentary institutions. This could be done by Fund staff/ management interacting with the relevant select committees of legislature as part of the Article IV consultations. We welcome staff comments.

#### External Evaluation of Surveillance

The 1999 report of the External Evaluators had suggested that the process of surveillance be enhanced through periodic external review of individual staff reports. This regular outside review of surveillance output could provide additional impetus to quality improvement. While we note that the IEO has included “The role of IMF Surveillance in Crisis Prevention” in its future work program, this will not include a detailed examination of the quality of the Fund outputs on an ongoing basis. We therefore continue to feel that this suggestion bears merit.

#### Combining Article IV consultations with Program Reviews

We appreciate the concern that surveillance should not only be more transparent, but also clearly independent of crisis resolution initiatives. While this can be achieved by separating the Article IV consultations from program reviews and the consequent ‘stepping back’ process envisaged by staff, we are concerned about the impact of this suggestion on three counts. First, we may be losing synergies in the separation of these two activities. The suggestion that a separate Article IV consultation would be necessary for a critical examination of the medium term outlook seems to imply that this cannot be undertaken in the combined discussions. If the guidelines indicated by staff are followed, this may indeed be possible. Second, the increased strain of the resultant larger number of number of missions to program countries would not be desirable. With quarterly (and sometimes monthly) program reviews, an additional and separate independent Article IV consultation would unnecessarily increase resource demands on these countries. This approach requiring different reports could possibly confuse the authorities. Third- independent Article IV consultations may require drastically increased allocation of Fund resources. This may not be possible, or even defensible in the face of budget constraints. We therefore feel that the present practice of combined discussions can continue, but with the suggested guidelines in place. The timing of the Article IV consultations would then be dependent upon the program timetable. We agree that the under such circumstances, the country concerned can be moved to a twenty four month cycle subject to the two caveats suggested by staff. We would like to suggest a third stipulation. Normally, the rule should be that the aggregate number of Board discussions—formal program reviews and the Article IV consultation

should not exceed three per year. Whether this would be done through independent or combined Article IV consultations could be left to the discretion of management and staff.

#### Staff-Monitored Programs

While staff has adequately highlighted the experience of SMPs from the Funds point of view, we would be interested in knowing what was the impact from the member country's point of view. Track record SMPs were agreed with sixteen countries over the past three years. In only three cases were programs approved subsequently. Two SMPs are still current, but evidently the remaining eleven SMPs have expired. Staff's comments are welcome on why programs could not be approved for these countries- whether this has to do with the framework of the SMP or exogenous factors.

We appreciate the staff concern that the markets should not misinterpret the approval of signaling SMPs and clearer and tougher standards should be put in place to ensure this. We feel that apart from donors, creditors and external markets, a signaling SMP may also be directed inwards—domestically—with a view to build up support for reform. We should therefore encourage more members to participate in such SMPs. This will strengthen the crisis prevention role of the Fund and provide an incentive for policy improvement. However, we note that only four signaling SMPs were approved during the last three years (of which one related to a country which has been on such an SMP since the last ten years). It is possible that even these three countries would have been discouraged from approaching the Fund for such an SMP, if the higher standards of a precautionary arrangement had been stipulated. This would have led to an even lower utilization of this facility. In our opinion, the market is adequately sensitive to the fact that the signal of commitment to credible policies emanates from the member country concerned and not from the Fund and moving the goal posts in this program will not encourage improvement of policies in these countries.

Mr. Mirakhor submitted the following statement:

#### Key Points

There is a need to convey a more positive message regarding the Fund's surveillance strategy. One way of doing this is to change the label "crisis prevention initiatives" to "stability and growth initiatives;"

We support the MD's emphasis on growth in surveillance;

We need to develop an incentive structure to motivate countries to implement Fund's "stability and growth initiatives;"

We support the broadened framework for surveillance and the staff needs, however, to strive toward better selectivity of issues to be covered in the Article IV discussions;

We propose the introduction of a box on the conduct of surveillance in Article IV staff report;

We encourage the Research Department to organize a research program on asymmetry in surveillance.

The staff has produced an excellent set of papers for the biennial review of surveillance and we support their publication. Before commenting on issues for discussions, we offer some preliminary reactions to the Managing Director's "Fund surveillance and crisis prevention—key issues" which we believe focuses on the right issues.

As detailed in the staff's main paper, a series of initiatives were introduced by the Fund to strengthen Fund's surveillance following the capital account crisis of the 1990s intended to help countries improve their policies, better inform markets and, thereby, lessen the frequency and magnitude of financial crises. First structured as elements of "the architecture of the international financial system," they are now more and more identified as "crisis prevention initiatives."

While we do not question the importance attached to crisis prevention and support the underlying significance of each of the initiatives, we are concerned that labeling all Fund's work as "crisis prevention initiatives" risks blurring the distinction between regular Fund members and those subject to vulnerabilities, and between surveillance and program conditionality. The experience with the CCL is revealing in this respect, as regular Fund members—those for whom the CCL was designed in the first place—are reluctant to access this facility because of the negative perception that has come to be associated with it.

The MD rightly sees a need "to be clear what we mean by crisis prevention." We support his call but we believe there is a need to convey a more positive message regarding the Fund's surveillance strategy. One way of doing this is to change the label "crisis prevention initiatives" to "stability and growth initiatives." This will allow the Fund to better balance its advice to member countries between the need to reduce vulnerabilities and achieve macroeconomic stability, on the one hand, and, as the MD suggests, "pay more attention to the sources of growth in member countries, as well as the policy requirements for sustained growth," on the other. In addition, while we agree with the MD about the "need to pay much more attention to ensuring that our advice is heard and has impact," extreme caution is required in imposing "limits to collective solidarity with countries who do not take

Fund's advice seriously." We should not be discouraged if a few members do not seem to heed Fund's advice, and we should not generalize these exceptions to the whole membership. Fund's advice is demand-driven and as more and more members see the benefits of implementing Fund's advice, based on the framework of the new initiatives, the number of the exceptions decline. Our preference, instead, is to develop an incentive structure to motivate countries to implement Fund's "stability and growth initiatives" and to nurture, in surveillance, the same emphasis on ownership we hope to promote in program countries.

Turning to issues for discussion, we have the following remarks:

When assessing the broadened framework for surveillance, our main concern is related to the need to safeguard the quality and effectiveness of the surveillance exercise without unduly taxing the administrative capacities of member countries. Our chair supported the expansion of the coverage of surveillance, and countries in our constituency have found their voluntary participation in the new initiatives helpful in identifying and, more importantly, in addressing vulnerabilities. However, it is important to strive toward better selectivity of issues to be covered in the Article IV discussions with the authorities on the basis of the criterion of macroeconomic relevance. Better sequencing of reforms should also help make surveillance more effective. For example, countries should be encouraged to undertake an FSAP and implement its main recommendations before embarking on a program of liberalization of capital movements.

We continue to stress the importance of helping countries with limited administrative capacity to prioritize issues and to identify their need for technical assistance. Furthermore, we strongly advocate particular attention to growth and private saving in developing countries. While an adequate coverage of these issues may require reliance on the expertise of other institutions, and we continue to support the Fund's efforts to reach out, we are concerned that our expectations from collaboration may be frustrated. We note, for example, with regard to ROSCs that while the coverage has been satisfactory in the areas of fiscal, monetary, and financial policy transparency, bank supervision, and data dissemination, the modules outside the Fund's areas of expertise, namely those on corporate governance, accounting and auditing, and insolvency and creditor rights have not lived up to expectations. Finally, on this subject, it would be helpful if the Article IV staff reports would introduce a box that explains how selectivity and prioritization in surveillance have been achieved, what particular tools of surveillance have been used, and how outside expertise is integrated into surveillance.

On the modalities of surveillance, like other chairs, we appreciate the regular discussions on the WEO and WEMD and look forward to the contributions of the ICM Department to surveillance. The quarterly GFS

report will certainly help improve our understanding of capital markets and of the implications of developments in mature markets for capital flows to emerging markets. We join other chairs in their call for a deepening of multilateral surveillance and for a better integration of multilateral and bilateral surveillance. We also support Mr. Portugal's reference to the need for uniformity of treatment in surveillance. Perhaps for reasons having to do with budget considerations, many of the expanded tools of surveillance like FSAP and ROSCs are not used for assessing vulnerabilities in advanced economies. As demonstrated by the Enron case, issues of corporate governance, transparency, and accounting standards are relevant to all countries. They are perhaps even more significant for advanced economies in view of their systemic nature and the impact of their policies on markets and on developing countries. This issue gets to the heart of one of the most intractable problems for the Fund: the continuing asymmetry in surveillance; a problem eloquently addressed in the first four paragraphs of the statement of Mr. Zoccali and Mr. Le Fort. Perhaps the time has arrived to ask the Research Department to organize a research program addressed to finding ways and means of reducing, if not eliminating altogether, this asymmetry.

We broadly support the procedures for Article IV consultations although we see merit in the proposals made by Mr. Zoccali and Mr. le Fort to further streamline surveillance for low-risk countries and for the issuance of Statistical Appendices for SDDS subscribers. We also share the comments of Mr. Portugal with regard to surveillance in program countries. Like him, we do not favor the establishment of an institutional separation of surveillance from programs, and, in this context, share the concerns of Mr. Kelkar in paragraph 13 of his statement. The staff suggest guidance for conducting Article IV consultations in program countries so as to achieve a "fresh and independent look." Like Mr. Portugal, we see risks in the second and fourth bullets of paragraph 45 as they may weaken confidence in programs and send conflicting signals to the markets.

Finally, we have no particular problem with the framework for staff-monitored programs as they now stand. The risk we see is that by moving SMPs closer to regular programs we may contribute to further Confusion and misinterpretation about both. What this Chair strongly Advocates is the continuation, without formal Board involvement, of regular semi-annual staff visits between Article IV consultations. Our experience has shown that this framework is very helpful for the staff and for the authorities, as it offers the opportunity for continuous involvement of the Fund and close cooperation between the institution and member countries.

Mr. Bennett submitted the following statement:

Key Points:

Staff have done a commendable job of adapting their surveillance tools and activities to the rapidly changing global economy. That being said, we strongly agree with many elements of the frank and constructive informal note of the Managing Director. There is always room for improvement.

The aim should be to instill good risk management, to avoid unnecessary risks, and to develop shock absorbers in all members.

We see the FSAP and ROSCs as key drivers in ensuring that best practices with regard to risk management are followed everywhere. While much has been accomplished in this area, more could be done to integrate the work further into area department activities and to encourage all members to participate.

We would welcome a paper along the lines indicated by the Managing Director on the responsibilities of membership. It should consider whether certain aspects of the Fund's activities such as participating in the FSAP and publication of reports should continue to be voluntary.

We would welcome the development, in conjunction with the appropriate bodies such as the World Bank and perhaps Transparency International, of a ROSC module on governance.

The key multilateral surveillance reports—the *WEO* and GFSR—are excellent, but they could be improved with strengthened cooperation among all departments. For the two GFSRs that are published in the same quarter as the *WEO*, we would encourage a closer integration with the *WEO*.

My authorities welcome this opportunity to discuss the Fund's surveillance activities. I would like to thank staff for the comprehensive and well-written set of papers that were produced for this discussion. I also found the note circulated by the Managing Director to be particularly helpful in establishing a focus for today's discussion. I fully agree with the objectives that he sets. In particular, I agree that surveillance and crisis prevention are about risk management and avoiding unnecessary risks; it is neither possible, nor desirable to eliminate all risk.

Before getting into specific comments and what I hope are constructive suggestions, I would like to express for the record our appreciation for the efforts that the Fund has made to keep its surveillance activities commensurate with a rapidly evolving environment. We live in a world of rapid change, particularly in international financial markets and the

Fund has taken strong measures to keep on top of things. I am thinking in particular of the efforts to enhance financial sector surveillance. We think that the FSAP and ROSCs are an important means of strengthening risk management in members. Nevertheless, while much has been achieved, there is work to be done in implementing better the initiatives that are already underway and to respond to the next wave of innovations.

The remainder of my comments fall into two broad categories: bilateral surveillance and multilateral surveillance.

#### Bilateral Surveillance

I think that there are three keys to improving the effectiveness of the Fund's bilateral surveillance: (1) better policy advice; (2) candor, and (3) effective communication.

#### Better Policy Advice

There are several ingredients in making the best policy advice. It begins with excellent staff, and it requires on an ongoing basis: high-quality research, careful evaluation of past activities and learning the necessary lessons, correct focus, independence and objectivity. Some would add political realism to this list. I would agree, if political realism is properly defined.

On the latter point, we should be clear that political realism should not be code for watering down programs or giving in to special interests. We should also bear in mind that what is politically feasible is not some immutable constant, rather it is constantly changing. An iron law of economics is that what must happen eventually will happen, wishful thinking to the contrary notwithstanding. Today's political impossibility is often tomorrow's political imperative. I think that this point is well-illustrated by Canada's experience. Article IV discussions in Ottawa in the early 1980s were a lively affair with the Fund staff making the case strongly for fiscal consolidation and structural reforms to inject greater efficiency and flexibility into the economy and Canadian public servants explaining why the Canadian population would not accept such policy changes, at least not at the pace advocated by the staff. Inevitably economic reality intruded. Now attitudes in Canada are totally the opposite, voters place top priority on fiscal discipline and sustainability.

The Fund staff should stick to their comparative (and absolute) advantage: strong objective economic analysis and largely leave the politics to senior management and the Board. I say largely because staff input should be sought in making certain political assessments. For example, staff's knowledge would be relevant in determining whether there is sufficient



ownership of a program for it to be successfully implemented. If the judgment is that there is not, we should decline to enter into an arrangement. Staff can also help build “political” support for a program by meeting with a wide variety of groups in the country including a cross-section of politicians, NGOs and academics. I am aware that this is something that staff is already doing in a number of countries, notably in Africa, and would encourage that this model be followed as warranted throughout the Fund.

But there is scope for political sensitivity in the Fund’s policy advice. A key in this regard is not to micro-manage situations. In line with our efforts to streamline conditionality, conditionality should be focused on macro-critical areas and the authorities should be allowed the scope to choose the package of detailed measures that achieve the desired objectives. This will allow the authorities, to the extent possible, room to take account of the political context in which they are operating.

While the importance of political factors and governance varies, it is increasingly clear that they can play an important role in crises—both in precipitating an event and in making a crisis difficult to manage. Accordingly, I propose that a ROSC module be developed pertaining to governance and corruption. Given that these topics lie outside our core mandate, the module should be developed in conjunction with other interested parties such as the World Bank and OECD. I also support exploring the possibility of seeking input from Transparency International. In addition to encouraging members to participate in this ROSC module, I think staff should include governance concerns in surveillance reports whenever they meet the standard of macro relevance.

This leads me to the focus of surveillance reports. I agree with the current approach that balances selectivity with pursuing a hierarchy of concerns. And I think that the hierarchy should be regularly updated to reflect lessons learned and new concerns. I also agree that more attention should be paid to the sources of growth and the policy requirements for sustained growth, especially the links between trade and growth. I also see this as an issue for debt sustainability analysis. We would argue that more attention should be paid to the realism of the growth assumptions in these analyses.

Reports should deal comprehensively with the key sources of vulnerability and the need for shock absorbers—appropriate exchange rate regime and fiscal policies. Here I would emphasize the advantages of flexible exchange rates and the importance of built-in stabilizers and social safety nets, as well as the need to create fiscal room for maneuver. Attention should also be devoted to more prudent borrowing and debt management strategies—better risk management—and to strengthening domestic financial systems and capital markets. Currently, some staff reports include a sensitivity

analysis of debt payments to shocks. Such analysis should be standard for countries where the size and structure of the debt are a source of vulnerability.

Limitations on the availability and quality of data are a serious constraint on vulnerability assessments. It also seems to be the case that missions to a number of countries spend a significant portion of their time in the field constructing/compiling the data needed to carry out the required analysis. This occurs despite the fact that many of these countries have received considerable technical assistance in statistics. This problem must be addressed—either technical assistance must be made effective or another approach adopted. The current approach misallocates high-quality resources and undoubtedly is damaging to morale as well.

#### Candor

Producing high-quality independent surveillance has little hope of leading to necessary policy changes, if the country's problems and policy requirements are not discussed in a frank and clear manner. In this regard, I welcome the Managing Director's acknowledgement that there has been a lack of candor in assessing exchange-rate regimes in the past. Financial crises in the past five years have clearly illustrated that fixed exchange-rate regimes are prone to misalignment with economic fundamentals and are prone to speculative attacks. For countries that have a fixed exchange rate-regime in place, we would certainly encourage a more frank discussion of this issue during the Article IV process. But this guidance should apply to all significant macroeconomic problems and risks. We want the staff to have sufficient scope to present its independent analysis and professional judgment.

#### Effective Communication

Effective communication is another necessary condition for achieving the full impact of our surveillance activities. There are two parts to the communication issue: how much should be released publicly and the clarity, frankness, and comprehensiveness of the reports that are discussed by the Board. We will take up the first of these issues in the forthcoming discussion on transparency. On the latter, many staff reports are exceptionally well done. Some examples are the reports for Korea, Japan, the United States, and the FSSA for Iceland, as well as the reports on many African countries. But we need to strengthen the incentives for departments to produce candid forthright reports which are more "user friendly" in their layout and presentation. One area where the Board might be able to help is in the designing of templates for the different types of reports. I would suggest the creation of a working party comprised of members of staff and Executive Directors' offices to make suggestions that would ensure that needed information is in all reports in an easily accessible form.

### Program Countries

For program countries, there is a need to ensure that surveillance takes a step back from the program to provide an objective overview. There is also a need to reconsider the approach to Staff-Monitored Programs, both in terms of when a program is initiated and how it is reported.

### Multilateral Surveillance

I have the impression that the Managing Director's precepts for the Fund's relationship with other organizations could usefully be applied more vigorously to the Fund itself. The Fund is essentially organized as a collection of very independent departments. This works well when an activity falls neatly within the boundaries of a single department. When an activity cuts across the expertise and responsibilities of several departments, at times it seems that the coordination mechanisms in place are strong enough to produce the necessary level of cooperation.

One area where close coordination and cooperation are very important is in the production of the GFSR and the *WEO*. And I am concerned that the level of cooperation given these reports may need to be enhanced. Let us take the example of the GFSR. This new quarterly report clearly has the potential to make a significant contribution to the Fund's surveillance activities. In many respects it can play the role of a regularly updated global FSAP. Among other things, it can look at important developments in financial markets that cut across countries, such as regulatory arbitrage, and provide an outlet for the Fund's work on macro prudential indicators. But to do this, it must have access to the required resources. While there is a high level of expertise in ICM, it is not reasonable to expect the department with its limited resources to cover all aspects of global financial markets in the depth expected of such a report. The input of other departments, especially MAE and RES, as well as area departments is needed to get a full understanding of some developments and their policy implications. I would be interested in the management's views on whether coordination mechanisms with the Fund might be usefully strengthened.

Staying with the GFSR, we would suggest that two of the quarterly reports be closely coordinated with the *WEO* in the sense that the two reports examine an important global issue from their complementary perspectives. The GFSRs in *WEO* quarters should be discussed back-to-back at the Board and should be published simultaneously. I realize that this would pose a significant challenge to staff, but it is a challenge that I think is manageable with adequate planning and cooperation.

Finally, we would welcome a paper on the responsibilities of members along the lines suggested in the Managing Director's informal note. The paper

should examine the pros and cons of various measures aimed at strengthening surveillance, including making some activities that are currently voluntary, compulsory. It should also consider Mr. Mirakhor's suggestion of an incentive structure to motivate countries to implement good policies.

Mr. Wijnholds submitted the following statement:

#### Key points

Coverage of core issues should be 100 percent in all surveillance documents (table 1 of the document on surveillance in a program environment shows that we are not even close).

We should make better use of the expertise of ICM in surveillance documents.

Vulnerability analyses and debt sustainability analyses should be a standard part of each Article IV publication.

Analyses on structural policies and institutional issues should always have to pass the 'macro-economic relevance test'.

There should be a formal 'minimum data requirement' template for staff reports.

On effectiveness: 'timing is everything, if there is no money on the table'. Publication of all Article IV reports would also enhance effectiveness.

There should be an additional channel to communicate sensitive information to the Board.

A candid account of the dialogue between the staff and the authorities on key policy issues and of the general program strategy would increase the effectiveness of surveillance in a program environment. So would the presentation of alternative scenarios and an account of past surveillance.

A radical separation of surveillance and program work would not be practical. I agree with Mr. Callaghan on the need for a 'fresh pair of eyes'.

#### Introduction

I would like to thank staff for its thorough work, resulting in three excellent papers on surveillance. In addition to providing a review of the conduct of surveillance over the past two years, staff also raises two additional important and forward-looking issues: the role of surveillance in a program context and the procedures of Staff-Monitored Programs. In addition to

responding to the issues for discussion, I will also return to some of the proposals I made at the previous review of surveillance.

#### Coverage of surveillance

The original focus in Fund surveillance on monetary and fiscal policies, the exchange regime, and balance of payments developments has in recent years been expanded to broader vulnerability analyses, including for example financial sector assessments and their link to capital flows. I believe this slight broadening of what I would consider the 'core issues' is uncontroversial and in general, I support the developments as sketched in the papers. In addition, I support the MD's suggestion to include a more thorough assessment of the sources of growth. While agreeing that surveillance is not a 'one-size fits all exercise', I would expect the core issues to be covered adequately in all surveillance documents. Therefore, I was truly surprised when I saw table 1 (of the document on surveillance in a program environment). In my view, there is no good reason why any of these issues (with the exception of capital account vulnerability in non-market-access countries) should not be covered in all surveillance documents (be they stand-alone or combined documents). The fact that coverage in many cases is far below 100 percent, points to an obvious area for improvement of our surveillance. As a case in point, I note with regret that more and more surveillance documents seem to lack a serious discussion of reserves and reserve adequacy.

Fund surveillance of the financial sector has greatly improved due to the introduction of the FSAP and the development of the financial sector soundness indicators (formerly macro-prudential indicators). In particular, we now have more information on the potential impact of a financial sector crisis on macro-economic conditions. I welcome the increasing participation of emerging markets and industrial countries in FSAPs, as these countries are relevant for the stability of the financial system as a whole. I also support the Fund's efforts to intensify its assessments of offshore financial centers, since these centers play a large role in the intermediation of capital. Although I welcome the increased focus on financial sector assessments, I do get the impression that this part of surveillance could be better integrated in our standard Article IV work. While now recognized as a core issue, the treatment of financial sector issues is still not up to par with the more traditional areas of IMF-expertise. One reason could indeed be a lack of adequate information, but the way Article IV missions are conducted could also have something to do with it. I will return to this issue.

As a related point, I am not sure whether our surveillance is optimizing the expertise of the newly created International Capital Markets department. As I suggested at our last discussion, reports for countries with capital market access should describe the terms and maturity of borrowing, developments in

secondary market spreads, rating developments and alternative assessments by market participants.

Vulnerabilities may stem from various sources, such as an increasing debt burden, financial sector events and sudden domestic policy reversals. Analyses of both domestic and external debt sustainability have gained importance, as they are an essential element on which the private and the public sector base their judgments in providing external finance. Therefore, vulnerability analyses should be a standard part of each Article IV publication. On this score, there is a need for more consistent analyses by the IMF, in which all underlying assumptions are made explicit. The proverbial black box should be opened more frequently. Furthermore, stress tests and sensitivity analyses should be included, in order to determine the risks resulting from fluctuations of certain key variables such as changes in prices of imports or exports, exchange rates, and asset prices. Moreover, one could attempt to identify specific ranges for debt related ratios, indicating whether certain debt levels are likely to be sustainable, risky or possibly unsustainable. In doing so, the quantitative indicators should be placed against the background of the overall macro-economic developments of a country, also taking into account the levels of debt that have recently resulted in suspension or renegotiations of debt service payments in other countries. I encourage the Fund's work in this field and look forward to further discussing this issue in the near future.

I now turn to the large and gray area of 'non-core issues'. As we had an extensive discussion on this at our last review of surveillance, I was somewhat disappointed with the rather limited discussion of core vs. non-core in the documents. In my view, analyses on structural policies and institutional issues should always have to pass the 'macroeconomic relevance test' before they can be discussed in surveillance documents. This is similar to the approach that has been adopted with regard to conditionality. Staff should explain upfront why certain non-core topics that are discussed are of macro-economic relevance. Moreover, when undertaking non-core analyses, it should be clarified that these cannot be undertaken by other IFI such as the World Bank, or the WTO. Such avenues could also be explored when it comes to the preparation and publication of the selected issues papers.

Timely, reliable, and comprehensive data are key to an effective surveillance. As is noted in the staff paper, the quality as well as quantity of data has received growing attention over the past five years and co-operation with other international organizations has been strengthened. Further improvements, especially with regard to the presentation of data, are desirable. In our view, surveillance documents should contain statistical material with respect to the core areas, supplemented by data for other areas, if deemed necessary. In addition to the 'basic indicators', a balance of payment table, an overview of the budget, a monetary survey and a vulnerabilities table should be the bare minimum requirement and I propose

that a formal ‘minimum data requirement’ template be prepared for staff reports.

#### Effectiveness of surveillance

The effectiveness of surveillance as a crisis prevention tool depends on the ability to detect and address potential vulnerabilities in member countries in a timely manner. As to the correction of these weaknesses, it is important that the surveillance results in timely remedial actions. In non-program countries, peer and public pressure is the instrument for stimulating national authorities to undertake the necessary adjustment measures. To give Article IV consultations more bite, it would be desirable to plan missions less on the basis of staff schedules and more on the basis of the national policy agenda. For example, missions could be held in the initial stages of the budget preparation or immediately following an election. It could also be helpful if we could reduce the time between the visit of the mission, the discussion by the Board and, finally, the publication of the document.

We will discuss transparency separately. Given the enormous amount of issues already on our plate, this separation is understandable. At the same time, transparency issues go to the heart of the effectiveness of surveillance. The effectiveness of surveillance could for instance be enhanced by making the current publication policy on surveillance, i.e., publication of staff reports and public information notices, compulsory (currently, only 50 percent of Article IV reports is published). Publication would enhance transparency vis-à-vis the markets and the public at large. In order to alleviate the concern that the national authorities might then withhold confidential information, it may be considered to exclude such information from the published version. The current practice of publishing the FSSA, as a somewhat generalized version of the original FSAP, could serve as a useful example in this respect. Compulsory publication may—for understandable reasons—lead the authorities to withhold confidential information from staff or the Board. A possible solution for this dilemma could be to create an additional channel for staff, possibly in the form of a so-called ‘vulnerability supplement’, to communicate confidential information to the Board, with the ex ante assurance that it will not be published. This could overcome the problems discussed in the staff report, when, for example, exchange rate arrangements are not discussed at all, for fear of triggering a crisis. Transparency to the public should not come at the expense of transparency to the Board.

The ROSCs are key to promoting adherence to international standards and codes. They contain relevant information on the implementation of standards related to, for example, fiscal and monetary transparency, banking supervision and data dissemination. If published, financial market participants can use the information in their decision-making. In the paper, we suggest making a reference to the on-going efforts by the Fund—in partnership with

the World Bank and the FATF - to create a ROSC-module on Anti Money Laundering and Combating Financing of Terrorism. This in itself is a good example of the recent broadening of surveillance activities. Although ROSCs are voluntary, I see no reason why Article IV reports could not comment on the implementation of recommendations in ROSCs. This might also enhance the effectiveness of surveillance.

#### Effective surveillance in a program environment

Staff's discussion of surveillance in a program environment leads to some interesting observations. Program countries are in a way under 'continuous surveillance', with regular program reviews by the Board. Nevertheless, staff finds that some aspects of regular surveillance are not covered sufficiently in a program environment. In this regard, I fully support staff's recommendation on the need to include a candid account of the dialogue between the staff and the authorities on key policy issues and the general program strategy, even if this would reveal major differences. I have two additional suggestions with regard to surveillance in a program environment. The first is to include more scenario or sensitivity analyses with regard to the major policy options a country is facing. In the case of Argentina, the report could have included a discussion of the pro's and con's of other scenarios that would describe the consequences of abandoning the currency board arrangement, repegging the peso at a lower rate or introducing a flexible exchange rate. Another suggestion is to start every program document with a very concise account of past surveillance. This would enhance the accountability of surveillance and make clear why IMF lending has become unavoidable (due to an incorrect assessment, changing external circumstances or inappropriate policies by the member country?). I look forward to concrete suggestions in the follow-up paper.

The above suggestions might also address some of the concerns with regard to the alleged lack of independence of surveillance in a program environment. Although I generally agree with the idea that surveillance could be made more effective by making it more transparent, authoritative and independent, I also agree with staff that a radical separation of surveillance from program work would be impractical and involve substantial resource costs. In fact, I also wonder whether the (lack of) independence of surveillance is really the main problem. In my view, the issue is more with the presentation of the program than with surveillance as such. For obvious reasons, we might not want to (publicly) discuss the possibility of a program failure or a possible 'plan B' in detail and I do not see how this would change by creating 'institutional firewalls'. I do agree with Mr. Callaghan on the need to introduce a 'fresh pair of eyes' in certain program situations. In this regard, I welcome the recent appointment of a Director for Special Operations.



### Procedures for surveillance

Looking at the figure ‘Intervals between Article IV consultations in 2000-2001’, it is clear that most industrial countries are on a 12 months consultation cycle, whereas emerging market countries often face a longer consultation cycle (up to 24 months for many program emerging economies). As is noted in supplement 2, consultation cycles have risen steadily over the past five years. While maintaining some flexibility as to the timing of surveillance, I feel that a shorter effective consultation cycle for emerging market countries in particular, could be appropriate.

The Article IV mission and the preparation of a subsequent report is only part of surveillance. Without wanting to be self-congratulatory, I believe it is safe to say that the Board discussion of Article IV reports is a crucial part of the process. The Board discussion provides for an honest and fair peer review. It secures the involvement of the Board members (and their staff) but also, and probably more importantly, the involvement of our capitals. In Article IV Board discussions, Directors can give additional viewpoints, based on the experience in their own countries and can provide an ‘outside’ observation of a country’s policies. It is for this reason that I am not a great fan of concluding Article IVs on a LOT basis and I would not be in favor of measures to encourage greater reliance on the LOT procedure.

I realize that the Board’s request for a more extensive coverage of e.g. financial sector issues will have to be squared with existing staff constraints. The noted imbalance in coverage of financial sector issues might at least partly be caused by insufficient expertise on these issues by the ‘traditional’ members of the mission team. Simply adding additional members to the mission does not seem the best way forward. Instead, I would support suggestions by other Directors to investigate more innovative ways to conduct surveillance, e.g. by having a half-day session on financial sector issues (or a particular, macro-relevant structural issue) by means of teleconference. The experience with conducting part of a mission by teleconference for one of my constituency countries was quite positive (although this happened to be a program discussion). I would also urge staff to consider ways to employ scarce staff resources in a more flexible way. I now sometimes get the impression that the workload is not evenly distributed over all departments.

If my proposal for minimum data requirements in staff reports were to be taken on board, I could agree to allowing more flexibility in deciding on the production of statistical appendices. In my view, the most logical procedure would be for the Board to decide at the conclusion of an Article IV process, whether the preparation of a SA for the next review would be necessary.

### Staff-Monitored Programs

Staff-Monitored Programs (SMPs), either for track record building or for signaling, can be very useful for countries that for many possible reasons, are unable to conclude agreement on a full-scale UFR program. As a result of the 1998 draft guidelines, the form, documentation and communication of SMPs have improved substantially. Progress has been less evident in reporting on the performance under SMPs. This raises concerns, as it adds to the risk that official and private creditors may misjudge the authorities' policy program, which is presented like a Fund-supported program, but does not meet the same standards as a full-fledged Fund program. We agree with staff's suggestion to increase transparency in this matter and to have all staff assessments published. As SMP's are not just surveillance (but also technical assistance and program work), it might be appropriate to discuss them in more detail at another occasion.

### Outstanding issues

Finally, I would like to repeat two additional requests that I made at our last review of surveillance. First, I would again ask staff to circulate staff papers prepared for other fora (most notably the G7). This would strengthen multilateral surveillance and increase transparency to the Board. Second, I believe the Board should be provided with a periodic report on the discussion that took place in the Surveillance Committee.

Extending his remarks, Mr. Wijnholds noted that, while the nature of a review meeting was to point out what could be improved and to voice criticism, it was important to note that the staff had been doing an excellent job on surveillance in general. That needed to be said from time to time. If Directors presented suggestions and critical comments, it did not mean that there was not generally great satisfaction with the staff's performance.

With regard to the role of crisis prevention, Mr. Wijnholds stressed that it was crucial that vulnerability assessments and debt sustainability analyses were a standard in Fund surveillance. More could and should be done in that regard. However, care should be taken not to overburden Fund surveillance, as other Directors had stressed, and that the test of macroeconomic relevance should also be applied to surveillance as it was for conditionality. The past tendency to work with some sort of shopping list under the Article IV procedure on issues such as income distribution should be entirely abandoned. He could agree with Mr. Shaalan and others that some of those issues could better be addressed by other institutions such as the World Bank, the OECD, and others, so as to avoid overburdening Fund surveillance.

The Fund should not focus excessively on growth in surveillance, as that would move the Fund's attention out of the core areas, Mr. Wijnholds continued and noted that he agreed with Mr. Shaalan in that regard. The main recurring issue that needed continuous attention was the question of how to improve the effectiveness of surveillance. In that context,

sufficient data were of importance, and his suggestion for a minimum data requirement template appeared to have considerable support in other Directors' statements either implicitly or explicitly. Also, the timing of staff missions was important for the effectiveness of surveillance, and more attention should be paid to the schedule of missions fitting in better with the political agenda of member countries. A more general publication of staff papers would also help improve the effectiveness of surveillance, and a number of colleagues had already noted that more candor was required with respect to exchange rate regimes. That point had also been made by the Chairman. However, the question remained as to how that should be done in Fund surveillance so as to avoid creating a crisis-like atmosphere. While there was an interest to have members publish Article IV documents to the greatest extent possible, there were areas where it was not feasible to be explicit. In order to remedy the problems arising from those constraints, he had repeatedly suggested the creation of a separate channel of information to the Board. Otherwise, there was a risk that out of fear of information getting into the wrong hands, the Board would, at some stage, not receive all the information necessary to judge a particular situation.

That issue could be further discussed in the context of the forthcoming Board session on transparency, Mr. Wijnholds suggested, but there were various ideas that should be considered. One could envisage providing confidential reports on sensitive vulnerability matters, for instance, only at the Board table, in a fashion similar to that applied to side letters, to ensure that those documents would not find their way into the wrong hands. Alternatively, the Board could be informed on those matters exclusively through oral briefings.

With regard to the symmetry of surveillance, Mr. Wijnholds considered that it was a fact of life that, generally speaking, for larger countries surveillance tended to be less effective. There was little that could be done about that. However, every effort should be made to make surveillance as symmetrical as possible. Whether a country was large or small, advanced or developed, uniformity of treatment—Mr. Portugal and others had made the point—was of paramount importance, also to avoid the impression that there were cases of special treatment.

With regard to the issue of more independence of surveillance in program countries, Mr. Wijnholds considered that it was a difficult matter, but that the idea of having a “fresh pair of eyes”, as Mr. Callaghan had put it, was a good way to approach the question.

Mr. Padoan and Mr. Vittas submitted the following statement:

#### Key points

Surveillance should remain centered on macroeconomic equilibrium. However, the maintenance of macroeconomic equilibrium over the long haul depends critically on success in addressing structural impediments to growth. This has implications for the breadth and conduct of surveillance.

Macroeconomic sustainability in one country is often dependent upon developments in neighboring countries. Hence, more emphasis on regional Surveillance is desirable.

The Report addresses only marginally the issue of the impact of bilateral surveillance.

Evaluating the causes of lack of impact of surveillance would represent an important instrument for the Fund's process of policy revision and upgrade.

Surveillance and program reviews serve two distinct, yet correlated, purposes.

Streamlining surveillance in the case of program countries is conditional upon improved program and conditionality design.

In assessing the use of signaling SMP it should be kept in mind that signaling is beneficial to countries to the extent that it increases transparency and that it conveys information that can be clearly interpreted. This suggests a need to adopt more rigorous quality standards and clearer guiding principles on performance reporting.

We thank Staff for a comprehensive report on the Implementation of Surveillance. As a general observation, we would underscore that Fund surveillance has contributed over time to an improvement in the quality of economic policy being pursued by a large and growing number of member countries. One reflection of this improvement is that the incidence of major crises, notably but not exclusively in the advanced countries, has declined markedly. Moreover, as highlighted in the recent *WEO*, global economic performance has tended to grow stronger, with economic upswings becoming more durable and downturns more shallow and short-lived. On the other hand, it is equally important to acknowledge that significant macroeconomic imbalances persist and that the frequency and severity of BOP and financial crises in emerging market economies and the developing world has not fallen. Hence, we need to continue to look for ways to improve the modalities and, above all, strengthen the impact of the Fund's bilateral and multilateral surveillance.

In the remainder of our statement, we will concentrate on four issues: a) the focus of surveillance, b) the impact of surveillance, c) surveillance in program countries, and d) Staff-Monitored Programs.

### The Focus of Surveillance

The rapid evolution of the world economy has inevitably affected the focus of surveillance, it has not, however shifted its purpose. This remains centered on helping member countries to attain and preserve macroeconomic equilibrium. However, changes in the global environment and lessons learned from crises suggest important qualifications for this general principle.

In the longer term, improved macroeconomic performance hinges on progress in tackling structural impediments to economic growth and requires a good understanding of structural and microeconomic phenomena. Hence, the assessment of growth perspectives (not only for PRGF-supported countries) is an essential part of macroeconomic surveillance. It has been firmly established that balance of payments equilibrium is best understood in a medium-term (intertemporal) horizon. This is particularly true when debt sustainability issues have to be addressed. Therefore, more analysis of the sources and determinants of growth is needed, keeping in mind that trade is a major, but not necessarily the only, determinant of growth. One of the policy messages the Fund has been sending out to industrial, emerging, and developing countries alike is that structural reforms in labor and product markets are key to enhance growth. To make the advice credible more and better evidence in this respect is needed.

The requirement for a good understanding of structural and microeconomic phenomena is particularly relevant in a situation of widespread capital account liberalization and of increasing risk of capital account crises. The way to counter these risks and make the best out of surveillance for crisis prevention is to enhance transparency and availability of accurate information, especially, but not exclusively, over financial sector issues. In several cases provision of information depends critically on willingness of members to collaborate. It is a key message of surveillance that transparency serves member countries' own interest as it will, among other things, deliver better market assessment and attract investment.

The role of standards and codes is a key component in this respect and their adoption should be encouraged. While the benefits of their diffusion in terms of better policies are unquestionable, it would be interesting to know whether there is any evidence, at least as far as the medium-term horizon is concerned, of a correlation between the adoption of good practices (as embodied in standards and codes) and improved market access. Staff comments would be welcome.

Macroeconomic sustainability in one country is often dependent upon developments in neighboring countries. Spillovers are relevant both when they produce negative results (as in contagion) and when they produce positive results (as in integration). Multilateral surveillance serves a key purpose in

taking into account spillover effects that are not considered in bilateral surveillance. However, like Mr. Kelkar, we are aware that there remains a “gray area” that is neglected by both. This is the area of regional integration that is not covered by monetary agreements and not considered in multilateral surveillance exercises. Concerns about contagion have increased the Fund’s awareness of such problems and their treatment in the different parts of surveillance activities. Yet further analysis of these effects is needed especially in surveillance of systemically relevant countries.

### The Impact of Surveillance

Surprisingly, the staff report addresses only marginally the issue of the impact of surveillance, an issue which should be central to our concern. Mr. Callaghan in his preliminary statement asks important questions in this respect. Ultimately, a measure of the impact of bilateral surveillance can be obtained only by looking at the extent of the policy change in member countries. However, some qualifications are appropriate in this respect.

First, differently from the case of programs, in the case of surveillance, policy changes can be obtained only if authorities are convinced that the policy advice is right and, ultimately, their implementation serves their country’s interest. This process might, and usually will, take time. As a consequence measuring the impact of surveillance should be assessed over the medium term. Keeping track of the evolving impact of surveillance is therefore important. To this purpose Article IV reports should include, in a more extensive and systematic way than at present, an assessment of the past record. In other words, we believe that each bilateral surveillance exercise should, more clearly than now, be considered and reported, as an intermediate step on one single path. Persistent divergence between policy advice and policy implementation would then signal a serious lack of impact.

Secondly, lack of impact of surveillance may be the result of limited capacity of a country to implement the right policy (and a lack of ownership) or inappropriate policy advice and hence failure to persuade a country’s authorities. Evaluating the causes of lack of impact of surveillance, as well as the causes of success, would represent an important instrument for the Fund’s process of policy revision and upgrade.

### Surveillance in program countries

Surveillance and program reviews serve two distinct, yet correlated, purposes. In practice, as the staff report notes, their distinction is often less than obvious. While surveillance offers a broader and comprehensive picture of a country’s situation, programs concentrate on a more limited range of areas and measures, also in the perspective of streamlining conditionality. However, if a program is well designed it should obviously concentrate on

the areas of the broader picture that are critical for performance. In this respect surveillance should also serve the purpose of readjusting programs. However, enhanced, or more frequent surveillance, is not a substitute for good program design and implementation. Streamlining surveillance is conditional upon improved program and conditionality design, i.e., one additional reason for treating the streamlining of conditionality above all as a qualitative exercise.

For the sake of reducing work pressures, the frequency of surveillance missions in program countries could be brought to 24 months. We would support this proposal provided that, as suggested, program interruption would automatically reinstate the 12-month cycle. We remain unconvinced of the proposal of creating “institutional firewalls” within the same Institution, that would probably weaken its operational efficiency.

#### Staff-Monitored Programs (SMPs)

SMPs for building track records are a useful instrument for creating the basic conditions for future use of Fund resources. They have performed better than “signaling SMPs” because they are guided by different incentive sets.

The incentive to adopt a signaling SMP may be simply to deal with a temporary policy problem. In this respect such programs have much in common with precautionary Stand-By Arrangements. In assessing their use it should be kept in mind that signaling is beneficial to countries to the extent that it increases transparency and that it conveys information that can be clearly interpreted. As the staff report indicates, this suggests a need to adopt more rigorous quality standards and clearer guiding principles on performance reporting.

In some cases, however, signaling SMPs may serve additional purposes in that they signal to other official lending institutions, such as the World Bank, the state of a country’s performance and hence they provide a peculiar form of “cross conditionality.” In such cases, it is obviously even more important to clarify and strengthen procedures and reporting practices. Staff comments on the practical relevance of these cases would be welcome.

Mr. Al-Turki submitted the following statement:

I thank the staff for a comprehensive and thoughtful set of papers for today’s discussion. It is clear from the papers that the Fund has taken a number of important steps over the past two years to enhance the effectiveness of surveillance. In particular, the establishment of the International Capital Markets Department (ICM) and the initiation of the quarterly Global Financial Report should strengthen Fund surveillance of capital markets. The increased attention to financial sector issues and better integration of bilateral and

multilateral surveillance are also notable. The broader framework for surveillance is appropriate in view of the changing global environment.

That said, it is important not to lose focus by overstretching the Fund's resources and expertise. We need to guard against the Fund becoming a jack-of-all-trades. Therefore, I fully agree that we should concentrate on issues related to external sustainability and vulnerability to balance of payments or currency crises. I also consider surveillance of the global impact of policies in especially the large advanced economies a priority. Indeed, abrupt changes in the exchange rates or interest rates of those countries could have a larger impact on the global economy than a balance of payments crisis in a small country.

In other structural and institutional areas, greater selectivity will be desirable. The coverage of surveillance in these areas should be approached on a case-by-case basis. In this regard, I agree with Mr. Portugal on the importance of even-handedness and uniformity of treatment. Greater cooperation and collaboration with other multilateral institutions is also needed.

Effectiveness of Fund surveillance ultimately depends on the countries' willingness to cooperate and implement Fund's advice and recommendations. To ensure such cooperation, the Fund must be viewed as a discreet and trusted advisor. To this end, the Fund's policy advice needs to be based on solid economic foundations, both theoretical and empirical. More importantly, the advice must be tailored to take into account each country's specific circumstances and implementation constraints. The Fund also needs to strike the right balance between candor and transparency, as Mr. Zoccali and Mr. Le Fort note.

Turning to quality of coverage issues, it is important to remedy the lack of adequate coverage of the financial sector outside the FSAP framework. Here, it is important to stress that FSAPs have long cycles and are appropriately voluntary. Therefore, it is a priority to strengthen the financial expertise in Article IV consultation missions. Here, I would be interested in staff's elaboration on the suggestion by Mr. Shaalan and Ms. Farid, that staffing constraints may have hindered this process.

Staff indicates that analysis of debt sustainability needs to be strengthened and I agree with that. While data weaknesses in the nonfinancial corporate sector could hinder the analysis, obtaining this data will take time and resources. Therefore, while encouraging countries to work on this issue with the help of the World Bank, I agree with Mr. Portugal that the staff should focus now on improving assessments for the part of debt for which data are available.



On exchange rate issues, there is a continuous debate within and outside the Fund on the appropriate exchange rate level and system under various conditions. Thus, while it is essential that the staff opinions are clearly formulated and presented to the authorities with the utmost candor, extra caution in disclosure is necessary given the sensitivity of the issue and the large margin of error in calculating an “appropriate” exchange rate.

Turning to the modalities of surveillance, the increased emphasis on multilateral surveillance is appropriate in view of rising trade and financial linkages among countries. In this regard, I continue to find the semi-annual discussions on the World Economic Outlook (WEO), as well as World Economic and Market Developments (WEMD) sessions very useful. In this regard, I found the combined WEMD presentation by the Research and the ICM Departments very effective. Complimenting these discussions with the expanded surveillance of financial markets has greatly improved the Fund’s ability to monitor and evaluate global developments and vulnerabilities, especially in the capital account. In this connection, the progress made in integrating the findings of the multilateral surveillance into bilateral surveillance should be further deepened. Greater regional focus in Fund surveillance is also important to better understand the reasons for and transmission of contagion from one country to another.

On Article IV consultation procedures, I can go along with staff’s proposals to encourage flexibility with the Selected Issues Papers and Statistical Appendices. In exercising this flexibility however, it is essential to ensure that statistical data will be readily and easily available from other sources.

Turning to surveillance in program countries, I am more convinced than staff regarding its effectiveness. Indeed, surveillance appears to be very effective in those countries given the program reviews, the continuous follow up by the resident representative, and the implementation of Fund policy advice as agreed in the program. Therefore, I do not agree that surveillance in program countries should become more independent. Program reviews by PDR and other functional departments as well as Management and the Board should allay any concerns regarding the coverage and/or appropriateness of policy advice.

Finally, regarding SMPs, I see a useful role for this instrument in building a track record. However, its role as a signaling device is not clear, especially as policies in SMPs are usually viewed as not strong enough to qualify for a Fund supported program. The fact that the vast majority of the SMPs are for building a track record could add further static to the signal. In this regard, precautionary arrangements appear to be a more suitable instrument. Therefore, I agree with Mr. Callaghan that the whole rationale for a signaling SMPs should be examined.

Mr. Andersen submitted the following statement:

Staff has produced a comprehensive and interesting set of high-quality papers for today's discussion. I would also like to thank the Managing Director for sharing his views on several key issues informally with Directors last week. The issues identified are indeed of key importance in our continuous effort to strengthen surveillance. Moreover, I agree on the need to start drawing lessons from current events for the future work of the Fund and, as stated on previous occasions, this chair would appreciate if priority would be given to conduct an in-depth review of the Fund's involvement in Argentina.

The broadening of the scope of surveillance from its original focus has been appropriate. It is necessary to cover the complex and evolving interrelationships between the forces that shape the economic fortunes of states. In light of the rapid growth of capital flows in recent years, I welcome the increased emphasis on financial markets in multilateral surveillance, the establishment of the International Capital Markets Department in 2001, and publications such as the Global Financial Stability report. However, the focus of surveillance must be under continuous scrutiny in order to preserve its effectiveness. I agree that surveillance is not a "one-size fits all exercise", but we should ensure that core issues are addressed adequately in all surveillance documents as mentioned by Mr. Wijnholds. In order to strengthen the coverage of the new surveillance areas, I encourage the Fund to continue to work with other relevant international institutions and take advantage of their expertise not the least to avoid duplication of basic work.

It remains to be seen whether steps taken to enhance the effectiveness of surveillance have been successful and will contribute to preventing the occurrence of new crises. I take some comfort from the resilience of the global economy and the international financial system, in the face of the recent economic slowdown and the September 11 events, as emphasized by the Managing Director last week. Moreover, I am pleased to note that so far spillovers from recent crises on other economies appear to have been generally limited. This may to some extent reflect strengthened crisis prevention efforts in other countries. At the same time, the Argentinean case has demonstrated that there is room for improvement in various areas, including the need to better address the underlying reasons for the weak fiscal situation. I agree that crises very often have a lot to do with factors relating to political processes and governance, and that we should focus more on taking advantage of expertise and advice of other institutions in areas of importance where the Fund is not sufficiently equipped.

The quality of financial sector surveillance should be equivalent to the analysis of other core areas. Certain selectivity is inevitable but financial sector surveillance should be ranked high as macroeconomic risks are strongly

influenced by risks in the financial sector. The Financial Stability Assessment Program is important and efforts should be made to cover the membership as a whole within the timeframe initially envisaged. Where FSAPs have not yet been carried out, I encourage that analysis of the financial sector, in the context of Article IV consultations, be strengthened by including the necessary expertise. Therefore, it would be useful for the Fund to give increased weight to financial experience in the recruitment process. Furthermore, if feasible with current staff resources, consideration should be given to including MAE staff in more Article IV missions.

In regard to analysis of countries adherence to international standards and codes, the ROSCs process has proven to be a valuable addition to the Fund's surveillance, and I encourage its further application.

The quality of vulnerability assessments appears to be constrained by data availability in the private sector, especially in the non-financial corporate sector. This is a cause for concern, and authorities in the respective countries, in conjunction with FSAPs, should try to create incentives for the private sector to disclose data that are essential for vulnerability assessments. If surveillance serves as a crisis prevention vehicle, it is essential that the data is reliable. Better data availability is also important for improving debt sustainability analysis. Therefore, I support increased efforts to strengthen such analysis.

I also agree with the staff that a more explicit and candid discussion on exchange rate regimes is needed in many cases to increase the effectiveness of surveillance. The exposure of balance sheets to exchange rate and interest rate shocks, e.g. currency mismatches on private sector balance sheets, has proved to be an important parameter in various crises. These parameters should have received more attention before the crises erupted and, thus, in the Fund's surveillance. I regard it as a serious problem that the coverage of medium-term debt sustainability issues has been inadequate in many vulnerability assessments with insufficient attention to the sensitivity of projections to exchange rate and interest rate movements.

I support certain flexibility regarding consultation frequency, mission size and the scope of staff reports in cases where the economic situation appears to be satisfactory. However, consultation frequency must have a clear timeframe even though it might be expanded. Thus, ad hoc consultations should only be considered in exceptional cases and they should not be a substitute for planned consultations. Selected Issues papers should only be produced when the staff assesses that there is a need for it. However, I am reluctant to discontinue publishing statistical appendices although they might be streamlined especially in the case of the advanced economies where a wealth of statistical data from various sources is readily available. In this regard, Mr. Wijnholds's proposal that a minimum data requirement template

being prepared for staff reports is worth considering. In addition to streamlining the surveillance documentation, there may be other ways to reduce staff's workload that could deserve further attention, including taking more advantage of IT developments by using, for example, teleconferences more frequently. Also, the increased availability of relevant national documents on the Internet should contribute to resource savings.

The main vehicle of effective surveillance is relevant and timely high-quality policy advice based on our ability to detect in a timely manner issues of importance in the promotion of macroeconomic and financial stability. Apart from the Fund's analytical capacity in addressing the issues of relevance, our leverage should benefit from our universal membership. Moreover, we should always be mindful whether incentives are in place so that our advice is heard and has an impact. In non-program countries, peer and public pressure remains the most promising avenue for stimulating authorities to take the advice on board in their policy formulation. I agree with Mr. Callaghan on the importance of how the Fund approaches its policy advising task and look forward to a response to his questions. It may indeed be relevant to look closer into the Fund's internal governance in order to ensure that the necessary continuity and consistency in the policy advice is achieved. A related issue concerns the degree of transparency inside the Fund. I find the regular country matters sessions as well as the ad hoc briefings on individual countries to be very useful and appreciate when statements by the staff and travel reports by management are circulated to the Board. I support Mr. Wijnholds' request for the circulation of staff papers prepared for other fora and for reports on discussions in the Surveillance Committee.

Staff is right in emphasizing that some key aspects of surveillance is not covered sufficiently in a program framework and that combined reports often have suffered from lack of coverage of core issues. It is important that surveillance is exercised in an uncompromising and candid manner, and this could be achieved by increasing the independence between Article IV surveillance and program monitoring. Moreover, a separation may make it easier to see the wood for the trees. However, the increased independence should not come at all cost. I support the staff's proposal that the Board should establish a clear guidance on the role of surveillance in program countries along the lines outlined by the staff rather than establishing an "institutional firewall" between the program and surveillance activities. This would mean, among other things, increased emphasis on the assessment of risks in the short- and medium-term outlook and providing a candid account of the policy dialogue between the staff and the authorities. I concur with the proposed rules on the timing of Article IV consultation in program countries and on the consultation cycles in cases where sufficient economic progress has been made. I believe that the framework will become more stable and transparent, once clear rules on the timing are established.

I welcome the improvements of SMPs, which the draft guidelines discussed in 1998 have provided. However, monitoring of performance under SMP could be enhanced especially in reporting. Therefore, I support the proposal on strengthening requirements for reporting on performance under SMPs and efforts that will increase transparency.

Mr. Yagi and Mr. Yanase submitted the following statement:

#### Key points

The Fund's surveillance during the past two years has generally been appropriate. It has covered a broad range of issues, while maintaining its focus on critical issues.

How to cover a wide range of issues in surveillance is a serious challenge. There will be a need to increase area departments' involvement in FSAPs and ROSCs and strengthen their expertise on financial sector and other issues.

Given that an improvement in data availability cannot be achieved soon, the Fund should explore ways to carry out surveillance better in countries where only limited data are available.

We support the staff's proposal to increase the flexibility of the modalities of the Article IV consultation, including by allowing members not to prepare statistical appendices.

We agree that surveillance of program countries needs to be independent of existing programs, but this independence is also necessary for program work such as program review. Thus, we do not see any need to differentiate between surveillance activities and program work.

We are concerned that the distinction between signaling SMPs and Board-agreed programs has been blurred. Deeper and more comprehensive analysis of the role of signaling SMPs is necessary before we agree on the staff proposals.

#### Introduction

We welcome today's discussion on the review of the Fund's surveillance activities. We thank the staff for preparing a useful and informative set of papers. The Fund's surveillance is a global public good and we need to continuously improve it so that its effectiveness can be maintained and improved. We hope today's discussion, in which we can assess our initial experiences with various initiatives that were introduced after the Asian crisis

to improve crisis prevention and the Fund's surveillance capacity, will provide useful insights into how surveillance can be improved.

#### Scope and focus of surveillance

The Fund's surveillance needs on one hand to cover a broad range of issues, while on the other hand to maintain its focus on critical issues. The broadened coverage of surveillance is necessary to detect economic imbalances of member countries at an early stage. At the same time, surveillance must be focused on being able to detect potential problems before they become full-fledged. We believe that the agreement reached at the last review, that 1) assessment of the external sustainability and vulnerabilities of a country should be the center of the broadened framework; 2) a selective approach is necessary; and 3) the coverage of non-core areas should be limited to those that have macroeconomic relevance, is still valid today.

In our view, surveillance activity during the past two years has been broadly satisfactory in following these agreed principles. We are pleased that while the Fund's surveillance covers a wide range of issues, prioritization has been achieved reflecting the significance of each issue to a country's macroeconomic stability. We are also pleased that discussions on the impact of an individual country's policies have lately often taken place in the context of the Article IV consultation. As interdependence among economies has increased significantly in recent years, we believe these discussions add significant value to our surveillance exercise.

As staff recognizes, it is not easy to cover a broad range of issues while maintaining high quality analysis. This problem is particularly acute for financial sector issues, given their crucial importance to macroeconomic stability and the unique expertise they require. As the Fund moves to cover financial system issues as one of its core areas, we believe it is worth taking a new look at the modalities of the Fund's involvement in these issues, including institutional aspects. For example, currently MAE is carrying out FSAPs, which are the main vehicle for the Fund's work on financial sector surveillance. We understand the rationale of MAE's being in charge of the FSAP initiative in the beginning, but we wonder whether this will continue to be the best arrangement. In future, it might be useful to increase the involvement of area departments. Since FSAP is not a one-time exercise and continued monitoring of a country's situation is needed, outputs from FSAP should be integrated with other country work and excessive reliance on a single department's resources should be avoided. Thus, it might be useful to increase the involvement of area departments. Greater involvement by departments needs to be accompanied by a strengthening of the expertise of country desks on financial sector issues in the medium to long term.

Greater involvement of area departments may also be beneficial in the case of ROSCs to integrate them into surveillance activities, since they are becoming essential elements in Fund surveillance.

The paper notes that a lack of data is an important constraint on adequately carrying out vulnerability assessments and sustainability analysis. While the importance of data as a precondition to good surveillance is undisputed, the fact is, it may not be possible for some countries to bring their data up to a satisfactory level in a short period of time. We understand that for many countries most of the mission work is devoted to collecting and reorganizing data. This effort is important and appreciated, but staff should also examine how best to conduct surveillance when the available data are less than satisfactory.

#### Modalities of surveillance

We consider the recent changes in multilateral surveillance broadly appropriate. In particular, the quarterly issuance of the Global Financial Stability Report is a useful addition to our high-quality multilateral surveillance products. We hope the report will play an important role in our surveillance activities by informing the Board and area department staff of the latest developments in the international financial markets.

On the question of the modalities of Article IV consultations, we should start our discussion by asking what the core role of the consultations is. This chair believes that the core purpose of the Article IV consultation is to periodically assess the sustainability and vulnerability of each member's economy. We do not feel there is a need to perform full-scale consultations every year with every country if assessments of sustainability and vulnerability can be undertaken without such consultations. Given the need to utilize the limited staff resources efficiently, any part of the normal consultation process that both staff and the authorities consider unnecessary should be eliminated, unless the streamlining compromises the above-mentioned objective of Article IV consultations. We thus support the staff's proposals, including allowing flexibility on whether a statistical appendix needs to be prepared. In deciding whether to prepare a statistical appendix, however, staff should assess the availability of alternative data sources to ensure that the quality of surveillance is not affected.

#### Surveillance in program countries

While welcoming the opportunity to discuss surveillance activities in program countries, we believe many questions need to be considered about the relationship between surveillance activities and program work before we decide what kinds of changes are necessary. For instance, do surveillance and program work have different objectives? Are there conflicts of interest

between the two activities? How should we deal with the problem of staffing if we separate the two? Regrettably, these questions are not analyzed in depth in today's paper. Further discussion based on comprehensive and objective analysis is clearly necessary before we reach any conclusions.

We agree with the staff that surveillance activities should be independent of existing program frameworks. We differ from the staff, however, in believing that program work also needs to be independent of the existing program framework. If a change in environment requires and adjustment of the framework, it should be done in the context of program work. We believe this view is generally shared by the Board. For instance, in the discussion on conditionality in January it was confirmed that program reviews should not only monitor economic developments of a program country against an existing program but should also look at whether the program is still valid. If changes in a member's situation make the program framework no longer appropriate, then the staff needs to revise the program.

Thus, on the proposed Board decision to clarify the role of surveillance in program countries, while our views are not final, we are concerned that adopting the Board decision may send a wrong signal to staff. The Board's decision may be understood to mean that in program work staff does not need to assess the appropriateness of the existing program. This would be counterproductive to the agreed Board understanding that program work, including program reviews, should evaluate the appropriateness of program frameworks, and that neither surveillance nor program work should accept frameworks as given.

Staff also raises a question about the frequency of Article IV consultations in program countries. We believe a fundamental review of the program framework, whether we call it an Article IV consultation or not, should be conducted at the start of a new program and half-yearly, or annually at the most, thereafter. Even if we do not call this review an Article IV consultation, it will consume as much staff resources as an Article IV consultation. Therefore, in terms of resource savings we do not see significant merit in lengthening the frequency of Article IV consultations to every two years as proposed by the staff. We can, however, support the proposal, as it will allow the timing of consultations to be adjusted to program cycles, which is very important for program countries.

#### Staff-Monitored Programs (SMPs)

We have some concern that after the 1998 draft guidelines were prepared and the institutionalization of SMPs, including strengthened publication requirements, progressed, the difference between the SMPs and Board-approved arrangements became blurred. This is particularly problematic for signaling SMPs, as noted by staff. We were concerned to



learn that some MDBs in their own lending activities accept that these programs indicate the Fund's involvement. We believe the staff's proposal to strengthen the requirements for reporting and transparency risks further reducing the perceived difference between the Fund's formal arrangements and SMPs and increasing the likelihood that the signaling effect of SMPs will be misunderstood. Even if we make further efforts to clarify the difference between formal arrangements and SMPs, we cannot be optimistic about their effectiveness, judging from the current behavior of MDBs, which are supposed to be well informed as to how the Fund works. It is difficult for outsiders to understand the difference Board involvement makes on the signaling effect of programs.

We therefore think there is a need to visit the fundamental issues regarding the function of SMPs before reaching final views on the proposals suggested by staff on signaling SMPs: What kind of role is expected of SMPs? How do outsiders, including other international organizations, currently perceive SMPs? Is the current reporting of SMPs to the Board adequate? We look forward to hearing other Directors' views on these issues at today's discussion and to explore them further in the future.

On the track record SMPs, we need to make clearer that these SMPs are one form of prior action. In this regard, we can support strengthening the reporting on country performance under these SMPs to the Board.

Mr. Cippà submitted the following statement:

I thank staff for the comprehensive set of papers setting out the difficult issues regarding the implementation of the Fund's principal activity, namely surveillance. In the introduction to the last biennial surveillance review, staff stressed that the review should only be seen as an interim assessment of the Fund's surveillance activity. This cautious approach was dictated by the fact that many surveillance-related initiatives were in their initial stages and their impact could not yet be evaluated. Although Fund surveillance must evolve constantly to adapt to the changing circumstances, in my view, we are currently experiencing a consolidation period with many of the initiatives now fully on stream. The important task in such a period is, as stressed by the Managing Director in the recent informal discussion, to "implement more wholeheartedly and consistently the initiatives that are already underway."

The biennial reviews are an important element in our endeavor to improve the effectiveness of Fund surveillance. I welcome the frank and often self-critical tone of the report, which provides a good basis for improvements in our surveillance activities. However, I was a bit disappointed that the report did not bring out clearly where we stand in terms of the implementation of the results of the external surveillance review conducted in mid-1999. The

external review contained a large number of recommendations, many of which have been taken into account. But for the sake of transparency and accountability, it would be important to have a clear picture of how the Fund followed up on the results of the external review.

### Focus and Quality of Surveillance

Over the past years, I have often stressed the importance of maintaining the focus of surveillance on the Fund's core areas in the context of the broadening of the surveillance mandate. In my view, macro-relevance must continue to be the key factor for deciding to include areas outside of the traditional sphere. I welcome and share the staff's overall conclusion that the focus of surveillance has remained sufficiently focused. Increased selectivity has effectively prevented a dilution of the surveillance focus. The staff report impressively illustrates this by describing how the focus of Article IV consultations differed between the different groups of countries. While it is difficult to judge if selectivity was always appropriate to country specific circumstances, staff did not present any evidence which would justify major doubts.

While the focus of surveillance has been broadly satisfactory, I was concerned by several issues raised by staff regarding the depth of coverage. Staff note that financial sector issues are now a standard element of surveillance. Having strongly supported the efforts to increase Fund surveillance in the financial sector, I welcome this development. However, the substantial variations in coverage of these issues highlighted by staff are worrisome. I agree that a differentiated treatment of financial sector issues is warranted based on their relevance for respective national economies. In cases, in which the financial sector, for various reasons, does not pose immediate concerns for macroeconomic developments, a less intensive scrutiny is well-justified. But staff indicate that coverage often seems to be determined by other factors, namely the degree of resources and expertise that are invested.

It does not come as a surprise that in most cases only an FSAP can provide the basis for an in-depth assessment of a financial sector. The complexity of the sector and the numerous interlinkages between central bank, supervisory authorities, commercial banks, insurances and corporate sector make it impossible to adequately perform financial sector surveillance within the framework of the traditional Article IV mission. Our experience with FSAPs in Poland and Switzerland has highlighted the resource intensity of this process and we seriously ask ourselves, if adding an MAE expert to the mission can guarantee adequate coverage. Crisis prevention is at the heart of all our surveillance activities and the new focus on financial sectors was a direct response to the financial crises over the past years. If we are serious in our endeavor to make the Fund's crisis prevention role more effective, we

should see how we can better optimize the use of our scarce resources available for financial sector surveillance. I realize that this poses a problem within the current framework of voluntary FSAP participation.

As regards the significant differences in the treatment of the Fund's core area, namely exchange rate issues, staff's conclusion is of concern. Staff note that coverage has been limited and the depth of analysis has varied, which is clearly at odds with the current operational guidelines that note that "briefing papers and staff reports should contain an explicit and candid appraisal of a member's exchange rate regime and exchange rate level." A crucial factor for the limited coverage in many countries is surely the concern of adverse market reactions. This touches upon the sensitive issue regarding the balance between confidentiality and transparency. Over the past years, I have been among those advocating that a continuous, frank and transparent provision of information is an important way to enhance Fund surveillance. While significant progress has been made in this area, candor in the area of exchange rate regimes has often been elusive. In our informal discussion, the Managing Director mentioned the problem of providing sufficient incentives for countries to heed Fund advice. I think that increased candor can be a very strong incentive.

In the same vein, the coverage of external vulnerabilities and debt sustainability issues must be made more consistent and the analysis should be more extensive. Of course, we can safely assume that also in these areas market sensitivity played an important role in limiting coverage in specific cases. Notwithstanding the progress in the provision of debt and reserves data by members and the increased focus on debt issues, these issues are at the root of the current financial crises. Regarding vulnerability analysis, I took note of the fact that the lack of data on private sector debt profiles is often a constraining factor. Before moving into yet another, in this case very costly, data collection exercise, like Mr. Portugal, I think the Fund should first make more efforts to improve the analysis with the data available.

On trade issues, I fully agree that the Fund should foster an open international trading system and trade liberalization and should, therefore, continue to address trade issues in the context of surveillance. The staff's proposal for being more selective, namely to concentrate on countries with serious distortions and on systemic trade issues of market access, seems reasonable.

Staff raises the issue of the often incomplete integration of new areas into a coherent overall assessment. I failed to get a clear idea from the staff report how serious this problem really is. It would have been helpful to have more information and specific examples where this issue surfaced.

Regarding the use of outside expertise, I fully share the Managing Director's views that the Fund should increase its efforts to tap into the know-how of other institutions. Enhanced collaboration and better use of existing material is an important element of coping with the increasing surveillance workload.

#### Multilateral surveillance

Multilateral surveillance has a strong basis in the semi-annual WEO discussions, with the WEMD sessions providing excellent opportunities to guarantee continuity. The quarterly discussion on the Global Financial Stability Report is also valuable in that it ensures a more regular assessment of financial market developments, including possible impacts on emerging market financing. An area in which I found progress has been less notable, is the better integration of multilateral into bilateral surveillance. While the impact of the policies of major advanced countries on the global economy is usually covered in the WEO, I find that the regional impact of policies of other important countries are not adequately discussed in Article IV consultations. A more consistent coverage of regional aspects in bilateral surveillance would be particularly important for emerging markets.

#### Procedures for Article IV Consultations

I agree with the proposed clarification and expansion of the current policy as outlined in paragraph 38. Particularly, I agree that the possibility of LOT conclusions should be retained, but they should continue to be used sparingly. Moreover, I support flexibility regarding the mission size and the issuance of selected issues papers. In my view, attention should also be given to keeping selected issues papers focused on practical policy issues. The more theoretical essays should be published under the Working Papers series. On the issue of flexibility of producing statistical appendices, I continue to support staff's proposal, because I think it contains sufficient safeguards to ensure that the availability of high-quality economic information for all member countries would be guaranteed. Although the savings in terms of staff resources are small, even these are important when considering the tight constraints we are facing. However, I would support Mr. Wijnholds's proposal for establishing a 'minimum data requirement' template for Article IV staff reports.

#### Surveillance in Program Countries

The staff report presents an in-depth analysis of the problems associated with conducting surveillance in program countries. While the review underscores the difference in depth and breadth of coverage between stand alone and combined Article IV staff reports, it remains unclear to me how serious the problem really is. Although the point can be made that

surveillance and program work are two different animals, in my view, they overlap to a very large degree. Given the workload in program countries, coverage of some issues will naturally be narrower in many combined Article IV staff reports. However, this aspect is probably more than compensated by the strong framework provided by the LOI and the more in-depth knowledge of the economic challenges.

In my view, drastic measures such as institutional firewalls or double mission chiefs are not appropriate. I am also not sure about the utility of the proposed specific guidance of the Board for surveillance in program countries. Surveillance should be the same for all countries. While I agree that the issues stressed in the proposed specific guidance are important, they may point to a shortcoming of Article IV discussions in general, not only for program countries, and should, therefore, be stressed more generally. More work is needed to better define the issues raised by staff. I think the main responsibility for ensuring the independence and objectiveness of the Article IV consultations in program countries lies with PDR. Furthermore, the extensive review process that is a hallmark of the Fund should provide additional safeguards. To strengthen the existing framework further, I could go along with a pilot project, in which missions are augmented by a staff member who would ensure the adequate coverage of more general Article IV topics and provide an 'outside' perspective.

#### Staff-Monitored Programs (SMPs)

The review of SMPs confirms their usefulness as an instrument for establishing a track record. However, staff confirms my doubts as regards the large potential for misunderstandings in the public in the area of signaling SMPs. While means could be found to improve the understanding of such SMPs, in my view dropping this alternative is more efficient. Members looking for Fund endorsement of their economic policies should opt for precautionary Stand-By Arrangements. A well-recognized standard and Board approval are the best guarantee for a successful signaling.

Extending the remarks by the Swiss chair, Mr. Szczuka noted Mr. Djojosebroto's comments on the tension that, at times, appeared in Article IV surveillance missions between the aspects of examination and actual dialogue. Thus, Article IV missions appeared, on occasion, to be following a uniform checklist and would, at the end of the mission, surprise the authorities with their final statement and their assessment, without that assessment having been part of a serious dialogue with the authorities beforehand. That issue had been discussed in the Board at an earlier occasion, and the-then Director of PDR, Mr. Boorman, had indicated at that time that the issue would be investigated further, including the question as to whether mission briefs should be disclosed at the beginning of the consultation process and constitute a basis for the discussions. The staff's comments on the results of that investigation would be welcome.

With regard to capital flows, Mr. Szczuka associated himself with Mr. Zoccali's statement according to which focusing exclusively on the recipient side would be inadequate. It was equally important to look also at the origin of the capital flows and at the origin of money that was being laundered. A symmetric approach regarding the evaluation of those developments was important.

With regard to prior actions in SMPs, Mr. Szczuka considered that, based on his personal experience with an SMP with 14 prior actions, he agreed with Mr. Portugal that such an approach was an exaggeration. While there might be cases of SMPs where prior actions had some justification, they should be used only when a strong case could be made in their favor.

Mr. Djojosebroto and Ms. Manivat submitted the following statement:

We welcome today's discussion on this important topic and would like to thank staff for the thought-provoking documents. It is recognized that surveillance is one of the cornerstones of the Fund's activities. The staff papers highlight the formidable challenges for the Fund with surveillance taking on a broader perspective given the changes in the global economic environment, but at the same time, it needs to be "more keenly aware of interdependencies among economies and more focused on crisis prevention."

#### Steps for More Effective Surveillance

Before commenting on the specific issues raised in the staff papers, we would like to first provide our initial reactions to the informal remarks made by the Managing Director last week on Fund surveillance and crisis prevention. We are encouraged by the Managing Director in pinpointing the two core issues arising from our recent experience: better policy advice, and greater impact. While the Fund should be commended for consistently adapting to the changing global environment and more demanding agenda, there is room for strengthening the effectiveness of surveillance, and, as a starting point, this requires a fresh look at the exercise. The Managing Director had highlighted the need to ensure that the Fund's policy advice is heard and has impact. On this, we share Mr. Callaghan's view that the failure of governments to adopt the Fund's advice may not be all the fault of the governments, but the result of shortcomings in the nature of the advice, how it is delivered, and its persuasiveness. We believe the Fund's track record in providing the right advice should be added to the list. It would be useful if staff could provide an analysis of the extent to which Fund advice on major policy issues had been right.

Besides the above, a number of Directors, including our chair, had previously commented that the Fund's conduct of bilateral surveillance has somehow evolved into more of a mandatory "examination" rather than a meaningful dialogue where Fund staff exchange views with the authorities

and provide advice on important macro-economic policy issues. The Article IV consultation is often an occasion where mission staff asks a set of questions, and only at the concluding session present their assessment of the country's economic situation and policy framework. It would have been more helpful if, as a standard practice, staff could share their briefing notes with the member country at the start of the consultation process, presenting their preliminary concerns and assessments, so that the country authorities can engage in more useful dialogue and exchange of views with the mission staff on the areas of concern. We believe this would contribute to a more transparent and fruitful consultation process as it would promote a more candid and focused dialogue between staff and the authorities and enhance "country ownership" of the Fund's policy advice. Our chair had raised this matter previously and the previous Director of PDR had promised to review the Article IV consultation process. We would appreciate staff's comments on the status of this review because it is evidently missing from the set of staff papers for this discussion.

The Managing Director had pointed out that even with the largest industrial countries, the Fund had only a limited capacity to affect the policies of these countries, even when these present risks to the global economy and financial stability. If even the largest industrial countries, being the major shareholders of the Fund, do not seem to take heed of the Fund's advice, it raises questions about the quality of the Fund's advice. It would thus be difficult to convince the wider membership of the Fund, perhaps with the exception of program countries, to accept the Fund's advice.

We believe that the quality of Fund's policy advice could be improved significantly through a number of key positive steps. Member countries often hesitate to follow the Fund's advice because in many instances, the advice has not been all that practical. The Fund therefore needs to take into account the political feasibility, social implications, and institutional arrangements of member countries. In short, the Fund needs to be more in tune to the country's needs and circumstances or as Mr. Callaghan noted in his preliminary statement, it is not what policy measures need to be adopted, but how the policy changes can be successfully implemented. We recall a few instances when we questioned staff on the political and social feasibility of their policy recommendations and were told that these are not matters for the staff to consider, but for the country authorities themselves to work out.

We would therefore like to reiterate the view of many Directors during our discussion on enhancing country ownership that there is a need to have more staff with policy implementation experience in developing countries, and more continuity of staff, particularly for program countries. We also concur with the Managing Director that the Fund needs to pay more attention to the sources of growth in member countries and the policy requirements for sustained growth. We can no longer assume that the "standard policy

prescription,” for example, liberalization of every sector of the economy, privatization, and flexible exchange rate, would automatically induce foreign capital into a country, without a critical analysis of the sectors most likely to drive growth. These would be concrete positive steps in the right direction that would greatly enhance the effectiveness of Fund surveillance.

### Coverage and Focus of Surveillance

Turning to the issues raised in the papers, staff correctly identified the critical issues in the context of coverage and focus of surveillance as summarized on page 8 of the Overview paper: how to maintain a proper focus on the issues that are most critical, given the wider range of issues; how to ensure adequate quality of coverage, given the extension of coverage to areas outside the Fund’s traditional focus; and how to integrate the issues into a coherent assessment. Macroeconomic relevance should remain the key test for inclusion of issues in the Staff Reports. Issues related to external sustainability and vulnerability to balance of payments or currency crises should continue to receive the highest priority. We are concerned, however, that some issues such as the global impact of policies in the major industrial countries have not received more attention and adequate depth of coverage. On this, we find Mr. Portugal’s comments very convincing.

Coverage of trade policies, for instance, does not seem to have received adequate attention for an in-depth analysis, especially in the industrial countries. We are often told that in the case of the major European countries, the issue should not be addressed at the individual country’s Article IV discussions, but should be raised in the context of the meeting on Monetary and Exchange Rate Policies of the euro area. Yet, we may be lucky to find two short paragraphs on this issue in the paper. Sometimes it is mentioned in the *WEO*, but more in the context of the broader global trade agenda. While we recognize that countries in the euro area are subject to a common trade policy framework under the purview of the European Union, surely there are differences in the implementation of this policy framework in the different EU countries. For example, the level and extent of agricultural subsidies in one EU country will differ from another even though they are both subject to one common EU policy framework. It is particularly difficult for the Board to bring peer pressure to bear on the trade policies of any particular EU country under a broad discussion of EU-wide trade policy. On the other hand, trade issues in the other industrial and developing countries have a pertinent and permanent place in the Article IV reports and trade liberalization is one of the key structural conditions imposed by the Fund on program countries. While we are encouraged by staff’s comments that trade issues is an integral part of surveillance especially for the large advanced economies whose policies have severe implications on the developing countries’ market access, the real test is in the implementation and how we



ensure uniformity of treatment across the Fund's membership. We would welcome staff's response on how this could be addressed.

Another example of how difficult we can all agree on what issues deserve an appropriate focus in surveillance is staff's definition of "systemic issues" on page 12 of the Overview paper. Staff's definition is issues that are of "broad interest" to the Fund membership as a whole, such as efforts to combat money laundering. We would have thought systemic issues mean issues that have important implications for the global financial system, and, as such, these would deserve to be covered regularly. Issues that are of mere broad interest would not.

#### Financial Sector Surveillance

We view the Fund's work on financial sector as an on-going process, and the coverage and emphasis are broadly appropriate. At this stage, we see no conflict between the nature of Fund bilateral surveillance, which is mandatory and conducted annually, and that of FSAP and ROSC, which are voluntary. We are not clear why an in-depth analysis of the financial sector is not possible in context of the Article IV; if the problem is staff resources as alluded to on page 15, we should be able to make procedural arrangements to allow for more intensified work and rely more on the expertise of other institutions where appropriate.

#### Surveillance in Program Countries

Although there seems to be differing views, we appreciate the concerns raised on whether surveillance lacks independence from program activities when combining Article IV and Use of Fund Resources (UFR) discussions. Even if we accept the argument that the combined discussions tend to be less effective than stand-alone Article IV consultations in non-program countries in presenting a critical assessment of recent economic developments, short- and medium-term prospects and vulnerabilities, and differences in views between staff and the authorities on key policy issues, there is no simple solution to these perceived problems. In the absence of a realistic and ideal solution, we can support the proposal for establishing clear guidance from the Board on the role of surveillance in program countries. Greater awareness of the problem by Fund management, staff, the Board, as well as country authorities may help improve the conduct of surveillance over time, and the test again lies in the implementation. We are not certain, however, if a separate guideline on Program Review is needed as well to remind staff that, on such occasions, they also need to present a candid and fair account of the dialogue between the staff and the authorities, even if this would reveal major differences. From our experience, we find that such has not always been the case. We also find Mr. Callaghan's suggestion useful—more active oversight by management and preparedness to introduce a fresh

pair of eyes when necessary—including, if we may add, at the request of the country concerned.

#### Staff-Monitored Programs

The problems of SMPs seem to stem from its very nature in trying to achieve too many objectives. We agree with the views of other Directors that the rationale of SMPs be reviewed before any decision is taken.

#### Post-Program Monitoring

We agree with Mr. Portugal that the purpose of PPM is to provide early indication of potential problems in a country's capacity to repay the Fund. Only those structural policies that have a bearing on the external capacity to repay could be covered in PPM reports. Issues that are not linked to the capacity to repay should be covered in normal Article IV reports and not in PPM reports.

Mr. Usman submitted the following statement:

We thank the staff for producing a comprehensive set of papers for today's discussion, which provide a useful overview of the recent experiences in Fund's surveillance operations and of future orientations. Their contents serve to reconfirm the great importance that continues to be attached to the role of Fund surveillance. It is also evident from the papers that the surveillance procedures have expanded noticeably, reflecting a significant effort on the part of the Fund in discharging its responsibilities, notably, under Article IV, Section 3 of the Articles of Agreement. The broadened framework for surveillance both in terms of the coverage and modalities, to respond to the challenges of the changing global environment, is a clear manifestation of the Fund's determination to strengthen its surveillance role beyond the scope envisaged in the Articles. However, notwithstanding the progress made hitherto, what does not appear to be clear from the staff papers is whether the Fund's activity, as regulated by these procedures, has proved adequate to improve the effectiveness of surveillance. In this respect, it is evident that the effectiveness of surveillance will ultimately depend on member countries' willingness to cooperate with the Fund and on the timely availability of accurate information.

The Fund will no doubt have to be prepared to face up to the new and growing challenges, brought about by the phenomenon of globalization, which will continue to test the Fund's ability to adapt and to strengthen surveillance. The propensity to expand coverage for surveillance beyond the traditional core areas is, therefore, bound to remain a constant. This will, in turn, call for greater and appropriate selectivity in the application of the existing framework focusing on issues that are specifically relevant for

macroeconomic stability, external viability and growth in the distinctive circumstances of individual countries. In an environment of increased capital mobility and financial market integration, the scope of surveillance has been expanded in an attempt to expose ex-ante crisis vulnerabilities in member countries. Thus, the high priority accorded to the assessment of external vulnerabilities in the hierarchy of surveillance concerns is appropriate, and the increased emphasis being placed on financial sector surveillance, capital account movements and cross-country issues comes as a natural extension of the Fund's responsibilities. The increased use of FSAP to enhance surveillance in these areas is therefore, appropriate and should be encouraged by all members, particularly those whose policies have a systemic importance. Notwithstanding these efforts to expand the scope of surveillance, the main concern is that countries are still hit with crises in the traditional areas, particularly the exchange rate. Hence, it would be important that the Fund continue to enhance the surveillance techniques in this area, in order to better assist the member countries in preventing such crises.

On the expansion of surveillance to areas beyond the traditional core areas, while acknowledging the significance of the structural policies and institutional issues, on a country's economic performance, the criterion of macroeconomic relevance should be strictly observed in the coverage of these issues. We agree with the staff suggestion for a more selective approach in covering trade matters on those countries with serious trade distortions and in major advanced countries whose protectionist policies continue to prevent market access for developing countries and consequently constricting their growth potential.

While a comprehensive surveillance of all aspects of macroeconomic and financial issues in member countries would have been desirable, cost, time, and capacity considerations both from the side of the Fund and of the authorities will tend to limit its coverage. Prioritization and focus of surveillance in key core areas of vulnerability are therefore important and will contribute to maintaining the analytical rigor of the Fund's assessments.

We agree that countries with systemic importance should be given high priority in the surveillance process. However, little progress has been achieved so far, in reducing the inherent asymmetry in Fund surveillance, which has been a successful toll for influencing the policies of the developing countries, particularly those using Fund resources, but it remains ineffective in shaping the policies of those countries that have a systemic importance in global economy. Therefore, there is need to continue seeking ways and means of enhancing effectiveness of Fund surveillance over the policies of advanced countries not only to reduce the asymmetry but also to ensure that their national policies remain adequate to contribute to global growth and to maintain a stable international environment.

Substantive progress has also been made in enhancing the modalities of surveillance and adapting them to the new global realities. In particular, we welcome the number of initiatives taken to strengthen multilateral surveillance in light of the increasing trade and financial linkages. The conduct of the semi-annual discussions on the WEO and the more frequent sessions on the WEMD have been important vehicles in providing periodic assessments of key economic and financial developments and on alerting on possible systemic risks and vulnerabilities. Moreover, the quarterly Global Financial Stability reports will facilitate a more continuous monitoring of the developments in the financial markets. While some progress has been made thus far, like other Chairs, we believe that greater and more systematic integration of multilateral and bilateral surveillance is in order.

Regarding the Article IV consultations procedures, the staff proposition to include an element of flexibility on the Selected Issues Papers and on the Statistical Appendices seem to be reasonable, provided that the statistical information is readily available from other sources.

Regarding surveillance in program countries, we fully subscribe to the views expressed by Mr. Portugal. The staff have not presented any convincing arguments that would support the concerns raised about the effectiveness of Fund surveillance in program countries. Much to the contrary, the frequent program reviews only serves to reinforce surveillance and improve its effectiveness. Therefore, like many other Directors, we cannot agree that surveillance should become more independent from programs.

Mr. Scholar and Mr. Joicey submitted the following statement:

#### Key Points

International economic surveillance is an essential tool for strengthening crisis prevention and promoting global stability and growth;

An effective economic surveillance mechanism needs to be authoritative, comprehensive, focused, influential, and accountable;

The IMF is uniquely placed to undertake surveillance, through its responsibilities under Article IV, but questions have been raised about the adequacy of its coverage, the quality of its policy advice, and its influence over member countries;

Surveillance now covers a broader range of issues and as a consequence is more effective, although more needs to be done to promote take up of standards and codes;

It is increasingly well focused on addressing key vulnerabilities (though we need further work on debt sustainability analyses); it needs to pay more attention to the sources of growth, including trade;

There is no clear distinction between program and surveillance activities. This makes it harder for the IMF to evaluate critically the design and implementation of its programs—a central objective of surveillance;

This would be addressed through a greater distinction between the two functions, through changes to internal procedures, management lines and the role of the Executive Board;

Greater transparency would bring clear benefits in terms of increasing the Fund's influence, quality of advice, and accountability;

#### The importance of surveillance

International economic surveillance is an essential tool for strengthening crisis prevention and promoting global stability and growth. It provides a unique means to assess national and global economic prospects, to detect vulnerabilities at an early stage, to provide policy advice, and more broadly to promote international economic cooperation.

#### The criteria for effective surveillance

An effective economic surveillance mechanism needs to meet the following criteria:

**Authoritative:** it must command international respect, be a source of international expertise and best practice, and provide sound and credible policy advice;

**Comprehensive:** it must cover all the issues that are relevant to economic stability;

**Focused:** it needs to be well focused, highlighting the most important risks and vulnerabilities, to ensure problems are detected at an early stage;

**Influential:** its recommendations need to be reflected in the policies of member countries if problems are to be addressed at an early stage, crises averted, and uncooperative practices avoided;

**Accountable:** to retain the necessary influence and legitimacy, it must provide a sound basis for its findings and recommendations, be prepared to justify and defend them, and respond to criticisms and suggestions for change.

### The IMF surveillance mechanism

The IMF is uniquely placed to undertake surveillance, given its responsibility under Article IV to oversee the international monetary system and all 183 member countries.

Although Article IV is defined primarily in terms of “exchange arrangements”, it gives the IMF a relatively broad surveillance remit covering policies related to “fostering orderly economic growth with reasonable price stability” and “fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions.”

But surveillance must adapt to changing circumstances. Since the adoption of the new Article IV in 1978, questions have been raised about the adequacy of IMF surveillance in three respects:

coverage: does IMF surveillance have adequate coverage (in terms of comprehensiveness, focus and level of expertise) to spot problems early?

quality of advice: does the IMF make the right policy recommendations?

effectiveness: does the IMF have the necessary authority and influence over member countries to encourage them to change their policies and approach?

### Pressures on IMF surveillance

Recent developments in the global economy, the world financial system, and the international policy environment have increased the pressure to address these issues:

the liberalization of financial and capital markets: the enormous expansion of international capital flows has intensified the financial and trade links between countries and added new dimensions to effective surveillance. Increased economic interdependence has highlighted more starkly the need not only to monitor monetary and fiscal policy, but also the financial and corporate sectors to ensure policies are sustainable; it has emphasized the importance of data collection and provision so that market participants and authorities are alert to changes in balance sheet exposures and can assess the associated risks and vulnerabilities; and it has highlighted the need to put in place transparent policy frameworks that command market confidence;

the changing nature of financial crises: the crises of the 1990s emphasized the risks of sudden changes in capital flows; demonstrated the importance of monitoring the levels of public and private debt, including their

susceptibility to exchange rate and interest rate movements; and showed how weaknesses in the financial and corporate sectors exacerbate external financing difficulties and vice versa;

criticism of the IMF's approach: the IMF has been criticized for failing to anticipate crises; for applying a one-size-fits all model to countries; for advocating rapid capital account liberalization and paying insufficient attention to the foundations for stability and growth; for being reluctant to step back and provide an impartial assessment of the sustainability of the policy framework in program countries; for advocating policies that address its own interests as a creditor and those of other creditors; and for being insufficiently open to outside views, advice and review;

the limited impact of peer pressure "behind closed doors" and the increasing emphasis on transparency: traditionally the IMF sought to exert influence through peer pressure. Surveillance documents and discussions were originally confidential to allow for a full, frank and candid discussion between staff and the authorities, and between member countries at the Executive Board. The succession of crises throughout the 1980s and 1990s, however, raised questions about the effectiveness of confidential peer pressure. Increasingly the international community has emphasized the role that greater transparency can play in encouraging governments and markets to address risks at an early stage, without compromising candor.

#### The changing nature of IMF surveillance

##### Broader coverage

The papers for the biennial review show how the IMF has adapted to these pressures and broadened the scope of its surveillance. This has included, in particular, the development and dissemination of enhanced data standards; the development of codes of good practice on monetary, financial and fiscal transparency and the incorporation of these into the surveillance process through Reports on Standards and Codes (ROSCs); the strengthening of financial sector surveillance through the joint IMF-World Bank Financial Sector Assessment Program (FSAP); and giving greater attention to capital account issues and the sequencing of capital account liberalization.

The papers nevertheless suggest that there are a number of weaknesses. One is the uneven take-up of ROSCs and subscription to data standards among member countries. We need to find ways to give countries greater incentives to adopt these international best practices. Options include increasing the resources available for associated technical assistance and transitional support to enable all countries to meet the codes and standards, in cooperation with the World Bank and bilateral donors; including in all Article IVs a summary of which ROSCs a country has undertaken, the extent to

which ROSC criteria were met, the main follow-up actions the authorities intend to undertake, and areas where staff would recommend the completion of a ROSC. A second weakness is the IMF's ability to provide in-depth coverage of "new" areas, such as the financial sector (in cases where there is no FSAP), the non-financial corporate sector, and institutional issues such as corporate and public sector governance. Ways need to be found to give the Fund greater access to outside expertise to cover these areas, and to improve further cooperation with the World Bank and other organizations such as the FSF, WTO and ILO. We would welcome staff comments on steps to address these weaknesses.

Finally, we think it is essential that all Article IV surveillance recommendations take account of the sources of growth and the policy requirements for sustained growth. Experience has shown that this is a precondition for long term economic stability. Article IV reports should continue to focus on the most important structural impediments to growth, and where relevant the links between debt sustainability and growth. Trade links must also be given prominence, particularly where trade policies have significant external impacts on other countries.

#### Stronger Focus on Vulnerabilities

The Fund has made progress in strengthening the quality of its surveillance, for example assessing external financing requirements, making better use of market information, and analyzing the risks from contagion. We particularly welcome the Fund's new mechanism for monitoring the risks of capital market crises, bringing together expertise from different departments. The key priorities for further work in this area are: to strengthen and make more transparent our debt sustainability analyses; to agree firmer presumptive access limits; and to put in place a more effective sovereign debt restructuring process.

#### Surveillance in program countries

The lack of a clear distinction between program and surveillance activities creates a number of potential problems. In particular, it makes it harder for the IMF to step back and evaluate critically the design and implementation of its programs. But this is, or should be, a central objective of surveillance. In this context:

We welcome the detailed assessment in the review. On the basis of its conclusion that "reports on combined Article IV/UFR discussions for program countries frequently suggest a lack of independence of the exercise from the agreed program framework", we think there is a strong case for looking further at the scope for strengthening the independence of surveillance; this would strengthen the focus of the Fund on crisis prevention, and away from



the “firefighting” role of crisis resolution. This has been a key objective of recent reforms, but progress will be limited so long as very little distinction is drawn between surveillance and program activities. The current structure of the IMF embodies the assumption that program lending should be seen as an extension of surveillance. Yet if the IMF is to be held accountable for the provision of effective surveillance that promotes stability (and by implication reduces the incidence of crisis-lending) there is a case for a clearer division of responsibility;

Distinguishing more clearly the surveillance and program functions and establishing clearer reporting lines, including to the Executive Board, would increase the effectiveness of surveillance. We would welcome a fuller discussion of possible options. This should include, for example:

- looking further at the options for having separate management lines for program negotiations and surveillance;

- looking at whether there are better ways, in Mr. Callaghan’s words, to bring “a fresh pair of eyes” to surveillance documents during the internal review process;

- looking at broader institutional changes (see below).

#### Transparency

The IMF has introduced a number of transparency reforms. In assessing these and looking at the scope for going further, we need to consider carefully the potential tension between greater transparency and the Fund’s role as a provider of candid and frank advice. In our view—and given the large volume of financial and economic information and analysis readily available in today’s markets—this tension is more apparent than real. And there are clear benefits in terms of increasing the influence, authority and accountability of its surveillance mechanism:

- by disseminating its surveillance to the public and markets, as well as governments, the IMF can strengthen the incentives for members to address and act on its findings;

- by making clear the basis for its findings, the IMF can strengthen its authority and address criticisms that might otherwise undermine its influence;

- by opening itself up to outside criticism and review, the IMF can ensure that it takes account of outside expertise, that any weakness in its own approach are addressed, and that its advice is seen as international best practice;

all of the above will enhance the IMF's accountability, including to its members.

For these reasons, although the staff reports do not discuss transparency, we believe that further measures to strengthen transparency would play a central role in making Fund surveillance a more effective tool for crisis prevention. We would welcome staff comments on possible options:

having experimented with the voluntary publication of Article IVs over the last few years, we believe there is now a strong case for a presumption in favor of publication;

we think there is a good case for publishing reports at the same time they are presented to the Board;

we should consider establishing a strong presumption that IMF missions' concluding statements will be published immediately after surveillance missions.

#### Institutional Reform

The 1999 external evaluation of surveillance raised some questions about the effectiveness of the Board, noting that "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 the Board has considered and experimented with alternative procedures for Article IV discussions, we think there is a case for re-examining the objectives and purpose of Board discussions in the context of a broader review of the IMF's surveillance strategy. We would welcome staff comments on possible options:

arguably the Board's influence might be strengthened if less time was spent discussing Article IV reports, but it had a formal responsibility to set an annual surveillance remit, with the IMF staff and management reporting back regularly on their performance against that remit.

such a surveillance framework might help in terms of setting clear objectives, assessing the appropriate focus and effectiveness of the IMF's surveillance activities, and allowing the Fund to respond more quickly to changing priorities for surveillance.

## Conclusion

We have suggested a number of areas for further work. We would welcome staff comments and further discussion of these issues. Reform along these lines would ensure that surveillance is—and is seen to be—independent of decisions about crisis resolution.

## Annex: Response to Staff Questions

Do Directors agree with staff's characterization of the evolution of the broadened framework for surveillance?

We broadly agree and believe that this has strengthened IMF surveillance.

Do Directors endorse the suggested approach towards selectivity, macroeconomic relevance, and a hierarchy of concerns? Are there other issues (such as growth and the global impact of policies in individual countries) that ought to be placed high on the hierarchy of concerns?

We agree that Article IV surveillance should focus on vulnerabilities and risks to macroeconomic stability, within this broadened framework. As the staff papers emphasize, recent crises have demonstrated the significant macroeconomic effects of financial sector, corporate sector and institutional weaknesses. We agree with staff that greater emphasis should be placed on debt and balance of payments sustainability analyses in all countries.

It is essential that all Article IV surveillance recommendations take account of the sources of growth and the policy requirements for sustained growth. Experience has shown that this is a precondition for long term economic stability. Article IV reports should continue to focus on the most important structural impediments to growth, and where relevant the links between debt sustainability and growth. Trade links must also be given prominence, particularly where trade policies have significant external impacts on other countries.

Is there room for greater selectivity in surveillance?

In some cases. For example, we agree with staff that the coverage of trade issues in Article IV reports could be more selective, focusing largely on countries with serious distortions and/or where a country's trade policies have systemic implications for other countries.

Should the quality of financial sector surveillance measure up to the analysis of other core areas?

Yes. FSAPs are delivering both better assessments of financial system fragilities and higher quality policy advice. While we accept that FSAPs should remain voluntary, we hope that more can be done to persuade all IMF member countries to undertake them. We agree with Mr. Callaghan that it would not be appropriate to try to fully integrate FSAP assessments into every Article IV, but feel that it is important to put in place better mechanisms to ensure follow-up (perhaps by giving MAE staff specific country responsibilities, like FAD staff).

What is the role of ROSCs?

We strongly agree with staff that ROSCs have been extremely useful to both member authorities (in highlighting areas where their existing practices could be improved to match best international standards) and to staff (in generating greater data availability and improved institutional knowledge of the countries they monitor). We think the Fund should make greater efforts to promote ROSCs with country authorities and the broader investment community. See section A above.

Have the changes to multilateral surveillance been appropriate?

We welcome the more focused WEO and the introduction of the GFSR. In particular, we are pleased that the GFSR is helping to broaden work on international capital markets and allow for frequent analysis of forward looking systemic issues. We hope that this will be extended further in subsequent reports. In addition, more attention could usefully be given to integrating the discussions of financial and macroeconomic developments. We agree with staff that the coverage of trade issues in multilateral surveillance could be enhanced.

What scope is there for greater streamlining of consultation procedures and greater flexibility with respect to production of statistical appendices?

We agree that staff should be given greater flexibility in determining when to produce RED reports and Statistical Appendices. However, we would expect that core information relating to countries' national accounts, balance of payments, budget, labor market, and debt positions should be routinely included in Article IV reports. Cross-references to readily available sources of more detailed information should be included when Statistical Appendices are omitted.

We agree with Mr. Callaghan that we should go further in utilizing readily available research work within Article IV surveillance reports, as noted above, and that it would be appropriate for us to take a frank and self-critical look at the Board's contribution to the Fund's surveillance work. The

1999 External Evaluation of Fund Surveillance raised a number of questions in this latter regard. We have some doubts about the effectiveness of the Board's oversight responsibility and its peer pressure role.

What should be the role of surveillance in program countries? Should the timing of Article IV consultations in program countries be changed?

Given the importance of stepping back and evaluating critically the design and implementation of programs on a regular basis, we think we should be cautious in moving Article IVs for program countries from a one year to a two-year cycle.

Is there a risk of signaling SMPs being misinterpreted and should the arrangements for SMPs be revised?

We strongly agree with staff's concerns about the possibility of market participants misinterpreting the quality and Board endorsement of signaling SMPs. We agree with Mr. Portugal that this issue warrants a fuller consideration by staff and a separate Board discussion. There is a strong case for making a clearer distinction between signaling SMPs and track-record SMPs and for us to review our policies with respect to the monitoring and transparency of the former. We also need to discuss this issue directly with the MDBs to ensure that all Ibis treat these programs in a consistent manner.

The Chairman agreed with Messrs. Portugal and Wijnholds that a rather well-developed methodology and expertise on Fund surveillance was already in place and that Directors' statements aimed at improving that methodology further while acknowledging the excellent work of Fund staff. It was also welcome that Directors had already responded to his informal remarks made at the recent luncheon. The intention to encourage further thought and start a lively discussion on the matter of surveillance and crisis prevention had thus already produced the desired result. Surveillance was the Fund's "bread and butter" and one of its most important vehicles to demonstrate its ability to perform its functions well and to fulfill its mandate.

There seemed to be agreement on two essential points, the Chairman continued, on the need for high quality of the Fund's advice and for its effectiveness or impact. Those were the main issues that could guide the further discussion. It was the intention of staff and management to come back to the Board with more concrete steps on those issues before the summer.

The Deputy Director of the Policy Development and Review Department (Mr. Lipschitz) noted that Directors' comments could be grouped broadly around six issues—the impact and effectiveness of surveillance, its focus and depth, the integration of bilateral and multilateral surveillance, the modalities of surveillance, surveillance in program countries, and the appropriate use of staff-monitored programs.

On the impact of surveillance and the question as to whether the Fund's advice was being heard and how its impact could be enhanced, Messrs. Callaghan, Portugal, Andersen, Djojosebroto, and Ms. Manivat had argued that the Fund needed to pay more attention to issues of political feasibility and social costs and to draw on the experience with reforms in other countries. Mr. Kelkar had suggested that direct exchanges with parliamentarians would help get a better sense of political feasibility. That view was contrasted by Mr. Bennett's position, who warned that staff teams should not focus excessively on political feasibility, given that political circumstances changed, and that developing a long-term view was useful to exploit potential momentum for changing the horizon of what was considered politically feasible.

On the issue of effective communication, the Deputy Director noted Mr. Callaghan's argument that the staff needed to focus more on a dialogue with the authorities rather than with management and the Board. The suggestion to include parliamentarians in that dialogue appeared relevant. While the transparency issues raised by Mr. Wijnholds were also highly relevant in that regard, it might be more appropriate to discuss them in the context of the upcoming review of transparency policies. Messrs. Zoccali, Le Fort, and Mirakhor had stressed the importance of creating better incentives to ensure that the Fund's advice would be heard. They argued that existing incentives appeared to create some asymmetry in Fund surveillance; countries with borrowing needs were responsive, whereas major industrial countries with significant systemic impact were less moved by Fund advice. While the discussion about mechanisms to redress that apparent asymmetry had been rather profound, the Deputy Director wondered whether the perceived asymmetry had been characterized fairly as between developing and industrial countries. It appeared that the distinction should rather be made between the impact of Fund policy advice on countries with imminent financing needs and those with no such needs in the foreseeable future. That distinction could be regarded as rather natural, given that the nature of problems and the need for policy change in countries with immediate financing needs were, in any case, of great urgency. It was hence not surprising that radical changes occurred in such a context, whereas—in countries without any crisis—changes were more gradual and based on consensus-building and parliamentary processes, that were evolutionary by nature. For countries without immediate financing needs, the effectiveness of Fund policy advice should be judged on the basis of whether it influenced the domestic debate on the relevant policy issues. There were a number of examples in both industrial and developing countries where that had been the case. While such achievements tended to be less dramatic than major policy changes, a constant drum beat of policy advice that started to have an effect on the domestic political debate was important and demonstrated the effectiveness of surveillance.

Mr. Callaghan's observation that Board procedures did not exploit all the potential leverage that could arise from peer pressure seemed to be rather significant, the Deputy Director considered. Nothing could prevent a consensus of Executive Directors influencing the summing up of an Article IV consultation in such a way as to include sharp and detailed criticism of a particular aspect of a country's policies. Currently, the mission's concluding statement constituted the most influential document during a staff mission. However, with a high degree of consensus in the Board, summings up could be much more candid and rather effective in delivering a blunt message, especially in the case of countries that were

committed to PINs. The effectiveness of peer pressure could be considerably enhanced through this existing mechanism.

On the focus and depth of surveillance, the Deputy Director noted that there was consensus that the evolution of the framework of surveillance was an appropriate adaptation to changing global circumstances, and that, in individual surveillance exercises, selectivity was the only way to marry breadth and focus. In practice, operationalizing greater selectivity while maintaining uniformity of treatment was a delicate matter, as Mr. Callaghan had pointed out. Mr. Shaalan and Ms. Farid had indicated that selectivity should continue to be guided by the criterion of macroeconomic relevance, and most Directors concurred with that. The debate was rather on which areas—external vulnerability, balance of payments viability, macro policies, and others—should be at the apex of the hierarchy of the Fund’s concerns. In that context, a number of interesting issues had arisen. Thus, several Directors were of the view that sources of growth should be one priority area. Systemic relevance was another important consideration raised by Mr. Kelkar, and supported by Messrs. Padoan and Vittas, and others. While issues such as U.S. trade policies did not necessarily have macroeconomic relevance to the country itself, they were important to much of the rest of the world, and one could argue that whether a small policy change was important to the macroeconomy of the United States should not be the sole criterion of relevance given its systemic importance.

There appeared to be broad agreement that the staff had coped reasonably well with the broadened framework without losing focus, the Deputy Director observed. However, the view had been expressed that the staff could be more selective on some issues, of which trade policies was one. It was not regarded as useful to look at marginal changes in the trade policy of small countries without systemic relevance, while it was entirely legitimate to look at trade policies in major countries of systemic relevance or in countries where trade policies produced substantial distortions for the country’s own macroeconomic policy performance. Directors’ statements also revealed the widely shared view that some of the new issues were not covered as thoroughly as they should. It should be noted in that context that financial sector issues were at the top of the hierarchy of Fund concerns. While financial sectors had been covered well in cases where FSAPs had been conducted, in other cases, coverage was regarded as superficial, perfunctory, and not adequate.

A number of structural and/or institutional issues were critical to Fund policy advice, the Deputy Director stressed, given that they were crucial for macroeconomic policy making. One of them was corporate governance, and it had to be recognized that the Fund’s coverage in that regard lacked depth and expertise. Coverage of medium-term debt sustainability also needed to be strengthened, partly through providing greater clarity on scenario assumptions. Mr. Wijnholds’s suggestion to open the proverbial black box more frequently with regard to the staff’s assumptions particularly in the context of sensitivity analyses should indeed be followed. However, regarding debt sustainability, there was a problem with the dearth of critical data, particularly on corporate exposure to exchange and interest rate risk. In many cases, that exposure spilled over to the banks and ultimately the government, thereby limiting the available range of policy options. While the staff’s coverage in that area might be less than adequate, it was not clear how to remedy those weaknesses, although Mr. Portugal’s suggestion to increase voluntary participation in FSAPs and ROSCs was helpful.

Mr. Bennett, on the other hand, had wondered whether certain aspects of those activities should continue to be voluntary. Mr. Andersen had suggested including staff from the Monetary and Exchange Affairs Department in more Article IV missions, while Mr. Cippà doubted that this would necessarily improve the depth of coverage, given the constraints on staff resources. Mr. Wijnholds suggested enhancing the effectiveness of the conduct of Article IV missions through using teleconferences on financial sector and structural issues. Mr. Yagi and Mr. Yanase proposed an increase in the involvement of area departments in FSAP initiatives, with strengthened expertise of country desks in a number of those areas.

With regard to deficiencies in data, particularly those relating to debt, the Deputy Director noted the preference expressed by Messrs. Portugal, Al-Turki, and Cippà, for the staff to improve the analysis of that part of the debt on which reliable data were available, before asking for data on private sector balance sheet exposures whose collection was difficult and costly. All those considerations by Directors suggested that there was a considerable degree of agreement on the persisting gaps in the conduct of surveillance. However, no consensus was yet apparent on solutions to these problems.

There was broad agreement among Directors regarding the need for a better integration of bilateral and multilateral surveillance, including a more systematic incorporation of the conclusions of multilateral surveillance into bilateral surveillance, the Deputy Director continued. There was also a call for more analysis of linkages across economies, more attention to aggregation effects of country-by-country advice, and for better use of the particular expertise of the ICM Department in the Article IV process. The staff agreed with Directors that current practices were less than optimal in all those areas. However, one should not overlook the fact that progress had been made over the past two to three years. The recent work in the context of the WEO on the synchronization of cycles across the major advanced economies and, more generally, on linkages between economies had had considerable influence on the Fund's bilateral policy advice. The focus on systemic trade issues had been reinforced recently, both in the WEO and in the Article IV reports on the larger countries. Thus recent Article IV reports for large countries, as well as the WEO and the ICM Report, all contained considerable work on the systemic impact of policies of major advanced economies, as is shown in Box 5 of SM/02/82, Sup. 1. The need to avoid an overall contraction of economic activity had been a key issue in 2001 and in the Managing Director's October 5, 2001 statement, as a reaction to the events of September 11. From a global perspective, industrial economies had reacted appropriately, and the recession had proved to be relatively short-lived.

On the issue raised by Mr. Wijnholds of finding a mechanism to bring to the Board the most sensitive issues arising from the integration of bilateral and multilateral surveillance, the Deputy Director considered that it was highly complicated. Among management and the staff, the Surveillance Committee discussed the interaction and the concerns among major industrial countries and their impact on developing countries. The WEMD mechanism had proved an effective way of bringing that discussion to the Board without the staff having to sacrifice candor and directness. The management-staff Surveillance Committee also discussed vulnerability assessments, which represented an integration of multilateral and bilateral surveillance. In that context, all functional



departments were asked to bring to bear their expertise, while others provided a focus on problems of individual countries. An adequate mechanism had yet to be found to bring a candid discussion of that exercise to the Board. However, that possibility should be addressed with high priority in the following months. Further efforts to integrate bilateral and multilateral surveillance were undoubtedly needed, in particular with a view to integrating the Fund's expertise on capital markets better into Article IV reports.

Regarding the wider use of cross-country analyses in surveillance, an issue raised by Mr. Callaghan, the Deputy Director agreed that this was an area where the Fund should be in a position to add considerable value, given that the material was readily available. Progress had already been made in that regard, particularly in recent work on Western Europe and on EMU, with a significant part of the work consisting of the study of cross-country issues. The same applied to much of the work on Central European countries, and on Asian economies. However, much of that might have been contained exclusively in charts, tables, and other numerical material rather than having been explicitly discussed in the body of the text of the reports. Therefore, considerable further progress should be possible in that area.

On modalities of surveillance, the fourth area addressed in Directors' statements, two issues had been dominating, the Deputy Director noted—the flexibility in surveillance procedures and the strengthening of coverage in non-traditional areas, including the use of outside expertise. Regarding flexibility, there appeared to be broad consensus on the degree of flexibility that was inherent in the existing procedures, including in the production of Selected Issues papers. While it seemed necessary to revisit the staff's proposal to drop Statistical Appendices, there was some promise in Mr. Wijnholds's suggestion that, if agreement could be reached on a minimum set of tables for all reports, dispensing with Statistical Appendices might be possible. On the use of outside expertise to strengthen the Fund's coverage of non-traditional areas, Directors' positions seemed to diverge. While Mr. Callaghan suggested that the Fund should increase its interaction with the OECD, the WTO, the BIS, the ILO, and also with non-official private sector bodies, and while some other Directors have similar views, Mr. Shaalan and Mr. Portugal have questioned that approach.

On the issue of surveillance in program countries Directors' views had differed considerably, the Deputy Director observed. Mr. Scholar and Mr. Joicey regarded the lack of independence in surveillance from program frameworks as a serious issue. Messrs. Wijnholds, Callaghan, Andersen, Djojosebroto, and Ms. Manivat agreed that it might be a matter of concern. On the other hand, Messrs. Shaalan, Usman, Mirakhor, and Portugal were not convinced by the analysis to that effect presented in the staff papers, and felt that lack of independence and effectiveness of surveillance in program countries was not an issue of concern at all. Those differences in assessment notwithstanding, most Directors agreed that a radical separation of surveillance and program activities was neither feasible nor desirable. Reservations mentioned in Directors' statements were excessive resource costs and potential problems in providing consistent advice. In view of that, there appeared to be a possibility of consensus on a relatively modest reform that would entail explicit guidance on surveillance in program countries and the need to take a fresh look at program design and at the critical assumptions about the global economic environment. Also, there appeared to be

broad consensus among Directors on moving to a 24-month cycle for program countries with the particular provisions and caveats presented in the paper.

On the issue of staff-monitored programs, the final topic addressed in Director's statements, the Deputy Director noted that most Directors had expressed unease about the role of signaling SMPs and saw a need to re-examine the rationale for SMPs in that context. Messrs. Portugal, Scholar, and Joicey had questioned the use of an individual instrument such as an SMP, for two rather different purposes—building a track record and providing a signal to creditors. In that context, Messrs. Cippà, Al-Turki, and others had noted that a Stand-By Arrangement might be a more suitable device for signaling purposes. There appeared to be broad support on the need for clearer guidance regarding the reporting on performance under signaling SMPs. In that context, the valuable suggestion had been made that signals to the markets could be provided by simply publishing Article IV reports and PINs and without having to rely on an SMP for that purpose. However, Mr. Shaalan, Mrs. Farid, Mr. Yagi, and Mr. Yanase objected to the proposed presumption of publication of reports relating to SMPs, citing concerns that this would run counter to the voluntary nature of the Fund's publications policy, and might also blur the distinction between SMPs and Fund arrangements.

Mr. Mirakhor thanked the Deputy Director for his comprehensive comments and addressed two points raised—the issue of political feasibility and questions relating to SMPs. On political feasibility, while the argument that one had to be careful when making a particular policy recommendation within a program context that might not be politically feasible was reasonable, talking about political feasibility in the context of surveillance was an entirely different matter. It was extremely important to recognize that there was a catalytic role for the Fund not only in the financial field, but also in the domestic political field of a member country. Avoiding making policy recommendations that, at a particular point in time might not be considered politically feasible was not serving the membership well. There were numerous cases of countries where the authorities explained, in the context of Article IV consultations, that a particular policy measure was not politically feasible only to implement that very measure within a short time span thereafter. That demonstrated clearly that avoiding to raise issues about measures that, in the Fund's view, needed to be implemented was wrong.

On SMPs, Mr. Mirakhor noted that they were more than just a signaling device, and that they were extremely helpful for countries that did not need Fund financial support, but required a particular framework that was well-established in terms of both macroeconomic policy and structural reform, and which they could present as their own program. It should not be overlooked that there were a number of successful SMPs that had fulfilled that function.

Ms. Lundsager agreed with Mr. Mirakhor's remark that Fund advice should inform domestic policy debates and that the Fund should not hold back its advice in the context of surveillance. While the domestic political process would determine the countries' policies, the Fund's unbiased and objective view of the need for policy changes was important.

Responding to the Deputy Director's comments on trade as a systemic issue, Ms. Lundsager considered that trade was already being discussed in all countries and economic unions where it was of systemic importance, such as the United States, the European Union, and Japan. However, the suggestion not to talk about trade in many other countries risked losing sight of the huge potential to improve trade relations also among developing countries or within regions. Brazil and India were respectively important markets for countries in the region. The same was true for China's role for smaller Asian economies. By focusing exclusively on trade with the largest markets in the world, one should not lose sight of how improving trade relations in various directions could be beneficial. While that was a time-consuming exercise and while the WTO worked on that, the opportunity to make sure that the Fund would promote trade where it could be beneficial should not be lost. Not all trade took place with the United States—although one could get that impression when reading United States Article IV staff reports. The fact that there was significant trade among other countries should be kept in mind.

Mr. Portugal agreed with Mr. Mirakhor on the issue of the political feasibility of policy advice, and considered it also useful to take a long view, as suggested by Mr. Bennett. That long view had to be based on the best option. However, that was still not sufficient. It was important not only to outline the final destination to be reached, but also to provide a roadmap or a strategy of how to reach that point. The idea was not at all to water down the action that was needed, but to achieve more by indicating how the action should be taken. That implied not only having a clear view on the best policy option in the long run, but also an understanding of the constraints and of a strategy to adopt the policy effectively in view of those constraints. That was the idea he had mentioned in his preliminary statement with reference to the importance of sequencing, gradualism, and innovative approaches, Mr. Portugal clarified.

With regard to the issue of the unevenness or asymmetry in surveillance, Mr. Portugal disagreed with the Deputy Director's view that the distinction was predominantly along the lines of countries in need of Fund financing and those without that need. Rather the dividing line ran between industrial countries on the one hand and emerging market and developing countries on the other. It was clearly the case that systemic problems caused through policy changes in industrial countries tended to be overlooked in the process of surveillance. That had also been documented in the staff report by the fact that, whenever there had been a crisis in an emerging market country, changes in the surveillance framework had been triggered. Conversely, important events in industrial countries, such as a prolonged recession or deflation, sharp swings in major exchange rates, and other misalignments never triggered any change in the framework of surveillance. Thus, the asymmetry in surveillance appeared to be clearly established. An example for that was the issue of HLIs. When the suggestion was made that this issue needed attention, it had been left to the Financial Stability Forum, but not to Fund surveillance.

Mr. Scholar conceded that, while having sparked some debate, the notion of independent surveillance did currently not seem to provide much clarity with regard to the actual issues concerned. The notion represented a somewhat confusing shorthand label for many different things and possibilities, not all of which were objectives of the British chair.

Questions had arisen as to what independence actually meant in that context and of what surveillance should be independent. There was also a more profound question about what was meant by surveillance. Some Directors appeared to suggest that surveillance was more effective in program countries than in non-program countries because of an apparently greater impact on the policies of those countries. Program implementation should not be confounded with surveillance as both were two distinct notions. On the other hand, surveillance was not simply represented by Article IV reports or the process of Article IV missions. It was a public process, even if the staff report was not published, and that work was interlinked with efforts to assess various features of the world economy, risks, and possible responses.

Part of the current exercise of reviewing surveillance amounted to a self-critical evaluation by the Fund of the whole spectrum of its activities, Mr. Scholar considered. As Mr. Kelkar had said at a recent lunch, there was no monopoly of wisdom, everybody made mistakes, and it was important to have the opportunity to assess them. In the current context, it was important to strengthen the Fund's capacity for such assessments. That was particularly important in the case of program countries, where the impact of the Fund's advice was much greater than elsewhere. However, the issue was not confined to program countries.

While there appeared to be a fair degree of consensus on the actual issue, Mr. Scholar acknowledged that the label that had been put on it had caused problems and had gotten in the way of looking squarely at the underlying issues. In his statement he had attempted to look comprehensively at the purpose of surveillance and the principles that should guide it as well as at possible responses to the problem that had been identified. Further staff comments on that issue would be appreciated. The review of surveillance was an excellent opportunity to broaden that issue beyond simply looking at procedures, and to take a more fundamental look at the purpose of the activity.

Mr. Djojosebroto requested a more detailed explanation from the staff about his concern relating to the way staff missions conducted surveillance work, especially in Article IV consultations. In his view, it was standard practice for the mission to share their briefing paper with the authorities at the beginning of the meetings and to explain their assessment and concerns so that a lively discussion and a frank exchange of views between the mission and the authorities could follow. However, in practice, missions would start with a set of questionnaires and the collection of data, which, with the level of technology available, could be collected electronically beforehand from Fund Headquarters. At the end of the mission—sometimes on the last night before departing—the mission would distribute their findings and conclusions. That was not an effective way to conduct surveillance.

Mr. Wijnholds agreed with the Deputy Director's assertion that nothing prevented Directors from utilizing Board summings up to deliver clear and candid messages, if that corresponded to a sufficient consensus among them, and that there was more room for maneuver for the Board in that regard. One problem was, however, that summings up were already drafted beforehand. Consequently, the staff should be flexible to change the text over the course of the Board meeting so as to reflect what was actually being said and, in

particular, to take into account those points that differed from the staff appraisal. While 95 percent of the staff appraisal tended to be reflected in the summing up, there were times when clear disagreement with the staff appraisal was not incorporated with the same clarity in the summings up.

On the suggestion to take along staff from the Monetary and Exchange Affairs Department on Article IV missions, Mr. Wijnholds considered that it could have been useful also in the latest Article IV consultations for the Netherlands, when supervisory reform had been discussed. In other instances, staff from the International Capital Markets Department could usefully be added to missions. The interaction between departments was important, and involving those other departments somewhat more regularly in Article IV surveillance would be useful. The Deputy Director's comments on the question of sensitive surveillance material discussed among management and staff and channels for making it available to the Board had been welcome.

On staff-monitored programs, particularly on those with the purpose of providing signals to creditors, Mr. Wijnholds considered that the publication of Article IV staff reports could not provide an equivalent signal to the World Bank or the donor community more broadly and was hence not sufficient to obviate signaling SMPs for countries that—for various reasons—did not qualify for a fully-fledged Fund-supported program.

On the interesting but difficult matter of political feasibility and the question to what extent the staff should get involved in that, Mr. Wijnholds considered that it was important for the staff always to be aware of the political possibilities in a given country and to combine taking the long view with a good sense of realism. Countries would often stress the uniqueness of their situation as a way of demonstrating the constraints to political feasibility. Cross-country analyses could be helpful in that regard by providing the staff with possible arguments. While Mr. Portugal's call for a roadmap was useful, it should also be noted that countries would often insist that they know their political possibilities best and that the scope for the staff to suggest detailed roadmaps would therefore be limited.

Mr. Shaalan agreed with Mr. Wijnholds on the need to include staff from the MAE or the ICM departments in Article IV consultation missions, but noted that quietly adding seemingly small tasks like that to the staff's workload would eventually lead to higher stress levels, unless the tasks were matched by an increase in resources. The MAE department, in particular, was understaffed and overstressed with the considerable work on FSAPs and the ROSC exercises. Adding another worthwhile effort to that workload should be carefully considered, given that it would put additional pressure on the staff. In the early 1990s, fielding an Article IV mission with more than five staff members had required a special permission from management, whereas currently having eight or nine mission members was not at all unusual.

Mr. Padoan thanked the staff for the enormous effort made in updating and upgrading the surveillance process. On the impact of surveillance, he shared the view that, in the absence of a program, surveillance was effective through persuasion and influence on the policy debate. Thus, by definition, providing a short-term view would not be adequate, given

that it was a medium- to long-term process. In that respect, one should recall that surveillance was carried out not only by the Fund, but also by other international institutions, whose work also had an effect that was relevant to the domestic policy debate. That dimension should be taken into account when considering the important issue Mr. Callaghan had raised regarding the relationship between the Fund and the other institutions in the context of surveillance. In that respect, could the staff indicate whether it was possible to incorporate in surveillance exercises—be they Article IV consultations or others—an assessment of the past impact of Fund surveillance so as to measure its effectiveness in some way?

On the issue of asymmetry of treatment, Mr. Padoan differed with the view expressed by other Directors that there was such an asymmetry or unfairness at all. In his time on the Board, there had been numerous recommendations to industrial countries, most notably in Europe, including from the Chairman, on the need to increase efforts to advance with structural reforms and to contribute to global growth by boosting their own growth potential. Thus, when taking both bilateral and multilateral surveillance into account, it appeared that recommendations were made to industrial countries as often as they were made to other countries. That should be considered carefully, before arriving at the conclusion that there was an asymmetry of treatment in the conduct of surveillance.

Mr. Bennett noted that he was in full agreement with the position outlined by Mr. Portugal regarding political feasibility and the need for the Fund to provide a road map or at least an indication to the authorities and to the population, more generally, that the Fund was sensitive to the political constraints faced by governments. While it was the Fund's task to come up with the right economic answer to a situation, more effort needed to be devoted to presenting a practical way to put that answer into place. Part of the role of Fund surveillance was also to inform the domestic policy debate, as Mr. Mirakhor had pointed out. Partly for that reason he had called for exploring the possibility of having a ROSC module on governance—an issue of importance in all countries.

The Chairman considered that the issue of providing a roadmap or a strategy on how to achieve the objectives set out in the staff's long view of economic solutions to a country's problems could usefully be coupled with Mr. Kelkar's suggestion about a more intense dialogue with legislatures in democratic systems. In that context, a comment made by Mr. Callaghan's predecessor questioning the usefulness of Fund advice on fiscal policy, if it was delivered a few days after parliament had voted on the country's budget, was very pertinent. It was indeed crucial that Fund advice fit in with the policy cycle in a country. While that was undoubtedly already being taken into account in the staff's work, it would nonetheless be useful to go further in adjusting the schedule of surveillance missions so as to be most practically aligned with the political decision making process in member countries.

Mr. Barro Chambrier agreed with Messrs. Bennett, Portugal, and Mirakhor on taking into account political feasibility in providing Fund policy advice. The important role that Fund advice could play in informing the domestic debate should clearly be reflected in the summing up of the current Board discussion. Surveillance in program countries was not an issue of great significance, as far as his constituency was concerned. It was important to have substantive Article IV consultations also in program countries. Article IV consultations

tended to be so resource-intensive that it was difficult to divorce them from program reviews, as that might further delay their completion. For the countries in question, the main focus was on the review process. While it was, therefore, difficult to separate both exercises, the fact that they were conducted jointly should not be considered a problem.

On SMPs, Mr. Barro Chambrier agreed with Mr. Mirakhor that it was important to differentiate between countries that were in need of financial resources and those that were not. There should be a focus on those countries with an urgent need for resources, given that there was not always an effective signaling effect and given that the need for resources was particularly urgent at an early stage. While that issue went beyond the topic of the current Board discussion, there was nonetheless a need for a mechanism that could provide an effective signal to the donor community. That was particularly important for countries emerging from conflict.

Mr. Cippà clarified that, in his view, adding an expert from the MAE department might not be sufficient to achieve adequate coverage of the financial sector, given the complexity and resource intensity of the FSAP process. His suggestion would be to do rather more than adding only one expert to a mission.

The Deputy Director of the Policy Development and Review Department (Mr. Lipschitz) agreed with Ms. Lundsager that the issue of trade had to be covered both for countries of systemic as well as of regional importance. Part of the current work agenda was to draw up a list of countries of significant regional impact and focus on the regional implications of their trade policies. In addition to that, there would also be a focus on trade for countries where particular distortions were of macroeconomic significance. Those were the criteria that the staff currently applied.

On the purpose of surveillance, the Deputy Director considered that the position outlined in the staff papers came close to the concerns raised by Mr. Scholar. The staff also had the impression that surveillance in program countries required a reassessment at a fundamental level, and the question had arisen whether the program context provided the appropriate environment for that. Surveillance in program countries should go beyond a marginal assessment in terms of the program performance criteria and benchmarks. Article IV consultations should therefore be distinct in their purpose from program reviews.

The notion described by Mr. Djojosebroto and Mr. Szczuka about staff missions that arrived, asked a series of questions, and eventually produced a final statement that was a surprise to the authorities, was rather worrying, the Deputy Director considered, and would not be in line with best practice. However, it would not be appropriate for the staff to share management's briefings for the mission with the authorities. Those briefing papers contained strategies and political assessments that should be closely kept. It was best practice within the staff at the beginning of a mission, to lay out the principal concerns for the authorities and to indicate the direction the mission would likely take. A final statement on the part of the mission should rarely come as a surprise to the authorities.

On Mr. Wijnholds's remarks on SMPs, the Deputy Director clarified that he had not meant to propose dropping signaling SMPs altogether but had noted the suggestion raised by Directors to simply publish staff reports. However, the issue of SMPs needed further attention by the Board, and that could hardly be resolved during the current Board discussion. Mr. Mirakhor's point that SMPs did not just concern establishing a track record and providing signals to creditors, but that there were countries with a need for ongoing help in implementing a program without those particular objectives, was of considerable significance. There were, of course, other mechanisms that had been used informally: for example, there were some countries where the staff had established a practice of twice-yearly consultations because these were seen so useful by the authorities. However, as stated before, the issue of SMPs had to be revisited more broadly at a later stage.

A summary evaluation of the past impact of Fund surveillance in staff reports as requested by Mr. Padoan and Mr. Portugal would be difficult to perform, the Deputy Director considered, given that it was near impossible to establish a counterfactual scenario for comparison. While success had many parents, failure was an orphan. Thus there could be considerable disagreement between the Fund and the authorities as to the relative importance of Fund policy advice for successful policy changes. For example, in the case of the abolition of the *scala mobile* in Italy, the Fund was convinced that the regular drum beat of its advice starting in the 1970s was effective in helping bring that about. However, Mr. Ciampi maintained that it had been his idea, while many others were also convinced that it had been theirs. Similarly, the progress made in Germany regarding the policy debate on various structural issues was an interesting departure for the Fund. Throughout most of the 1970s and 1980s, the Fund had been badgering the Germans on macroeconomic issues on which, by and large, they had been doing a fine job. Late in the 1980s, the staff had become rather frustrated with the lack of impact, and a staff paper called "The Federal Republic of Germany: Adjustment in a Surplus Country" concluded that macroeconomic policies were essentially fine, while the microeconomic situation was dreadful. Subsequently, the staff specified the salient microeconomic problems, which had a considerable influence on the domestic political debate and, eventually, some repercussions in policy changes. However, there was no doubt that Mr. Tietmeyer was convinced that the principal reason for that change came from a group within Germany. That demonstrated how success had many authors and how difficult it was to specify the counterfactual needed to evaluate the impact of Fund advice.

Mr. Padoan considered that, with all due reverence to the views of Mr. Ciampi, who was currently the President of the Republic of Italy, it should still be considered a success for the Fund to find that the ideas behind its advice to Italy were shared by the person who ranked highest in that country.

The Deputy Director of the Policy Development and Review Department (Mr. Lipschitz) agreed with Mr. Padoan's view, but cautioned that it would be immodest for Fund staff to claim too much of the credit.

The Chairman considered that it would remain important to evaluate the Fund's capacity of judging the effectiveness and soundness of institutions, given their crucial role for the proper functioning of market economies. In that context, the lessons learned about cases



of corruption and institutional inefficiencies should inform an approach to dealing with governance issues in a consistent manner. The stronger dialogue with legislatures, as suggested by Mr. Kelkar, might be helpful in that context to strengthen the Fund's own expertise on how to evaluate institutions appropriately. While the Fund was not in a position to lecture governments on the issue of governance, the lessons learned in past surveillance work on how the soundness of the institutional framework related to a sound economic performance was of considerable importance going forward. That was one of the preconditions for the Fund to understanding the priorities for supporting capacity-building efforts, and providing technical assistance on institutional matters. Those issues should be discussed in more depth at a later stage.

Mr. Wei made the following statement:

We welcome today's discussion and would like to express our appreciation to staff for providing the well-written set of papers which comprehensively covers the Fund's surveillance experiences during the past two years. Over the past decade, the coverage and framework of surveillance has been gradually expanded and, as staff points out, surveillance is currently substantially different from what prevailed at the time of the Second Amendment to the Articles of Agreement and the 1977 Surveillance Decision. While it is understandable that most of the changes and evolution of the framework have been driven by the need to adapt it to a changing global economic and financial environment, we emphasize that, on the one hand, the main purpose of surveillance should not change, while on the other that changes in Fund policy on surveillance should be made in line with the new features of the world economy.

Moreover, this evolution, as acknowledged by staff, has increased the difficulties in maintaining the quality of surveillance, the challenges for keeping the focus on issues that are critical for macroeconomic stability, as well as the difficulty for selectively integrating the various issues into a coherent overall macroeconomic and financial assessment. Therefore, I agree with other speakers that exchange rate regimes and policies, monetary and fiscal policies, the financial sector, assessment of external vulnerabilities, and related structural and institutional issues are central to the Fund's mandate. It is important that a high degree of selectivity be applied when dealing with issues outside the Fund's core areas of competence and expertise. We are of the same view that selectivity should continue to be guided by the criterion of macroeconomic relevance. Regarding trade issues, I agree with staff's suggestion that they be selectively included in the case of countries with serious trade distortions that hamper macroeconomic prospects, and particularly in large advanced economies whose trade policies have adverse implications for developing countries' market access. Like Mr. Portugal and other speakers, I underscore the importance of guarding against the tendency of member countries to try to use the process of Fund surveillance to address

international problems that are beyond the Fund's purposes, mandate, and expertise.

That being said, I would like to turn to some specific issues.

On the issue of strengthening surveillance for industrial countries, the macroeconomic policies of major economies, in particular, the major industrial countries, greatly influence the regional and global financial markets, stock markets, and capital flows. Therefore, these impacts should be given sufficient attention and discussed in depth by staff during the Article IV consultation. Closely related to this, the volatility of the major currencies has a systemic impact on the international financial system. In this regard, the importance of staff's advice and policy suggestions on how to prevent and mitigate these excessive volatilities cannot be overemphasized. I associate myself with Mr. Wijnholds's point on the symmetrical treatment of members on surveillance.

On the issue of FSAPs and ROSCs in the context of surveillance, while I agree with staff that coverage of financial sector issues has to attain greater depth to measure up to other areas, we are of the view that participation in the FSAP should continue to be voluntary. This same principle should also apply to ROSCs. We support Mr. Yagi's proposal to increase area department staff's involvement in the FSAP process.

In this regard, we welcome Mr. Scholar's suggestion to encourage more members to take up FSAP and ROSCs through increasing technical assistance resources. However, we disagree with him on the idea of putting more pressure on the authorities to pursue ROSCs' recommendations. For many developing countries, considerable time has to be allowed for implementation of the recommendations due to their weaker institutional capacities. Even with sufficient technical assistance, more time is needed to enhance the authorities' ability to follow up on the policy recommendations.

On multilateral surveillance, we welcome the progress made in improving multilateral surveillance in response to the increasing global economic and financial linkages. The expanded surveillance of financial markets with the establishment of the International Capital Market Department is welcome and commendable. Growing interdependencies among countries have underscored the importance of integrating bilateral and multilateral surveillance. We welcome the progress made in this regard. For the larger industrial countries, such integration should lead to a greater emphasis on the global impact of their policies in Article IV reports.

On Article IV consultation procedures and documentation, we are of the same view that Article IV consultations remain central to the Fund's surveillance. Frank and candid discussions between the Fund and the country

authorities lie at the heart of surveillance. It is important for the Fund to effectively perform its central role of confidential advisor to its members. We agree to the proposed flexibility on Selected Issues Papers. On Statistical Appendices, while we believe that the information in these documents is important for effective surveillance, we join Mr. Yagi and others in supporting staff's proposal allowing flexibility as to whether such an appendix needs to be prepared.

On the issue of surveillance in program countries, like other speakers, I am not convinced that the conduct of surveillance in program countries raises significant concerns about its effectiveness and do not share the view that surveillance needs greater independence from program activities. However, we could support moving the Article IV consultation for program countries to the 24-month cycle with the qualifications given in paragraph 48. This would not compromise the quality of surveillance but would help, at least to some extent, to reduce staff's work pressures.

Lastly, on Staff-Monitored Programs, like Mr. Shaalan and other speakers, we agree that clearer guidance should be given to staff on the inclusion of progress under SMPs in the Article IV staff reports. However, we do not agree with the proposal to have a presumption of publication of the authorities' MEFP and staff performance assessment.

Mr. Moreno made the following statement:

I would like to join others in commending the staff for the excellent papers they have prepared for this discussion. We will submit our full statement for the record. At this moment, we would like to stress some of our main points for discussion. There are three areas on which we would like to concentrate our comments: the coverage of surveillance, the modalities and tools of surveillance, and surveillance in program countries.

The expansion of surveillance beyond its regular focus on macroeconomics to areas such as structural policies, financial sector, and vulnerability assessments introduced a trade-off between the breadth and the focus of the surveillance exercise of the Fund. Greater breadth might deviate attention from the most critical issues of individual countries. We believe that the main conclusions and focus of the 2000 surveillance review remain valid. The necessary extension beyond the core issues has to be coupled with selectivity, and macroeconomic relevance should remain the key test when deciding on the widening of surveillance. However, we share the view expressed by other Directors that systemic relevance should also be an important criterion to be considered.

There are certain areas where the expansion of surveillance can be considered horizontally across countries, namely surveillance over the financial sector and capital account issues, which will be generalized.

However, selectivity should be considered or understood on another basis, depending on the needs of each country or on systemic relevance. We understand, nevertheless, that there is significant room for country group differentiation on surveillance needs, as reflected in Box 3 of the staff paper.

In this sense we consider that, in general, many structural and institutional issues have adverse macroeconomic and growth implications, and are an important part of the surveillance exercise of developing countries. In areas such as this, there is a need to enhance cooperation with the World Bank, the OECD, and other institutions to take advantage of their expertise. These considerations will have direct implications on the different modalities and tools of surveillance.

Regarding Article IV consultations we believe that, as the cornerstone of surveillance of individual countries, they should remain as systematic and rigorous as possible, particularly on core macroeconomic issues. In this sense, we join those who reject the possibility of excluding statistical appendices. We do not agree with the staff's proposal to discretionarily eliminate statistical appendices according to a public availability criterion. We could accept a certain reduction of statistical appendices for advanced economies provided that there is easy access to quality statistics. Nevertheless, for the rest of the countries, the Fund should keep the annexes in order to facilitate the surveillance exercise of the Board and to reinforce its role as a primary provider of statistics.

The Selected Issues papers, on the other hand, do provide an adequate tool for greater flexibility, and we concur with the staff that they should be guided by the support they provide to the staff report. We would like also to welcome the different initiatives of staff to conduct multiple country papers on issues that are parallel on various countries at the same time, since they provide useful cross-country comparisons. We believe also that Article IV consultations should be discussed at the Board. Therefore, if there were any changes in the current policy of lapse-of-time conclusions, it should be to limit it even further rather than extending its use.

Concerning FSAPs, ROSCs, and vulnerability assessments, we believe that they have proven to be key surveillance instruments and, hence, should be systematized and enhanced with increased resources. The voluntary nature of FSAPs and ROSCs has limited production. In this sense, we believe that peer pressure and the setting of an example by the leading advanced economies could be useful to enhance a widespread conduction of FSAPs.

Regarding multilateral surveillance, we are encouraged by the progress made so far and outlined in the staff report. However, like other Directors, we would like to stress the need to further integrate multilateral and bilateral surveillance. We particularly value the work done by the International Capital

Markets Department. We believe that it is important to make greater use of its expertise to improve surveillance over financial sectors. In this sense, we would favor increased human capital resources for this department to improve its production on bilateral issues, particularly FSAPs, vulnerability assessments, and Article IV consultations. We would also like to stress, like Mr. Padoan and Mr. Vittas and others, the need to put more emphasis on regional surveillance.

Finally, regarding surveillance in program countries, we would like to associate ourselves with Mr. Portugal's comments in his statement on the separation between surveillance and program activities, and particularly his comments on Paragraphs 45 and 46 of the staff report. Finally, regarding the political feasibility debate, I partially agree with Mr. Portugal, Mr. Barro Chambrier, and Mr. Bennett, but I think that we should be cautious on this matter. I am not sure that the Fund could always provide the right policy implementation strategy. As the Managing Director has pointed out, there are many institutional issues, but there are also many social and political issues, and I am not sure that we have the right expertise to judge them with sufficient accuracy.

Mr. Kiekens made the following statement:

It is a pleasant duty for me to express gratitude to the staff for its fine work in preparing today's review of surveillance during the last two years, and to extend that gratitude to all who contributed to this surveillance during that period. The report convincingly shows how the scope of surveillance has been broadened and adapted, and how its quality has been improved. All this has been achieved with the same amount of staff resources as used during the last ten years. Table 2 on page 51 of the supplementary paper shows that last year we had 170 consultation missions averaging 4.2 staff members each, which is about 10 percent less than the average staffing for the last ten years. Obviously the staff's productivity is on the rise.

In one of the better treatises on the Fund, Manuel Guitián discusses "the unique nature of the responsibilities of the IMF." Rather than its lending to crisis countries or its provision of technical assistance, it is the Fund's surveillance mandate that makes it different from all other institutions. The purpose of our surveillance is not to produce still another high quality study, but to influence the policies of individual countries for their own betterment and for the international common good. In this sense the Fund's unique responsibility is essentially political—making the necessary possible.

The Managing Director's question of how to make surveillance more effective—in other words how to better convince governments to adhere to the Fund's recommendations--goes to the heart of the Fund's mandate. Obviously it would be a serious mistake to limit the Fund's policy

recommendation to what seems to be politically possible. By becoming members of the Fund countries commit themselves to a code of conduct that is essentially summarized in Article IV. This international commitment is not limited by real or alleged political difficulties. The objective of Fund surveillance is precisely to help countries overcome their present political difficulties and to foster a higher degree of ambition than the prevailing political consensus of a particular country at a particular time. That being said, surveillance is as much an art as a science. Its effectiveness starts with high quality analysis: this is the scientific part. Its effectiveness is realized through skillful interaction with political, social, and intellectual leaders and with public opinion. Transparency is obviously an important ingredient of the Fund's political influence. Equally important are the skills of the mission chief in presenting the recommendations in such a way that they can be accepted, not only as justified, but also as desirable and therefore politically feasible. Mission chiefs must be more than good economists; they must be skillful political analysts and outstanding communicators. Management must take this into account when selecting mission chiefs.

I would now like to comment on the issues for discussion in the order of their listing in the staff paper.

Fund surveillance should address all issues critical for assessing countries' compliance with their Article IV obligations. The Fund's surveillance covers the whole world, but its staff is limited. Therefore we must proceed cautiously in extending our surveillance beyond the basics—the exchange rate, fiscal and monetary policies, and the financial sector. Macroeconomic relevance, external viability and vulnerability to balance-of-payments crises are suitable filters for selecting the objects of surveillance.

The staff should look outside for help in addressing macroeconomically relevant structural issues that lie beyond its own expertise. The OECD, for example, is better qualified to analyze the structural rigidities in product and labor markets that slow growth. The Fund should rely on the research this organization when studying structural rigidities in the advanced economies and proposing remedies. For the developing countries, the World Bank's considerable knowledge of structural issues can enrich our Article IV consultations.

The Fund should continue to strengthen its own expertise on countries' financial sectors, and become the leader in the preservation of the soundness of financial systems. This was one of your ambitions when you became Managing Director. The FSAP has very usefully enhanced the Fund's surveillance of financial systems. Because of its potential for heading off financial crises, it should become a mandatory part of Fund surveillance, a view I have expressed before, even though it may not be politically feasible at this time.

There is growing consensus among the membership that on the occasion of Article IV consultations, the staff should discuss with governments and report to the Board on issues that, though outside the Fund's strict surveillance mandate, are broadly interesting to the membership and relevant for sustainable growth and financial soundness. Examples of such issues are trade matters such as opening markets in the advanced economies to exports for which developing countries have a comparative advantage. Other such areas include money laundering and the financing of terrorism, corruption in both developing and advanced economies, unproductive expenditures and their financing, particularly in countries embroiled in civil wars, and the promotion of health care and education where their absence is a major obstacle to growth and poverty reduction.

That being said, the assessment of a country's vulnerabilities and external debt sustainability should remain central to the Fund's surveillance. Two years ago I suggested that one lesson of the Asian crisis is that our surveillance should be enlarged to scrutinize the values-at-risk in the balance sheets of the important sectors of an economy, namely the government, the central bank, the banking sector, the corporate sector and the household sector. Mr. Wijnholds, Mr. Bennett, and Mr. Andersen today made broadly similar remarks by asking for stress tests and sensitivity analyses to determine the risks resulting from fluctuations in key variables such as exchange rates, interest rates, asset prices, and prices of exports and imports. For this kind of surveillance to be effective, we need more adequate data, especially in the corporate sector. This topic of a balance sheet approach to surveillance will be discussed in a Board seminar before long. Ideally, this seminar should have been held before today's review, to prevent the findings from becoming a mere academic exercise.

After the debt crisis of the 1980s, the Fund decided to make faster progress in analyzing external debt developments. Today, twenty years later, we still need to make more progress in this area. Too often the Fund fails to produce a meaningful medium-term debt sustainability analysis. As the staff candidly observes in paragraph 21 of the main paper, "Without adequate attention to the sensitivity of the projections to exchange rate and interest rate movements, they are little more than token exercises."

Nowadays only the industrial countries are actually on the standard 12-month cycle for Article IV consultations. For many countries, the real consultation cycle tends towards 24 months, although only 15 countries are formally assigned such a cycle (see Figure 1, p.21 of the main paper). Reducing the frequency of Article IV consultations limits the Fund's ability to forestall financial crises. We should reduce the intervals between consultations, especially for developing countries without programs, for which the average interval was about 18 months in 2000–01.

I support the staff's suggestion to increase both the frequency and the independence of the surveillance of program countries. Ideally, program negotiations should be based on a recent Article IV consultation. If this is not possible, the consultation should take place six months or less after program approval. The Board should establish specific guidelines reinforcing the Article IV consultation's independence from an on-going program. We do not have the resources to assign a country's surveillance and program negotiations to separate staff teams. We must therefore be pragmatic by giving the Policy Development and Review Department explicit responsibility for ensuring that surveillance is reasonably separated from program negotiations and reviews.

I now come to a more contentious issue. I disagree with the suggestion that the staff and countries should have more freedom to eliminate statistical appendices. The current rules already excuse the staff from producing statistical appendices for countries with many sources of high quality economic analysis. Further reducing the production of statistical appendices will damage the quality of the Fund's surveillance but win only a minuscule reduction (estimated at three staff years) in the staff's work burden. To be effective, surveillance must be based on reliable statistics, and I cannot think a single good reason for publishing the staff assessment without a full statistical basis, unless that basis is readily available elsewhere. Of course, the content of statistical appendices should be adapted in light of the evolving structure of an economy. More than before we need detailed data on capital flows, and the composition of balance sheets in broad sectors of the economy. Making comprehensive statistical data available would allow Board members, governments, and the markets to make their own analyses without being limited to the staff's appraisal and a limited set of core macroeconomic indicators, a succinct balance of payments, and a summary of fiscal and monetary accounts. In this connection it is striking that even for countries with a statistical appendix, information of the capital account of the balance of payment remains scanty, as for instance in the latest Article IV report on the Russian Federation. As I said before, I agree that statistical appendices can be omitted if the data are readily available elsewhere. But we need a good understanding of what "readily available" means. Data published under the SDDS do not lend themselves readily to economic analysis. These data are expressed in local currencies without ratios to key variables such as GDP and without percentage changes between successive years. We need sufficiently long and consistent time series that are electronically accessible free of charge.

Mr. Djojosebroto agreed with Mr. Kiekens's view on the issue of Statistical Appendices.

Mr. Portugal thanked Mr. Kiekens for his always clear, enlightening, and eloquent speeches. While he agreed with Mr. Kiekens that the Fund should be cautious about extending surveillance beyond the core areas, the description Mr. Kiekens had given as to



what the core areas were appeared to present a rather more limited picture. At the same time Mr. Kiekens had claimed that there was ample consensus that the Fund should also extend surveillance to certain areas that lay beyond the core mandate, among which he had listed issues such as trade. Trade was, however, clearly one of the Fund's core areas, given that Article IV described one essential purpose of the international monetary system as facilitating the exchange of goods and services. The Article also said that members had an obligation to collaborate not only with the Fund on those matters but also with each other with regard to both exchange arrangements and exchange rates. That clearly established trade as being among the Fund's core responsibilities. Mr. Kiekens had also listed a number of other issues such as unproductive expenditures and the quality of health care and education and suggested that, given the Fund's universal membership and surveillance mandate, there might be a need to cover those issues as well. While those issues were undoubtedly important, it was likely that including those areas outside the core responsibility and expertise of the Fund into the scope of surveillance would overburden the staff and undermine the quality of surveillance overall. Hence doing so would not be efficient. More importantly, including those non-core areas would also undermine the very legitimacy of surveillance, as expanding the scope beyond what countries had agreed to could be regarded as a misuse of the mandate, albeit for matters that, in and of themselves, were worthwhile and useful.

Mr. Barro Chambrier thanked Mr. Kiekens for his contribution and considered that the issue regarding statistics related to the Asian crisis was rather serious. The staff could perhaps provide some clarification in that regard. Also, it seemed rather surprising that, in the case of Turkey, Mr. Kiekens as Executive Director had difficulties to find the appropriate statistics. That was all the more surprising, as Mr. Kiekens tended to be rather strict with program countries delaying their provision of statistics. The incident could, perhaps, help explain that not everything was perfect.

Mr. Kiekens considered that the exact scope of surveillance could not be deducted simply by reading an Article IV that had been drafted 50 years before and amended on the occasion of the Second Amendment. The precise scope of surveillance was determined by practice and by the broad consensus—changing over time—among the membership of what they considered as relevant for the institution. If, 20 to 30 years ago, the question had been raised whether surveillance should focus on an issue such as money laundering, the answer would certainly have been no. Now the consensus was, that, while it was not a mandatory part of Fund surveillance, countries would be invited on the occasion of the surveillance missions to reply voluntarily to a questionnaire. There was thus a consensus to broaden the interaction between the staff and the authorities and report it to the Board, while the issue concerned was not necessarily, as yet, a full part of surveillance.

Trade matters constituted as well a rather difficult area, Mr. Kiekens stated. Article I of the Articles of Agreement defined the core mandate of the Fund as promoting exchange rate stability and convertibility with the purpose of facilitating trade. The promotion of trade was thus not the direct mandate of the Fund. When read in a more orthodox way, the Fund's mandate included promoting one of the essential conditions for trade to develop—i.e., convertibility and exchange rate stability. It was, of course, the Fund's mandate to promote

employment and growth. However, that was only the ultimate objective of the immediate mandate of financial stability, debt sustainability, exchange rate stability, and convertibility. It was important to make the distinction between the means and the ultimate purpose. That being said, there was an evolving consensus in the membership to consider part of the trade issues as being core Fund business. To what extent that was the case depended on practice and on the consensus in interpreting and applying the Articles of Agreement.

With regard to the lack of appropriate statistics for giving a speech on Turkey, Mr. Kiekens clarified that the topic of that speech had required data that were particularly difficult to obtain. The speech had been given at a conference focusing on the trajectory of the country's economy, spanning to the year 2023—when the Turkish Republic was to reach its 100 anniversary of existence—and had focused on the evolution of productivity during the past two decades in comparison with productivity and income developments in the European Union. Relevant data on related issues were not readily available even with the help of Fund staff and the country's authorities.

Ms. Lundsager made the following statement:

I would like to thank Mr. Lipschitz for his very extensive comments. I think he did a very good job of trying to pull together and look at the totality of things, which is really the aim of our meeting today. Frankly, I find there is almost too much to get a handle on here, and I hope we do come back to it in the way the Chairman has suggested. I think it would be very useful to get together in a very informal setting to talk about some of these issues and have an easier exchange on how our authorities feel about some of them. It may then be possible to pull together in one discussion many of these difference issues that right now we are still segmenting just because we cannot handle it all in one discussion.

Certainly, the papers before us today have very usefully pulled this together and brought us up to date. What I really appreciate about them is how frank they were in terms of what we have achieved, but also what we have not been able to achieve yet and what we still need to work on. I think that candor is very much appreciated. I would like to go through some of the topics for discussion and pick up on some of the remarks of my colleagues this morning.

It is very important, in our view, that the evolution of surveillance really be linked to the ongoing changes in our economies, a point made by Mr. Kiekens just now. One of the key things, of course, is to prevent crises. This is something that we focus on almost every day in our country work here and in the work on some of the other issues that we cover. The decision to broaden coverage is therefore appropriate, and we have to have flexibility if we are going to be able to achieve that ultimate goal. Surveillance is certainly based on macroeconomic relevance and also on systemic relevance. What is key in the macroeconomic relevance is the proper external vulnerability assessment.

In that regard, I was somewhat surprised to see in the paper—a point noted by Mr. Wijnholds as well—that a number of what we regard as core macroeconomic issues/objectives were not covered fully. Some exchange rate and macroeconomic policies were only covered satisfactorily in 70 percent of the Article IV consultations reviewed in the staff paper, and I was surprised that coverage of those issues did not equal 100 percent, as I would have assumed. That shows some of the things we need to work on.

Candor in surveillance is central to the quality of the analysis, and I think it is important that the staff feel that they can talk to the authorities in a very frank manner. This has been part of our discussion this morning that it is important that the staff feel that they can lay out the issues and should not hold back, particularly since these meetings are private.

I know, Mr. Chairman, that you periodically meet with my authorities during the course of the year. You are very frank in terms of what you lay out with them, regarding systemic issues, and how what is going on in the U.S. relates to the rest of the world, and you have no hesitation in saying that clearly to my authorities. I think that is the kind of approach that staff should be taking in every single case.

It would be helpful for reflecting more of that candor in staff reports—in the reports on the United States candor is not usually lacking—if the staff highlights the issues that were raised with the authorities, and the way in which the authorities responded. Sometimes I feel that staff reports are a little too polite, and that the staff should be a little more frank. This comes back to that issue we were talking about earlier in terms of summings up, how we could try and change what we do in summings up, which is very difficult to achieve. That is something that we as the Board should perhaps consider among ourselves. Increasing transparency in Fund assessments certainly goes hand in hand with improving surveillance, and we will come back to this later.

In terms of coverage of new elements of surveillance as we go forward, Mr. Kiekens just gave a very eloquent explanation of how we have to adapt to changing times, and I think of what Mr. Wijnholds said in one of our budget discussions about how the Fund is a 50-year-old institution and could be heading into this sort of coasting on a downward trajectory. We must avoid that and adapt to a changing world. One of the issues to which we have to adapt is money laundering and terrorist financing. We will discuss that on Monday. But we have already started doing that. We had that as part of the United States Article IV consultation last year, and it will continue this year. It is also coming up in consultations with other countries.

More broadly, it is important that we focus on the financial sector. There has been much discussion of that around the table. It is important, as many have said, that we try and cover these issues thoroughly, not just in

countries that are undertaking FSAPs. Doing that right will take some original thinking, but I am sure that the staff will come up with some concrete suggestions in that regard. Certainly, reporting on a variety of financial sector indicators in Article IV consultations and FSAPs will be important, and while we see that in many cases, we do not see it in all of them. Mr. Callaghan made a useful suggestion in that regard, that we start asking in Article IV consultations to what extent the country concerned has used collective action clauses in its external bond issues. I thought that was a very useful suggestion.

On ROSCs, I was sitting here looking at the table on how many countries have engaged in which types of ROSCs, and the table showed a diverse group of countries. I certainly hope that we will be broadening this as we go forward. Many of these assessments referred to regulation and on ways to help countries identify weaknesses and scope for improvement.

Fund surveillance can also help countries to develop domestic capital markets more broadly. It is important to have the adequate regulation. While we have insurance ROSCs, we have securities ROSCs, it is also at times helpful to give countries advice on how to make use of those kinds of markets more broadly so that we do not have countries that depend entirely on banks for domestic finance. In that way, we create a diversity of financing sources available to the private sector, when there is trouble in the banking sector. It is also useful to focus on how those various markets are developed, which does not only concern the issues of regulation but also the institutional side.

It would also be useful to follow up on the many suggestions that are included in these reports. I noticed that in some of the reports, like in the Canadian Article IV staff report, there was some discussion of a follow-up to the FSAP. That is very helpful. Also, more active ex ante assessments of vulnerabilities are essential, and incorporating medium-term debt sustainability is key. We are seeing this more and more in our papers, and we expect that the staff will continue to do this.

I have to agree with many other Directors that growth is key in the context of surveillance. Long-term sustainability cannot be achieved without growth. Population growth without economic growth to support rising living standards is not sustainable. Therefore, I recommend that we continue to focus on how that all fits together. We also think it would be helpful to come back to our macro prudential indicators, something we have talked about before. We will be seeing more reports on that, but that must fit together as well so that we can have a rounded out picture.

On procedural issues, we are interested in trying to streamline procedures to save time, where possible. I have been prepared to accept fewer statistical appendices. Of course, consultations with individual Directors will continue if a Director feels that his authorities wanted that. Coming back to

Mr. Kiekens's point on the data, part of my concern is that I feel the countries' authorities themselves have to have good data; it is not just that the Fund has to have good data. Let us take a step back and do what we can to make country authorities have the data they need to undertake their economic policy management. Perhaps we can have a separate discussion on this; this is also key for the technical assistance that is provided by our Statistical Affairs Department.

Regarding the independence of surveillance and some of the suggestions that have been made in terms of having it separated from program development and review, we think the suggestions that Mr. Lipschitz has made in terms of standing back and trying to take an overall look are the way forward. As most colleagues around the table have said, we do not have the resources to have a totally separate body of staff independently doing surveillance work versus program country work. But I think what is key is the point that the Article IV consultation can take a step back and look at the big picture and remind those working on program details how other developments in the economy are going to have an impact on how the program turns out. It is useful to keep that Article IV process as part of the program review process. I am a little concerned about the fact that so many countries are not on the 12-month cycle and that 24 months plus 6 would be too long. There should be an Article IV consultation within 6 months. The staff have enough contact and enough exchange of correspondence with country authorities that, if they start seeing problems emerging, they could recommend an Article IV consultation, even if it is before the end of the 24 months cycle. I am reluctant to have a Fund-supported program come forward with no Article IV consultation in two years, and then there will be a consultation within six months. It would be preferable to do it a little bit in advance, anticipating perhaps even before it is at all obvious that there would be a need for Fund resources. I think this is a point that really comes back to one of the themes of the paper about shock absorbers. What we want countries to do is to become strong enough that they can withstand some of the normal shocks and also unexpected shocks—weather, developments in the world economy, oil prices, whatever it may be—so that we do not have wild gyrations in economic performance. I would hope that instances would be extremely rare, where a program comes forward with no Article IV consultation during the preceding 24 months.

On staff-monitored programs, like many other speakers, we have had many concerns. We have voiced them in individual cases in the Board. We are worried that SMPs are taken by the public as the Fund blessing a program when it has not come to the Board for review. While the Board is aware of it, the policy matrix has not been approved by the Board. Therefore, we really are not comfortable with that confused signal.

We endorse the staff's suggestions how to address those concerns in terms of making it explicit that SMPs are not endorsed by the Board.

However, it seems that the broad public does not understand the difference between an SMP and a Fund-supported program. When a staff member gives a press conference at the end of a mission, that is taken by the public as the Fund speaking, even though that report has not come to the Board. It is therefore important that the Fund expresses those differences more explicitly and clearly.

The suggestion of having more transparency is a good first step. If you are going to have a staff-monitored program for signaling purposes, that would be helped by publishing the staff report and by having more transparency with regard to economic issues. It would also be useful going beyond that and aim for a precautionary Stand-By Arrangement, which would provide for a somewhat more rigorous framework that would come to the Board for approval.

I would like to raise one additional issue, for which I do not need an answer from the staff today. It concerns the “comfort letters” that the Fund provides to other international institutions when they are about to go ahead with a program, whether it is a regional development bank or the World Bank, and when the Fund does not have a program in place. My understanding is that in these the Fund gives the IDB or the World Bank information about the performance of a particular country so that that institution will go ahead with their lending program. It would be useful for the Board to have more information on the content of those “comfort letters”, and regarding the criteria used for the assessments that they contain, and how consistent they are across countries and regions. While Directors hear about that indirectly via colleagues at the other institutions. Well, what does the Fund really think about this, you know, someone is going to come or provide a letter, it might be useful to provide Directors with some idea of how that process works.

It would be useful, if the Board could address these numerous issues at a later stage in a more informal fashion after the discussion on transparency will have taken place.

Mr. Barro Chambrier agreed with Ms. Lundsager that the issue of “comfort letters” was important and that the ambiguity entailed in that needed to be addressed. Those letters were often used in countries under a staff-monitored program and appeared, at times, to put the staff into a difficult position, particularly when they were not able to provide a strong positive statement, given that the program was not supported by the Board. The difficulty was that, in cases of countries with SMPs, the staff could not play its catalytic role by unlocking support from other multilateral institutions. In the absence of a Fund-supported program that was difficult. Both in his and in Mr. Rustomjee’s constituency were a number of cases like that. Further reflection was needed to address that matter at a later stage.

Mr. Shaalan wondered whether not all Stand-By Arrangements were precautionary in nature so that there a precautionary arrangement as such did not actually exist.

Mr. Bischofberger made the following statement:

At the outset, I thank Staff for the comprehensive and candid set of papers and for the extensive work undertaken to evaluate the Fund's surveillance activities, as well as the comprehensive comments given by Mr. Lipschitz earlier this morning. Furthermore, like others, I found the informal note circulated last week by you, Mr. Chairman, to be particularly helpful in establishing a focus for today's discussion, and I agree with the objectives that you set.

It is of great importance to take a critical look at the Fund's surveillance in regular intervals, given the changing global environment and the central role surveillance plays in the international financial architecture. I agree, Mr. Chairman, that we already have accomplished a lot in terms of sharpening our tools and we need not start from scratch. And it is true, as underscored by Mr. Padoan and Mr. Vittas in their statement, that surveillance has contributed over time to an improvement in the quality of economic policy being pursued by a large and growing number of member countries including my own, if I understood Mr. Lipschitz correctly. But it is equally true that we need to make ongoing efforts to further improve both the quality and the impact of the Fund's surveillance.

This latter point is important and it is underscored in many of the stimulating statements, and by previous speakers. I fully share the view on the need to enhance the impact of the Fund's surveillance. I might add that I tend to side with Mr. Bennett on the issue of political feasibility, namely that the Fund needs to strike an appropriate balance between taking account of political constraints within member countries on the one hand and acting as an objective—albeit at times demanding—advisor on the other hand.

I would like to pick up a comment which came up earlier in today's discussion, namely that the Fund should not only say what country should do but also how a country should do it. I fully agree with that and I think Mr. Portugal made the point very clearly. The only comment I have on this line of reasoning is that we should try to avoid to conflict with another principle we have, namely not to micromanage. Avoiding micromanagement was an important issue in the discussion which we had on streamlining conditionality.

I shall focus the remainder of my remarks on some of the issues for discussion raised by the staff:

While the selective broadening of the coverage of Fund surveillance is generally on track, there is—of course—scope for further improvement. Staff as well as a number of Directors have identified some valid issues here. Like others, I would, in particular, emphasise the significance of explicit and candid discussions on the exchange rate regime.

Also, given the importance of financial sector issues, we need to ensure an adequate depth and quality of surveillance in this area. I agree that the best way to achieve this is to produce high-quality Financial Sector Stability Assessments (FSSAs). This is clearly not costless and perhaps we must be more selective while not utilizing the privilege of equal treatment when choosing the countries to participate in the FSAP at an early stage. This should be coupled with cost-effective modalities of monitoring in between FSAPs. Even so, there remains the issue of non-participation in the FSAP and I note Mr. Bennett's suggestion to examine ways to strengthen incentives to participate.

As regards ROSCs, the present limited availability of modules in non-core areas clearly underlines the need for close coordination with the World Bank and other outside experts in this as well as in other areas. At the same time, I would add here that – important though ROSCs are - not every code or standard is of equal importance to all countries in every situation. The monetary and financial policy code and the four supervisory standards that are already covered in the FSAP should clearly be prioritised. This being said, I find Mr. Bennett's proposal to develop a ROSC module pertaining to governance and corruption very interesting.

More generally, on the question of coverage, I would, like Mr. Wijnholds, emphasize the criterion of macroeconomic relevance and I would echo Mr. Callaghan's remarks on the appropriate degree of selectivity and the need to avoid a "one size fits all"-model.

Turning to the modalities of surveillance, I strongly support the notion of enhanced flexibility. I agree that—if utilized—the leeway offered by the current policy on mission size and scope of Staff reports, on Selected Issues Papers and on LOT-conclusions of Article IV consultations is sufficient. I can therefore go along with the retention of the current procedures. However, simply encouraging more flexibility may not be enough, as experience to date has shown. Some changes to the incentives structure governing, for instance, the production of Staff and background reports, might therefore have to be considered.

On a related point, it is not quite clear what to make of the increasing gap between de jure and de facto consultation cycles. If de jure cycles constitute the desirable norm, we should think of ways how to align de facto cycles more closely with this norm. The savings that would hopefully be generated from increased flexibility could, for example, be used to this end.

On the production of Statistical Appendices, I can go along with allowing more flexibility as long as this is done in a careful way, paying due attention to the need to ensure effective surveillance. In this connection, I



found Mr. Wijnholds' idea of a "minimum data requirement" template interesting and worth exploring.

As regards program countries, I agree that the independence of surveillance needs to be preserved or even strengthened. In fact, surveillance should serve an important function of uncovering and helping to correct possible inconsistencies of programs. I can, however, not agree to the idea of "institutional firewalls" for reasons of both, resource constraints and effectiveness. Clearer guidance as suggested by Staff appears to be preferable. Compliance with such guidelines should be monitored on a continuous basis and in the context of subsequent reviews. In addition, special organizational arrangements, along the lines proposed by Mr. Callaghan, might be examined.

Finally, on the issue of signalling Staff-Monitored Programs, the primary responsibility to ascertain that certain credit conditions have been met is, of course, incumbent on each and every creditor himself. That being said, the Fund and its members should seek to send as clear signals as possible on program performance, and I agree that the current procedures and the low degree of utilization of the present publication possibilities are conducive to misinterpretations. The proposals made in paragraph 55 of the main document should go a long way towards attenuating these concerns.

Mr. Duquesne made the following statement:

Let me thank not only the staff but also my colleagues for an impressive assessment, in written and oral form, of the Fund's work on surveillance. The papers and statements are comprehensive, clear, and informative. Overall, we endorse the staff's views on selectivity, macroeconomic relevance, and the hierarchy of concerns; but we would like to reiterate our stance against any one-size-fits-all approach. In that regard, it is urgent to improve the quality of the coverage of medium-term debt sustainability issues, and we are somewhat concerned about Paragraph 21 of SM/02/82 that states that the "coverage of medium-term debt sustainability issues has been inadequate in many vulnerability assessments", and that the medium-term balance of payments scenarios are a little more than token exercises. That raises some concerns, and I would like to hear more from staff on this problem.

I would insist on four avenues suggested by the staff: Article IV consultation procedures, coverage of financial sector issues, surveillance in program countries, and SMPs. But before turning to those issues, I would like to make a more general point with regard to the fundamental issue which you, Mr. Chairman, raised informally with us last week. As Mr. Callaghan pointed out in his statement, at the heart of Fund surveillance is policy advice, which we hope would translate into policy action. Comprehensive, timely, and transparent surveillance misses the target, when its implications are not taken into account by the concerned country and do not translate into policy

changes. I therefore agree with you, Mr. Chairman, on the need for us to pay more attention to ensuring that our advice is heard and has an impact. Surveillance should be judged not by the quality of the staff report, not by the quality of the debate among us, but by its effect. One way of doing this could be by expanding the contact with parliament in a specific country—the idea put forward by Mr. Kelkar last week to which you referred.

Let me turn now to the four points that I already mentioned. First, on consultation. I have mixed feelings about the proposed streamlined consultation procedures. While I have no objection to retaining our current policy on a lapse-of-time conclusion of Article IV consultations, I am not at all convinced by the proposal to encourage flexibility on mission size and the scope of the staff report. Of course, this decision falls within the responsibility of management and we have no intention to micromanage the Fund, but we have a real concern in terms of credibility of our surveillance. Maybe the results of these changes will be assessed in our next biennial review, but let me flag where I see the problem right now.

Like Mr. Kelkar and Mr. Kiekens, I am strongly opposed to leaving the decision on whether or not to produce a statistical appendix to the staff, even if that is decided in close consultation with the member's Executive Director. The Fund is the sole provider of consistent and accurate statistics on many developing and emerging market countries, and in these cases it is providing a public good to member countries and to the public. Therefore, I have nothing to add to the arguments put forward by Mr. Kiekens, which coincide with mine.

On the question of financial sector, we welcome the fact that the coverage of those issues has become a standard element of surveillance. FSAPs and ROSCs, on a comprehensive or on a stand-alone basis, are powerful tools to ensure adequate coverage of financial sector and institutional issues, and we should insist on widening the participation in those exercises. Let me note in passing—and maybe to reassure Ms. Lundsager—that France should be on the list of countries that have completed an assessment of the Basel Core Principles for Banking Supervision. This information has been provided to the Board during our last Article IV discussion, hence there is a mistake in the respective table of the staff paper.

In more general terms, the use of other sources of information, not only the World Bank and the OECD, but also FSF, WTO, ILO, and others to cover new areas of surveillance should be encouraged. It is nonetheless indispensable to define clearly the rules of the game by deciding a lead agency on every issue and by maintaining a distinctive accountability.

I thank the staff for a candid assessment of the report on the combined Article IV/UFR discussions for program countries. The present relationship between Article IV consultations and program frameworks does not call for

establishing, as also said by Mr. Bischofberger, an institutional firewall between these two activities. I agree with many colleagues, including Mr. Mirakhor and Mr. Portugal, on this point. In my view, it does not call, either for moving members under Fund arrangements to a 24-month cycle. Like many other Directors, I share the staff's views on the risks and costs associated with the radical separation of surveillance and program activities. That would also weaken the Fund's expertise on a particular country, and could lead to administrative overburdening for the Funds and the local authorities. I also share the staff's view on the need for clear guidance from the Board, insisting notably on a critical review of medium-term prospects and a candid account of the dialogue between the staff and the authorities. That proposal seems to be contradicting the suggestion of moving to a 24-month cycle in the case of program countries. The staff assessment leads me to think that yearly assessments are all the more important for those countries.

Article IV consultations are crucial in providing insight into macroeconomic and structural issues. Program countries usually face tremendous challenges and need intensive and ongoing contact with Fund surveillance. If we want, as Mr. Lipschitz said, to take a fresh look, it is difficult to assume that this look will intervene only every two years. Let me add that I cannot accept the idea that we have to make the *de jure* policy coincide with the *de facto* situation. It should be, if I understand Latin correctly, the other way around.

Turning to SMPs, like Ms. Lundsager and others, I have a problem with signaling SMPs. While SMPs certainly have a central role to play for those member countries that are unable to access a Fund-supported program and want to establish a track record with the objective of accessing such a program, be it a PRGF-supported program or a Stand-By Arrangement at a later stage. However, member countries that can access a Fund-supported program but prefer not to do so for various reasons should not, in my opinion, participate in an SMP. Like Mr. Cippà, I think that they should opt for a precautionary Stand-By Arrangement. Another alternative would be a Fund-monitored program. In any case, the Board should be involved for many reasons: to ensure uniformity of treatment, to limit the risk of misunderstanding by the outside world—a point that was made by Ms. Lundsager—and to give due consideration to the implications of such a program vis-à-vis other multilateral institutions, notably in terms of burden sharing.

To summarize my position, I agree with the staff that signaling SMPs should be associated with the conditionality of upper tranche programs and that their results should be assessed in a transparent manner. Such programs should not remain SMPs; they should be decided upon by the Board. It remains an open question whether that should lead to the multiplication of

precautionary Stand-By Arrangements or the revival of Fund-monitored programs.

Let me conclude by commenting on the alleged lack of independence of surveillance. Like Mr. Wijnholds, I do not see that as the main problem. The real issue is indeed one of efficiency and transparency. In terms of efficiency, like Mr. Portugal, I support Mr. Padoa-Schioppa's position that the impact that surveillance has had should be regularly assessed. I am also convinced that the unique mix of staff expertise and political judgment by this Board is the real value added of this institution, and the Board is also the place to judge the political feasibility that was referred to by our Dean and many others. Regarding transparency and presentation, I tend to share the views of Mr. Wijnholds that we need, in certain cases, to be ready to study various options or scenarios in some cases discretely. Clearly, any kind of separation of surveillance from programs is not a solution.

Mr. Lushin made the following statement:

Let me begin by thanking the staff for their great effort in compiling the reports, which are before us today. They reflect clearly big challenges that the rapidly changing world economy puts before the staff and also demonstrate their determined efforts to face these challenges. They also show that so far the staff has been responding adequately to the Board's guidance in the area of surveillance. Let me now turn to the issues suggested for discussion.

#### The Broadened Framework for Surveillance

Fund surveillance develops continuously in line with a changing global environment. As a result, the coverage of surveillance expanded to include financial sector issues, structural and institutional policies and assessments of crisis vulnerabilities. In these circumstances maintaining a proper focus becomes a challenging task and requires rational selectivity. A broad agreement had been reached during the previous Review that this selectivity should be based on the criterion of macroeconomic relevance and we think this remains valid nowadays as well. Clearly, external sustainability and crisis vulnerability should always be at the apex, as well as the exchange rate arrangements and the soundness of fiscal and monetary policies.

The macroeconomic relevance of the so-called "non-core" issues is country and time specific. Therefore, leaving the coverage of these areas for a particular country to the staff's discretion is the only practical solution. In other words, we believe that the current selective practice of the coverage of non-core issues in bilateral surveillance as exercised by the staff is appropriate. The staff also asks if other issues—such as growth and the global impact of policies in the large advanced economies—ought to be placed high

on the hierarchy of concerns. While we agree for such a treatment in case of major countries' impact on the global economy, we are not quite sure that it is warranted for growth. Directing the staff towards the elaboration of growth stimulating policies may be sending them into un-chartered waters, where sound policy recommendations, apart from the most obvious ones, may be difficult to suggest.

### The Conduct of Surveillance

While maintaining a proper focus appeared to be the lesser challenge so far, ensuring the depth of coverage in the new "core" areas, such as the financial sector and the crisis vulnerabilities, proved to be more difficult. We agree with the staff that the availability of FSAP results could really make a big difference for the depth of financial sector surveillance. Given the limited amount of resources for the FSAP activity, greater selectivity is needed in determining countries that are expected to go through this exercise first of all. It seems that emerging market economies, especially those with market access, should have a priority in this regard. At the same time, the voluntary nature of countries' participation in FSAPs should be preserved.

Another "new" area of concern is vulnerability and sustainability analysis, where the lack of data and sometimes the lack of sound methodology have at times constrained the comprehensiveness of assessments. In this area the staff has already indicated some promising avenues for improvement. Here we talk about adding the sensitivity analysis to the changes in exogenous variables to the medium-term balance of payments scenarios and also about strengthening the analysis of debt sustainability. The outcome in the CIS5 countries, which in less than 10 years arrived to unsustainable debt levels, clearly attests to the necessity to improve the procedures of debt sustainability analysis.

### Multilateral Surveillance

We welcome increased emphasis on cross-country themes and multilateral surveillance. Analyses relating to spillover effects and cross-country comparisons appear in the increasing number of Article IV consultation reports, and this undoubtedly increases their quality and usefulness. *WEO* and GFS reports are of top quality and their focus reflects adequately the most recent developments in the world economy.

We admit that multilateral surveillance provide valuable inputs for bilateral surveillance exercises. However, we believe that there is still some way to go in establishing a stronger coordination between these two areas. There is also another type of coordination that may need to be improved—coordination between multilateral surveillance and individual country's programs. We noticed, for example, that in many UFR cases

baseline balance of payments scenarios include forecasts for exports and private capital inflows that are at times overly optimistic compared to historical trends. We wonder if these projections are subject to any form of multilateral clearance, say, by adding up export and capital inflow forecasts across countries and assessing the totals against *WEO* and GFS data.

#### Article IV Consultation Procedures

We generally support a reasonable degree of flexibility in Article IV consultation procedures. Given the existing shortage of resources, this flexibility could allow for some optimization of their usage while not compromising the key objectives of the whole exercise. Therefore, we can go along with retaining the current policy on LOT conclusions of Article IV consultations and be reasonably flexible on mission size and the scope of staff reports. This flexibility, however, should be such as to ensure adequate coverage of all the issues relevant for the proper assessment of a country's economic position. We can also agree with the proposed flexibility on Selected Issues Paper. This said, like Mr. Kiekens and some other Directors, we continue to remain unconvinced regarding the benefits of non-producing of Statistical Appendices. This is because we think that appropriate information should be readily available in area departments and that to arrange it as a set of tables should not be a great problem. If there is any information that requires considerable efforts for its collection but is not particularly useful, then there is an option to leave it out altogether and have more focused Appendices instead of having no Appendices at all.

#### Surveillance in Program Countries

Like many other Directors, we don't see any major controversy between programs and surveillance, especially of such a magnitude that would require an "institutional firewall". This said, we agree with the idea of a "fresh pair of eyes" expressed by Mr. Callaghan and support his proposal in this regard. Furthermore, we agree with the timing of Article IV consultations in program countries as proposed by the staff and largely share their ideas on how to increase the independence of surveillance in these countries. In the context of the last set of proposals, however, it is not quite clear whether the staff assumes that surveillance will reveal program's flaws. If so, how will the inevitable in this case conflicts and controversies be resolved? We would welcome staff's comments on this matter.

#### Staff-Monitored Programs

While we have no difficulty in understanding the rational and the appropriate rules for track record SMPs, this is not the case for signaling SMPs. The latter are intended "to convey a signal to official creditors, donors, and/or financial markets of a member's commitment to credible and sound

macroeconomic policies". At the same time, they do not have to meet the standards of upper credit tranche conditionality and, moreover, have major weaknesses in reporting, as the staff paper underlines. We wonder, what kind of signal the "signaling" SMPs can provide under such circumstances. The staff proposes some measures that would allow reducing the risk that signaling SMPs will be misinterpreted. While this is clearly an option, another option could be to reconsider the role of signaling SMPs and their inter-relationship with precautionary Stand-by arrangements.

Finally, we share Mr. Portugal's comments on Post Program Monitoring. We would also like the published version of the paper to have a reference indicating that as of end-March 2002 PPM in Russia has been finished.

After adjourning at 1:10 p.m., the Board reconvened at 2:30 p.m.

Mr. Barro Chambrier made the following statement:

I would like to thank the staff for preparing this informative set of papers. The Fund has broadened the coverage and modalities of surveillance to respond to the challenges of the changing global environment, and this has contributed to the improvement in the quality of economic policies. I would like to take this opportunity to acknowledge the quality of the staff's contribution to this critical pillar of our mandate. Since my intervention comes at this late stage, and given the substantial contributions already made by my colleagues, I share many of the views expressed by previous speakers and will simply stress a few points.

On the scope and focus of surveillance, I agree that broadening the range of potentially relevant issues should not come at the expense of maintaining proper focus and greater selectivity. I also believe that surveillance should not be a one-size-fits-all exercise. While ensuring that core issues are addressed adequately in all surveillance documents, we should insist on the principles of selectivity, macroeconomic relevance, relevance for country-specific needs and circumstances, and cooperation with other institutions in areas that are outside the Fund's core mandate.

In this exercise, we need to take into account the aspects of political feasibility, social implications, and institutional arrangements of member countries, especially in low-income countries. In this regard, there is an important issue regarding the link between the quality of the institutions and the effectiveness in the implementation of reforms. In our countries, we are hopeful that the Fund will provide the authorities with further assistance to improve their institutional capacity.

In the surveillance exercise, we should also keep in mind that promoting global economic growth is part of the Fund's mandate. Thus, I agree with Mr. Kelkar that the surveillance process should not only be directed at crisis prevention; but should also focus on discussing the sources of growth within a country and, in the case of major industrial countries, I think we have to pursue our efforts to detect the spillover effects of their policies on other countries in both a regional and a global context.

In this regard, there is a need to give greater attention to the coverage of trade issues, especially in the industrial countries. Increasing market access to advanced countries will not only help foster growth in low-income countries, but it will also ensure uniformity of treatment across the Fund's membership, as program countries are forced to open up their markets. I am also convinced that promoting a sound financial system is essential in the surveillance exercise. In this regard, I look forward to seeing the contribution of the International Capital Markets Department in helping low-income countries improve their prospects for access to financial markets. Likewise, in these countries, I would like to see the FSAP put more emphasis on promoting long-term financial instruments to mobilizing domestic savings and to finance investment.

On modalities of surveillance, like other chairs, I appreciate the regular discussions on the *WEO* and the *WEMD*, and look forward to the contribution of the ICM Department to surveillance. I would like to see greater integration of multilateral surveillance with bilateral surveillance as in the case of low-income countries. In the context of surveillance, regional surveillance plays a complementary role in providing the authorities with a comparative view of economic developments and outlook.

With regard to surveillance in program countries, I am of the view that we should proceed on a case-by-case basis and avoid any systematic separation of programs and surveillance, because it could lead to losing synergy and increasing the delays in the disbursement of tranches for member countries under programs. Having said that, I believe that surveillance should be part of a process that helps countries to define an all-encompassing medium-term policy strategy; as referred to by Mr. Zoccali, a strategy coherent with stability and growth. I regret that the current format tends to put more emphasis on short-term program benchmarks and issues. I would like to see greater emphasis on ways and means to foster growth and policy options for the medium term.

Finally, I support Mr. Mirakhor's view that we should develop an incentive structure to motivate countries to implement Fund advice. But, on this issue, as the Chairman mentioned earlier, the best incentive is the quality and effectiveness of our advice.



The staff representative from the Policy Development and Review Department (Ms. Schulze-Ghattas) responding to questions raised by Messrs. Portugal, Djojosebroto, and Lushin regarding the treatment of structural policies in the context of PPM, agreed that the focus of PPM was indeed on medium-term sustainability and the capacity to repay the Fund. However, according to the guidelines for structural conditionality, these were precisely the objectives on which structural policies under a program were supposed to focus. The staff did, therefore, not see any contradiction between paying attention to structural policies started under the program and focusing on medium-term sustainability and the capacity to repay the Fund under PPM.

On consultation cycles in program countries and the concerns expressed by Ms. Lundsager and Mr. Duquesne regarding the 24-month cycle, including the qualifications mentioned in Paragraph 48 of SM/02/82, the staff representative pointed out that those qualifications had been made with a view to ensuring that no country would be without an Article IV consultation for an inappropriately long period of time. Since most non-program countries were on an annual cycle it would be highly unusual for a country to be without a consultation for much longer than one year and a half. The six-month rule proposed by the staff implied that in the absence of a consultation within a reasonable time frame before the program was approved, there should be a consultation no later than six months after program approval. This would take the maximum lag to about 18 months in such cases, which, in the view of the staff provided adequate safeguards. There were, of course, also other safeguards for cases when a program moved off track.

On Mr. Kelkar's question concerning staff-monitored programs and the reasons as to why so few track-record SMPs in the past three years had been followed by Fund arrangements, the staff representative considered that this was partly explicable in terms of the sample of countries concerned. Since the publication of the staff papers, the record had changed somewhat. In the sample used in the staff paper were 14 track-record SMPs that were non-arrears cases and two cases with arrears, which, for that reason, had not been in a position to have a regular arrangement afterwards. Of that total, five SMPs had been followed by a Fund arrangement. Two of those had occurred only after the issuance of the staff papers currently before the Board, and one SMP had moved off-track, but the authorities and the staff had, nevertheless, begun program discussions. One SMP was about to expire, and the four remaining ones were still current. There had thus been only three cases where no track record had been established and, as a consequence, no follow-up program had been agreed.

On the question raised by Mr. Padoan and Mr. Yagi regarding the perception of signaling SMPs by other institutions, including the World Bank, the staff representative noted that this issue would be addressed in a follow-up paper, given the apparent need for a more thorough analysis of how the Fund should respond to members' needs for monitoring their policies for different purposes. SMPs were used to build a track record, to galvanize support for policy changes domestically, and to provide signals to private and/or official creditors. There was a considerable degree of discomfort with the way in which signaling SMPs were currently being used and also with the fact that the same instrument was applied to rather different purposes. The staff would also discuss the use of comfort letters and

address the issue of precautionary Stand-By Arrangements as a possible alternative solution. Mr. Shaalan had been correct in stating that there was legally no distinction at all between a Stand-By Arrangement and what was often called a precautionary Stand-By Arrangement.

Another staff representative from the Policy Development and Review Department (Mr. Desruelle), responding to Mr. Cippà's question about the follow-up to the external review of surveillance that had been conducted in 1999, recalled that 29 recommendations had resulted from that exercise. Among them the issue of the coverage of surveillance had received the greatest attention both in the Board and in a subsequent press conference. Those recommendations had spurred the thinking on that issue in the 2000 biennial review of Fund surveillance, in particular about the criterion of macroeconomic relevance and the hierarchy of areas of concern in Fund surveillance. There had also been a number of recommendations on procedural aspects of surveillance, such as the consultation cycle. However, these recommendations of the external evaluators had not found any substantial support in the Board and were, therefore, not pursued further. The external reviewers had, at the time, also touched on a few other Fund policies, in particular the issue of the publication of Article IV reports and on standards and codes. While the recommendation to experiment with an external review of a sample of staff reports had not been followed up, the creation of the Independent Evaluation Office had been a major development that would undoubtedly have a considerable impact on those questions. A number of the recommendations had related to the Fund's internal work practices, such as the delegation of responsibilities and the accountability of the staff. Those recommendations had been incorporated into the regular reassessment of internal practices.

Mr. Portugal considered that the justification used by the staff in SM/02/82, Sup. 2 for the selection of the sample of cases for determining the effectiveness of surveillance in program and non-program countries was not inherently consistent. Footnote 16 of the same document explained that both industrial countries and small states had been excluded from the analysis, as those countries had not made use of Fund resources during the relevant period. If the objective of the exercise was to compare program countries with non-program countries, it did not appear logical to exclude industrial countries from the sample, as they represented essentially non-program countries. Doing so might have had a considerable impact on the findings on the relative effectiveness of surveillance in the two groups. A clarification would be welcome as to why industrial countries had been excluded from the sample.

With regard to the relevance of environmental issues in the context of surveillance, Mr. Portugal wondered whether the staff could name the developing countries to which reference had been made in Box 3 on Page 11 of SM/02/82 in the fourth bullet point, and whether the staff had indeed applied the test of macroeconomic relevance to the environmental issues that had been addressed in those cases. The question was of particular importance for his constituency, given that environmental issues had been raised in the Article IV report of one of the smaller countries that he represented. In that case, an entire paragraph had been devoted to environmental issues without them having had any relevance for the macroeconomic framework. On that occasion the staff had answered the question as to why that had been incorporated into the staff report by saying that there was a regulation

asking the staff to do that in every country. With a view to avoiding the overburdening of surveillance with non-core issues, that regulation could be changed.

With regard to SMPs, it was important to realize that there might be countries that did not need Fund financing for balance of payments purposes but that needed World Bank or regional development banks' financing for investment projects, or might need to reassure private creditors that they were on a sustainable path, Mr. Portugal remarked. For those countries an informal but close relation with the Fund remained useful. It was indeed a problem that a single instrument was being used for both establishing a track record for the future use of Fund resources and also to reassure creditors. That latter function might usefully be fulfilled by a resuscitated Enhanced Surveillance Mechanism, which could replace signaling SMPs. The current model of SMP, that closely resembled a Fund-supported program, might be useful for those countries wanting to establish a track record.

The comments from the staff that there were no differences between looking at structural measures that were included in the program and structural measures that were needed to guarantee external viability were welcome, Mr. Portugal said. The assumption was, of course, that both would be the same, if the guidelines on structural conditionality were adhered to firmly. However, given the possibility that the guidelines were not followed strictly and in view of the fact that the staff did not see any contradiction between both, using the formulation that he had suggested might be more adequate to guard against the very possibility of the guidelines not being followed fully. There was also a possibility that there were structural measures that were not formulated for external viability purposes.

Mr. Scholar considered that Mr. Portugal had raised some important questions, particularly with regard to the sample used to analyze differences in the effectiveness of surveillance in program and non-program countries.

Mr. Scholar agreed with the suggestion made by Mr. Padoan and supported by Mr. Portugal and Mr. Duquesne to have a more systematic assessment of the impact of past surveillance exercises. However, the question arose as to whether the Fund was already in a position to provide such an assessment even internally, let alone in an Article IV document, that might be published. The questions that had to be asked were whether surveillance had any positive effect, whether the appropriate issues were being addressed, whether adequate advice had been given, and whether members listened and acted on that advice. While it was difficult to come up with a systematic way of answering those questions, nothing less was required. That was also the sense of numerous considerations presented in other Directors' statements on the issue of the effectiveness of surveillance. Mr. Callaghan's suggestions in that regard, particularly on looking at the role of the Board and on considering a mechanism for assessing surveillance were useful. The British chair had suggested a similar approach, based on the idea of an annual remit from the Board to staff and management to provide an opportunity to take a step back and consider the effectiveness of the Fund's work. It was necessary to perform a critical self-evaluation of the effectiveness both of program and surveillance activities, which, in turn, required a definition of the appropriate institutional context. That was also the background to the need for greater independence of the surveillance function in general.

With regard to the issue of greater independence of surveillance, Mr. Scholar agreed with the Deputy Director that there had been a consensus on the need for a fresh pair of eyes. However, that phrase could mean different things to different people. In the view of the British chair, it implied the need for some rather powerful ex-ray spectacles. However, it would be desirable, if the independence of surveillance could be taken further than that. In view of the fact that surveillance represented a big issue in the context of the Fund's work, Ms. Lundsager's suggestion to have a further discussion of some of the issues at a later stage was welcome.

Mr. Szczuka wondered why the issue of SMPs had been discussed in the context of surveillance, given that they were not actually part of the surveillance decision. Also, in the SMP guidelines from 1998 reference had been made to SMPs as being a tool for maintaining close contact with countries after a program. That was no longer needed given the introduction of PPM. Also, timely publication of Article IV staff reports could, to a large extent, serve the same purpose as a signaling SMP.

On the issue of the conduct of Article IV consultations—the question raised by Mr. Djojosebroto and himself earlier during the discussion—Mr. Szczuka thanked the Deputy Director for outlining the ideal model for such consultations. His experience related to two different departments. In those cases, it had occurred that the mission chief only arrived during the second part of the consultation, which made it difficult to begin with a presentation of the mission's brief. During four and half years at the Fund, he had never seen a mission brief, which suggested that the Fund was guarding its documents well. It was probably true that there were 182 different models of how Article IV consultations were conducted. At the least, it was likely that each mission chief had its own model. Hence, there appeared to be some room for improvement or a harmonization of practices in that area.

Mr. Mirakhor, responding to Mr. Szczuka's question as to why SMPs were being considered in the context of the current Board meeting, recalled that there had, in the past, been the Enhanced Surveillance Mechanism, which had, in effect, been replaced by the innovations brought about through PPM and SMPs. Hence, there was an organic relationship between both instruments.

With regard to Mr. Portugal's question on the incorporation of environmental questions in an Article IV staff report, Mr. Mirakhor recalled that there had been a Board decision in 1994/95 according to which environmental questions were to be considered in Article IV consultations. There had also been a similar decision to consider non-productive expenditures in the same context, and there were more decisions that affected surveillance. Just as in the case of discussions on conditionality, it might be useful also in the case of surveillance to collect all of those Board decisions and perhaps revise or streamline them where that appeared necessary.

Mr. Padoan considered it desirable to reflect in the summing up the general point raised by Ms. Lundsager on the need for devoting more time to many of the issues currently before the Board. That concerned in particular the issues raised by Mr. Scholar regarding the appropriate institutional set-up for surveillance in the future which had been discussed with

respect to the issue of surveillance in program countries, but which probably deserved more ample consideration.

Mr. Duquesne agreed with Mr. Padoan that there was a need to discuss those issues more informally, and that could be reflected in the summing up. However, on the question of institutional changes, the current debate had shown that the vast majority of Directors was not in favor of such a change.

The staff representative from the Policy Development and Review Department (Ms. Schulze-Ghattas), responding to Mr. Portugal's comments on the methodology used in analyzing the effectiveness of surveillance in program and non-program countries, remarked that the staff had attempted to assess the effectiveness of surveillance only in a rather limited sense. The staff had not attempted to assess whether policy advice was actually being followed. While that would have been desirable, it was difficult to do. The staff had compared the reports for program and non-program countries with regard to the breadth and the depth of coverage, the focus, the approach to assessing risks in the short- and medium-term outlook, the presentation of the policy dialogue between the authorities and the staff—in sum numerous typical elements of a standard Article IV report. For that purpose, a questionnaire had been designed in order to compare program and non-program countries that, in other respects, were similar, so as to rule out other factors that might also account for differences between program and non-program countries and could blur the picture. In the staff's view, including industrial countries would have stacked the odds against program countries, given that a good number of the points outlined above were covered better in industrial countries. Hence, the sample had been limited and industrial countries excluded to ensure the fairness of the exercise.

Mr. Portugal considered that the exercise had not actually addressed the issue of effectiveness but had only compared the extent of the coverage. However, the listed items of coverage that had been compared—recent economic developments, short-term and medium-term economic outlook, exchange rate and macroeconomic policies, structural reforms, financial sector issues, policy dialogue, and data issues—applied equally to non-program developing countries and non-program industrial countries. Therefore, it would be interesting to explore that question further.

The staff representative from the Policy Development and Review Department (Ms. Schulze-Ghattas) suggested the aspect of effectiveness be discussed bilaterally.

Another staff representative from the Policy Development and Review Department (Mr. Desruelle) responding to Mr. Portugal's question on the coverage of environmental issues and to the related comment by Mr. Mirakhor, noted that there was indeed a guideline saying that environmental issues should be covered, when relevant. Following the biennial review of surveillance in 2000, that had been interpreted as applying the criterion of macroeconomic relevance. With regard to the passage of the text to which Mr. Portugal had referred, it concerned a case of a country that depended for its export earnings to a significant degree on tourism and where environmental degradation had been likely to affect the prospects of that sector. Hence, in that case, the criterion of macroeconomic relevance had

certainly been met. The staff had looked into that also in the other cases. With regard to the names of the countries involved, the staff would provide that information to Mr. Portugal bilaterally.

**2. CAPE VERDE—POVERTY REDUCTION AND GROWTH FACILITY—  
THREE-YEAR ARRANGEMENT; AND INTERIM POVERTY REDUCTION  
STRATEGY PAPER AND JOINT STAFF ASSESSMENT**

Documents: Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility (EBS/02/54, 3/22/02; and Cor.1, 4/3/02); Interim Poverty Reduction Strategy Paper (EBD/02/47, 3/22/02); and Joint Staff Assessment (EBD/02/48, 3/22/02)

Staff: Moser, AFR, Kashiwagi, PDR

Length: 35 minutes

Mr. Barro Chambrier submitted the following statement:

Soon after taking office in early 2001, the Cape Verdean authorities decided to embark on a comprehensive program of economic reform, which they viewed as essential to improve macroeconomic fundamentals, sustain economic growth, and make a significant reduction in the level of poverty. Moreover, despite the fact that the per capita GDP is estimated at about US\$1,200, it should be noted that more than 30 percent of the population is considered to live below the poverty line. Unemployment is high and equity issues are of concern. In addition, because of the difficult living conditions in the country, the people have had a tendency to emigrate, so now it is estimated that there are twice as many Cape Verdeans living abroad than on the islands, and the economy is supported in a significant way through workers' remittances. This is an issue of concern to the authorities, as it does not bode well for long-term sustainability. The authorities, building on previous development plans, have put in place a strategy that addresses the main challenges facing the Cape Verdean economy.

The vision of the authorities was outlined in a document presented to the parliament in November 2001, and it described the government's economic development and poverty objectives, as well as its policy priorities for the medium term. This document, known as the *Grandes Opções do Plano*, set five priorities, namely: (i) the promotion of good governance; (ii) support for private sector-led growth and the broadening of the productive base; (iii) the development of human capital; (iv) the promotion of a holistic approach to fighting poverty; and (v) a balanced development of infrastructure across the country. It was the intention of the authorities to embark on a medium-term program of reforms with the aim of achieving their objectives.

However, the authorities were soon confronted with major financial imbalances that required their immediate attention. These imbalances had been brought about by the expansionary policies that had been followed in 2000, and which led to slippages in the Stand-By Arrangement that was then in place. In the event, the authorities implemented during the second half of 2001 a near-term macroeconomic stabilization and adjustment program, which was monitored under a staff-monitored program (SMP). The authorities showed strong commitment to the SMP, and implemented strong measures to tighten financial policies, while also implementing a number of key structural measures.

Performance under the program was good, as quantitative benchmarks were met or surpassed. Notable was the overall fiscal surplus (including grants) that was recorded, compared to a deficit that had been programmed, for the second half of 2001. This performance resulted from the strengthened tax administration, as well as in the collection of tax and nontax arrears, and the containment of expenditures well below the program ceilings. As part of the fiscal efforts, the authorities eliminated the subsidy on petroleum products, and reduced loans to university students abroad, which had been the major cause of the higher deficit in 2000. In addition, the government regularized a large part of its domestic arrears, and no domestic or external arrears were accumulated during that period. The improved fiscal performance allowed the government to reduce its indebtedness with the banking system. Money aggregates stabilized, although broad money grew faster than programmed, as emigrants' demand for domestic money balances increased with the rebound in confidence. The external current account also showed a significant improvement due to lower imports and falling world oil prices. The capital account registered a large surplus on account of strong private capital inflows and disbursements from external creditors. The level of international reserves increased. The authorities also implemented all the structural measures envisaged under the program, in the area of VAT, the central bank organic law, and the price mechanisms for petroleum products.

With the significant improvement achieved in the macroeconomic situation, the authorities are now focusing their efforts on the medium-term program. To help design and implement the programs and policies that will enable them to meet their medium-term goals in a way that is consistent with the overall macroeconomic framework, the government is developing a poverty reduction strategy paper (PRSP), which should be completed by 2003. In the meantime, the government has prepared an Interim PRSP that outlines the strategy. Consistent with the overriding priorities, the authorities will focus their efforts in the medium term on maintaining macroeconomic stabilization and a policy environment that encourages a broad-based increase in economic growth and poverty reduction. The broad quantitative objectives are: (i) increase the annual rate of economic growth from 3 percent in 2001 to about 5 percent in 2004; (ii) reduce the rate of inflation from 4 percent in 2001

to about 2 percent in 2004; (iii) reduce the external current account deficit (including grants) to about 5 percent of GDP; and (iv) increase gross international reserves to about 2.2 months of imports by 2004.

The broad objectives for this year are to continue the efforts aimed at ensuring macroeconomic stability and restoring internal and external viability. In this context the measures envisaged are expected to maintain economic growth at around 3 percent, reduce inflation to 3 percent and increase international reserves to about 1.7 months of imports. In this context, consolidating the fiscal position will remain a priority.

The overall fiscal deficit (including grants) is programmed to remain at 3 percent of GDP in 2002, despite the revenue-raising and expenditure reducing measures being implemented, due to the reduction in the stock of arrears and financing retrenchment costs associated with liquidating two public enterprises. A number of revenue measures are envisaged for 2002, but overall government revenue as a percentage of GDP will be lower than in 2001 due to lower remittances and tourist arrivals, as a result of the global economic slowdown.

On the expenditure side, the noteworthy measures are the introduction of an automatic and transparent pricing mechanism for petroleum products by end-June 2002, limiting salary increase to 2.5 percent, and limiting monthly subventions to university students studying abroad. Efforts to further strengthen expenditure control and monitoring will continue. Within this fiscal target, the government will ensure that priority social sectors are adequately funded. Thus, current expenditure on health and education will be maintained at 6 percent of GDP. In addition, the government will broaden the pension scheme to encompass elderly and disabled workers. The system of financing of studies abroad by qualified Cape Verdean students is being reviewed and a set of guiding principles have been laid down, aimed at controlling outlays in this category. In addition, the authorities have requested and received donor assistance to meet some of the education costs. A major focus of the authorities' fiscal efforts is on expenditure management, and in this regard, the authorities have sought technical assistance from donors to assist them in improving control over spending. The government will also improve its oversight and accounting of counterpart funds associated with the domestic sale of donated food aid. In this regard, a program review will be completed by end-June 2002, and guidelines will be established by end-October 2002, in consultation with donors.

As regards outstanding domestic arrears at end-2001, the government intends to regularize the stock of these arrears through a combination of cash payments and restructuring agreements and expect to complete these negotiations by end-June 2002.



The government is confident that with these measures, the fiscal targets will be achieved. However, the authorities are prepared to take additional measures, if necessary to ensure the achievements of the program targets and benchmarks. In this context, they will undertake a review of the budget performance every quarter.

Monetary policy in 2002 will be geared toward further stabilizing the macroeconomic situation and supporting the exchange rate peg. With the improving fiscal situation, net domestic assets of the banking system are projected to increase. Reduction in the growth of net credit to the government should enable for an expansion of credit to the private sector, thus contributing to domestic economic activity. In the implementation of its monetary policy and the achievement of the targets set under the program, the central bank will make active use of the monetary instruments at its disposal, including discount rates and open market operations.

Under the SMP, the government drafted a revised central bank organic law aimed at ensuring the statutory independence of the central bank and international best practices. The law was approved by the Council of Ministers in February 2002, and the authorities expect the law to become effective by end-June. The authorities will also continue their efforts to strengthen banking supervision, with external technical assistance.

The external current account deficit (including official transfers) is projected to increase to 11.3 percent of GDP in 2002, from 10.3 percent in 2001, mainly due to a decline in exports and services and lower remittances from Cape Verdeans living abroad, associated with the global economic slowdown. However, reflecting the commitment of the authorities to reform and the increase in investor and donor confidence, capital inflows are projected to increase and thus to limit the overall balance-of-payments deficit to 2 percent of GDP. More broadly, the authorities will continue to pursue policies that will further strengthen external viability. In this regard, they will continue to implement policies aimed at enhancing external competitiveness, promote nontraditional exports to take advantage of opening of markets, and develop the tourism sector, which seems to have excellent growth potential.

Structural reforms will be an important component of the program. The reforms are aimed at improving the environment for the development of a strong private sector and enhancing the competitiveness of the economy. The program of reforms will be implemented in cooperation with the Fund, World Bank, and donors, and take into consideration the implementation capacity of the country. In the beginning, priority will be on the reform of the tax and tariff systems. Preparation for the introduction of a VAT is under way, as well as plans to streamline the tariff system and reduce the rates. The new tariff system will be introduced in January 2003 together with the VAT. A new transparent and automatic pricing mechanism for the retail of petroleum

products will be introduced. As regards the privatization program, the food and distribution company (EMPA) and the urban transport company (TRANSCOR) will be liquidated in 2002, but to meet the large retrenchment costs, the authorities are seeking external financial support. In addition, three public enterprises, namely INTERBASE (a cold storage company), CABMAR/CABNAV (the shipyards) and TACV (the national airline) will be prepared for privatization.

In 1998, Cape Verde launched a comprehensive domestic debt-reduction operation in cooperation with the Fund, the World Bank, and donors. The plan was based on the creation of an offshore Trust Fund, funded by privatization proceeds and donor contributions, and which would issue claims on itself, as explained in Box 2 of the staff report. The idea was to retire the debt within 20 years without creating inflationary pressures in the economy. However, as the fiscal situation worsened and further domestic arrears were accumulated in 2000, donors froze their support. The domestic debt remains sizable and unsustainable, at about 24 percent of GDP, and the authorities would like to restart the operation. In light of the significant improvement in the fiscal situation, and the strong determination shown to address the economic and financial problems facing the country, the authorities are seeking donor support for their efforts, and intend to hold a donors' conference in the coming months with the view to restart the domestic debt-reduction operation. The new program will be based on the principles of sequenced disbursements, tied to further fiscal consolidation, as well as continued burden sharing between the government and donors. It is the intention of the government to reduce the domestic debt-to-GDP ratio to about 20 percent by end-2004.

The authorities recognize that the success of the program will depend greatly on the ability to monitor performance. In this regard, efforts will be made to improve the quality and timeliness of key economic and financial statistics. In these efforts, and to improve technical capacity, the authorities will request technical assistance from the Fund, the World Bank, as well as other multilateral agencies and donors. Strict monitoring of the program will be done by a special committee chaired by the Ministry of Finance and Economic Planning. The committee will prepare monthly reports, which will be submitted regularly to the Fund.

The medium-term economic development program of Cape Verde has a strong component devoted to poverty reduction. It is based on the 1997-2000 National Development Program and the National Poverty Alleviation Plan (NPAP) that targets rural poverty, while aiming at improving the effectiveness of poverty-reduction programs. To ensure that the poverty reduction policies are consistent with the overall macroeconomic framework, the authorities are in the process of developing a comprehensive poverty reduction strategy paper (PRSP), which they expect to complete by 2003. As a

first step, the authorities have put in place an I-PRSP, which has been submitted to the Board as part of the request for support under the PRGF. The I-PRSP contains a diagnosis of the poverty situation, including an analysis of the socioeconomic composition of poverty and the quality and timeliness of poverty statistics. The document presents the priority focus of the strategy, and expresses the strong commitment of the authorities to fight poverty. A nationwide participatory process is planned for developing the PRSP, with various consultative groups.

Overall, my Cape Verdean authorities are satisfied with the progress made under the SMP. They are confident that the medium-term program that they have put in place with the assistance of the staffs of the Fund and the World Bank is a strong one, and one that can restore internal and external viability, while helping to improve the growth potential of the country. They are also of the view that the successful implementation of the program will contribute significantly to the reduction of poverty and to an improvement in living standards, over the medium to long term. The measures already implemented attest to the authorities' strong commitment and ownership of the program, and they are hopeful that donors and multilateral institutions will continue to strongly support their reform efforts. In this regard, I would request my colleagues' support for the request of my Cape Verde authorities for Fund assistance under the PRGF.

Mr. Tombini submitted the following statement:

Let me at the outset thank the staff for the excellent set of papers and Mr. Barro Chambrier for his comprehensive and candid statement. We are very pleased to note the substantial progress made by the Cape Verdean authorities in adjusting the macroeconomic framework of the country under the staff-monitored program (SMP) during the second half of 2001. Likewise, we are very much encouraged by the development of a consistent and legitimate basis to fight poverty, with the conclusion of the Interim Poverty Reduction Strategy Paper (I-PRSP). We are prepared to support the staff's recommendation to approve the I-PRSP as presented in EBD/02/47, and approve the request for the Poverty Reduction and Growth Facility (PRGF) set forth in EBS/02/54.

After strong economic growth in 2000, the Cape Verdean economy slowed down in 2001 with estimated GDP growth reaching a modest 3 percent. Inflation has remained under control, with consumer prices rising by 4 percent on average in 2001. This economic performance was remarkable considering that the external environment deteriorated markedly last year. More importantly, however, was the strengthening of the macroeconomic framework during the second half of 2001.

After policy slippages, which had led to deterioration in the fiscal and external accounts in 2000 and in the first part of 2001, macroeconomic policy management improved substantially under the SMP. In 2000, the overall fiscal deficit, including grants, widened to 19 percent of GDP, from 17 percent in 1999. In 2001, even after a rough start, the overall fiscal deficit reached 3 percent of GDP, lower than the 5 percent target under the SMP. This was the central improvement in macroeconomic policy performance in 2001, and clear indication of the new administration's commitment to address the macroeconomic imbalances. We are also encouraged by the results obtained in the narrowing of the external current account imbalance, while acknowledging that the external borrowing requirements remain high. On the structural front, progress has been made in the areas of VAT, central bank organic law, and in the implementation of an automatic and transparent petroleum pricing mechanism, as noted by Mr. Barro Chambrier. Supported by greater fiscal discipline, the growth of monetary aggregates stabilized in 2001, although at a higher rate than initially expected, as the supply of money responded to emigrants' increased demand for domestic balances as confidence improved toward the end of the year.

Looking ahead, we are optimistic that sound macroeconomic policy management will be continued under the new PRGF arrangement. Particularly, we support the authorities' view that to achieve the ambitious growth rates, 5 percent on average in 2004, it is necessary to secure macroeconomic stability. A correction of the fiscal imbalances and further consolidation is all the more fundamental in view of the framework of a pegged exchange rate. We are also encouraged by the participatory approach adopted to develop the basis of the poverty reduction strategy, which reassures us of the high degree of ownership associated to the new arrangement.

We are particularly pleased with the focus of structural conditionality in the proposed program. The structural prior actions, performance criteria, and benchmarks are well focused in the core areas of the Fund, including measures to deepen fiscal consolidation, to improve monetary policy management, and to improve the efficiency of the tax and tariff structure. We commend the staff for the streamlining and focusing of conditionality in the proposed program.

In conclusion, we congratulate the authorities for their remarkable performance under the SMP, an example of how this facility can serve the purpose of establishing a good track record when there is strong commitment from the member country. With these remarks, we wish the authorities all the best in these challenging times.

Mr. Usman submitted the following statement:

We thank the staff for providing a useful set of papers and welcome the reassurance provided in Mr. Barro Chambrier's comprehensive preliminary statement as to the commitment of the Cape Verdean authorities to pursue the reform process. From the onset, since we are in broad agreement with the staff assessment, we fully support the Cape Verdean authorities' request for a three-year arrangement under the PRGF.

Cape Verde's performance under the SMP was extremely encouraging and we commend the authorities for achieving all quantitative and structural benchmarks. In addition, in 2001, the overall fiscal deficit declined to 3 percent of GDP compared with the target of 5 percent, monetary aggregates continued to stabilize, the current account improved substantially, and good progress was made on the structural front, including the elimination of fuel subsidies, the approval of a new legislative framework for introducing a value-added tax, as well as the liberalization of the external tariff regime. We also note that GDP is estimated to have grown by a commendable 3 percent despite the global slowdown.

However, although significant progress was made in stabilizing and modernizing the economy in the last decade, further efforts are needed to vigorously continue to address the country's poverty situation. Indeed, as noted by Mr. Barro Chambrier in his statement, despite the fact that per capita GDP is one of the highest in sub-Saharan Africa, 30 percent of the Cape Verdean population lives below the poverty line. We note, nevertheless, that the authorities have already completed the preparation of an I-PRSP, which provides a sound basis for the development of a fully participatory PRSP and for Bank and Fund concessional assistance. Moreover, as the staff has pointed out, the government of Cape Verde is experienced in focusing on poverty reduction within a participatory framework and has started developing a poverty reduction strategy since 1987. In 1977, it had also prepared a National Poverty Alleviation Plan, targeting in particular rural poverty and, more recently, has presented to parliament its development framework for 2002-04, the *Grandes Opções do Plano*, which clearly outlines the promotion of a holistic approach to fighting poverty as one of government's main priorities.

The Memorandum of Economic and Financial Policies candidly describes Cape Verde's economic performance in 2001 under the August-December 2001 SMP and outlines the government's medium-term program objectives for 2002-04. We note that the program adequately focuses on maintaining macroeconomic stabilization and a policy environment that encourages a broad-based increase in economic growth and poverty reduction. Likewise, the 2002 program was also appropriately designed and contained an ambitious agenda focused on ensuring macroeconomic stability and promoting private sector-led growth. Important elements of the program

include the reduction of the annual rate of inflation to 3 percent, and the increase of gross international reserves to 1.7 months of imports. We also note that the program gives adequate emphasis to structural reforms in the fiscal area, aiming at expanding the tax base and strengthening revenue collection. To this extent, we welcome the preparatory work in view of the substitution of the consumption tax by the recent approved VAT at a uniform rate of 15 percent. We are also pleased to note that the government intends to carry out a comprehensive review of custom and tax exemptions. The positive evolution on the budget reflects also a considerable effort at rationalizing and reducing public outlays while ensuring adequate funding for priority social sectors, including primarily health and education. We also welcome the government's efforts to establish a new financing mechanism for tertiary-level students to limit overseas scholarships. The authorities' efforts to improve transparency and good governance in public finances are also encouraging and we are pleased to note that an independent audit of the 2001 budget accounts will be accomplished.

The restrictive monetary stance that the authorities intend to maintain is consistent with the inflation target and external objectives set under the program, and we also welcome the reduction in the growth of net credit to the central government to allow for an expansion in credit to the private sector. In addition, like the staff, we strongly support the government's objective of implementing the new law in view of establishing an independent central bank with price stability as its primary objective to ensure macroeconomic stability and protect the exchange rate peg.

Mr. Barro Chambrier said that the Cape Verdean authorities intended to publish all documents relevant to the Board discussion.

Mr. Cho made the following statement:

Cape Verde is a clear example of how good policies can change a country's economic prospects. During the first 6 months after the inauguration of, the new authorities already initiated a notable improvement in the country's economic performance. The performance under the staff-monitored program has been encouraging, thanks to the authorities' strong ownership of the program. Obviously, financial imbalances mainly caused by the previous slippages from the Fund-supported program may take more time to be addressed. In this respect, we welcome the authorities' resolve to maintain economic stability and continue structural reform. As for the medium-term policy goal, we would also like to give full support to the authorities' determination to deal with the income inequality issue despite the relatively high income level in the region. The policy framework set out in the I-PRSP looks convincing in that the poverty will be alleviated with the country's pursuit of labor-intensive growth, with a fair chance given to the poor to overcome their poverty through training and education.

The authorities have already embarked on a new survey in order to sharpen the policy initiatives contained in the I-PRSP through an extensive participatory consultation with the civil society leading up to the full PRSP. I certainly support the PRGF for the Cape Verde, but as Mr. Barro Chambrier rightly noted, Fund resources alone would not be enough to support Cape Verde's current account deficit, which will take time to be narrowed, although they are expected to play a catalytic role in inducing private capital inflow.

Donor support appears to be inevitable in filling the financing gap. In this sense, it is encouraging that donors have already rallied to send a positive signal to the authorities' good policies. We also feel the forthcoming donors' meeting will be an occasion to resuming the domestic debt reduction operation.

Before I conclude, I have one minor point in relation to the proposed price mechanism for retail petroleum products. Despite the basic concept of reflecting market prices, the mechanism will continue to include some degree of cross subsidy elements in favor of products, primarily used by the poor, while eliminating any subsidy cost to the budget. This appears to be against the economic wisdom that an explicit form of subsidy is always better than implicit one, if indeed subsidies are inevitable. I am sure there is a justifiable reason behind the choice of implicit subsidy, and the staff may wish to comment on this area.

With these remarks, we wish the authorities all the best in continuing their efforts to enhance the confidence of donors and private investors, who will be important players in assuring success in macroeconomic management and their fight against poverty.

Mr. Komatsuzaki made the following statement:

Cape Verde corrected its internal and external imbalances under the staff-monitored program in the second half of 2001. I commend the authorities for the policy turnaround, which included improved tax collection, containment of public expenditures, and efforts to realize domestic arrears without accumulating new ones, all of which led to the reduction of the internal imbalances. Externally, the decrease in fiscal imbalance contributed to improvement in the current account, a strong build up in reserves, and the reduction of external arrears.

Looking ahead, the sizable and chronic current account deficit threatens the sustainability of the balance of payments and overall macroeconomic stability of the economy. It is encouraging to learn that the authorities are aware of the importance of reducing the deficit to ensure the stability of the foreign exchange regime and of overall macroeconomic

stability. Over the short term, this will require continued consolidation of the fiscal discipline started in the second half of 2001, as well as a prudent monetary policy. For the medium-term perspective, the broadening of the production base and attracting more foreign capital would contribute to relieving pressure from the external account and to raising economic growth.

At the same time, the authorities' efforts at poverty reduction should also be supported and strengthened. In this context, I welcome that they have requested a PRGF arrangement and I support the proposed decision. I broadly agree with the staff appraisal.

This chair welcomes the authorities' intention to further consolidate the fiscal position with a view to virtually eliminating the fiscal deficit and ceasing domestic bank financing by 2004 by rationalizing public expenditure. I also support the introduction of an automatic and transparent policy mechanism for retail petroleum products by end-June 2002 to delink the budget from fluctuations in the world market price, and support the containment of the wage bill.

Regarding monetary policy, I support the program's prudent monetary stance that is in line with growth projections. The introduction of a new central bank organic law is a sign of marked progress in ensuring the prudent management of monetary policy and I urge the authorities to adopt the law as planned.

I also support the proposed list of structural performance criteria and benchmarks, which should contribute to enhancing efficiency and transparency of the economy. However, I am also interested in the authorities' strategy to raise the growth rate. I am aware from Mr. Barro Chambrier's statement that support for private sector-led growth and broadening of the productive base are listed as one of the five priority areas, and from the well-written staff paper that the authorities are attempting to attract foreign private investment for tourism and light industry. I would be interested to know what the envisaged measures are specifically, either from the staff or Mr. Barro Chambrier.

This chair supports the conclusion of the debt sustainability analysis. It is encouraging to learn that the debt-to-export and debt-to-revenue ratios are expected to decrease significantly in the next 10 years. Given its heavy debt burden and the number of risks, however, the authorities are urged to fully implement the recommended policies to maintain economic sustainability. With these remarks, I wish the authorities every success.



Mr. Dohlman made the following statement:

There is good reason to be optimistic that Cape Verde's proposed PRGF-supported economic program will succeed in stimulating growth and reducing poverty. The authorities have demonstrated their policy resolve by performing relatively well under their recent Staff-Monitored Program (SMP). They have laid significant groundwork for key program reforms such as central bank independence, tax reform, expenditure controls, and debt management. And the authorities' well-balanced and comprehensive Interim Poverty Reduction Strategy Paper (I-PRSP) provides an important resource in addressing poverty. We therefore support this new PRGF-supported program for Cape Verde. Since we broadly share the staff's views of the key risk factors, as well as its general appraisal, we would just highlight a few issues.

On structural matters, the authorities seem on track for passing the central bank law and implementing the petroleum pricing mechanism and the new VAT. We have some broader concerns, however, about the authorities' institutional capacity to implement reforms in other areas such as budget planning, expenditure control, treasury operations, debt management, and data collection. In this regard, could the staff comment on the I-PRSP's schedule of activities for building capacity—particularly whether it is sufficiently comprehensive and achievable?

We believe technical assistance could be particularly effective in civil service reform. Such reform will be critical to meeting medium-term plans for reducing current expenditures. But it is not clear how the government will meet its health and education goals, expand the cabinet of ministers, and increase infrastructure spending, while at the same time reduce the wage bill as a share of total government expenditures (now one-third).

On debt issues, we agree with the staff that the currently unsustainable level of domestic debt remains one of Cape Verde's most pressing problems. Renewed donor interest in the domestic debt reduction operation (DDRO) represents an opportunity to address this, but aid flows will only be realized if Cape Verde can demonstrate its ability to implement fully its ambitious agenda. Pushing ahead with privatization plans, for example, would further boost DDRO resources while meeting goals to enhance the role of the private sector in the economy.

Regarding domestic and external arrears, we encourage the authorities to negotiate in good faith to regularize relations with all domestic and external creditors by the end-June 2002 target. On a related point, we strongly support the performance criterion on the non-accumulation of domestic and external payments arrears.

The authorities' comprehensive I-PRSP will undoubtedly contribute to the success of this program. We particularly welcome the central role given to the private sector for reinvigorating growth. Equally welcome is the focus of the government on infrastructure, human capital development, good governance, and contract enforcement (the recognition of the need to address disparities faced by women is particularly refreshing). Such steps will be critical to realizing the projected private capital inflows. We also welcome goals to boost agriculture and livestock production, and urge the authorities to maintain high natural resource management and conservation standards, particularly given competing tourism goals.

We have some concerns, however, about hints of selectivity in treatment by the authorities of specific sectors. For example, the I-PRSP (page 16) proposes strategic partnerships between the state and operators to help eliminate major obstacles to development. This process can be valuable, but resulting lessons should be broadly applied. The public works projects, the FAIMOs, also seem at cross-purposes to the authorities' emphasis on private sector-driven growth. We would have appreciated a more detailed discussion of how this public works program might be revised to better promote the authorities' private sector orientation and growth goals.

Finally, we welcome Cape Verde's expressions of support for the global fight against terrorist financing. However, the government does not currently have a blocking order in place on terrorist assets, as called for in the November 2001 IMFC Communiqué. We therefore urge Cape Verde to take the steps necessary to deny terrorists access to the international financial system, and to implement fully all UN counter-terrorism instruments.

The staff representative from the African Department (Mr. Moser), in response to questions posed by Executive Directors, made the following statement:

Let me start with the question on the implementation of the automatic and transparent retail price mechanism for petroleum products, and whether there was an issue with the authorities' subsidy proposal. Examining adverse social impacts from structural measures was an important aspect of the implementation of the government's plan this year. The authorities proposed, with the agreement of the Bank and the Fund, a temporary mechanism for continuing some subsidies to the poorest elements of the society. These subsidies will be reflected transparently in the budget, although the government said that they wanted to have no net impact on the budget, so that they would see higher prices for other petroleum products.

On the question about the growth strategy, particularly in the areas of tourism and how the government saw its role in developing and encouraging this sector, the government, working with its donor partners and particularly the European Union, will aim to develop an appropriate framework for

tourism on several of the islands not yet developed, both in terms of conservation and the environment. The authorities are now in the process of developing this framework with several donors and have put together a collaborative process with potential investors to help define the strategy. It seems to be progressing well. Also, in their public expenditure program, the authorities have pursued efforts to expand and improve the infrastructure of these islands, in terms of roads, airports, electricity, water, and telecommunications. This seems to be on track so far.

On the issue of weak institutional capacity, I would note that Attachment 1 of the I-PSRP contains a matrix detailing the institutional capacity and technical assistance needs of the government to implement the program, in terms of data requirements, monitoring requirements, and implementation issues. It also includes information on fiscal management and expenditure control, and broader structural areas such as pensions and the civil service.

With regard to the government's choice of sectors included in their strategy, the staff's understanding is that the government is not attempting to select winners and losers. The government mentions a role for itself, especially in tourism, to set the appropriate environment for the growth of these primary sectors over the next 10 years. It is their intention to sit down with the major players in these sectors to help design the framework.

Finally, the daily workers, which get paid for infrastructure in public works projects, are part of a poverty-reduction program that is primarily financed by donor food aid. It is under review this year, as the donors themselves are looking at several other options for interventions on the poverty side.

Mr. Barro Chambrier made the following concluding statement:

I would like to thank my colleagues for their comments and helpful policy recommendations. In spite of the short list of speakers, the quality of the discussion was high, and I will convey your comments faithfully to my authorities. I would also like to thank Mr. Moser for the responses just provided.

I will limit myself to reiterate the commitment of my authorities to steadfastly implement the program of adjustment. As Directors have echoed, Cape Verde is a good example of a country where the strict implementation of the measures, in spite of the limited administrative capacity, can make the difference. The Fund is playing a very useful role in Cape Verde, and my authorities are very keen to pursue this collaboration. I believe that the new government has made an impressive effort to continue good fiscal

management so as to reduce the imbalances, but they are aware that many challenges lie ahead. They intend to fully utilize technical assistance.

The key issue, among others, was the debt problem. And I would expect that you could convey to your capitals, that given the effort of the authorities, we should have some external support. We look forward to this support to help settle this debt issue, and the authorities are cognizant that much will depend on their track record.

On the growth prospects, there is a good potential for growth in the areas of tourism and services. The authorities believe that these two sectors are correlated and look forward to the intra- and intersectoral coherence, as mentioned in their I-PRSP. I believe it is their intention to create an environment that will encourage private investment, especially foreign investment, in these sectors.

On poverty reduction, much progress has been made, but the authorities want to eliminate poverty as much as possible, and they intend to do it through a combination of well-targeting measures, as well as by following economic policies that will foster growth and the creation of employment.

Let me conclude by reaffirming my authorities' commitment. They have taken already a very courageous decision to correct the fiscal imbalances, and I am sure that they will be encouraged by your support and recommendations today.

I would like to close by expressing my authorities' appreciation to Mr. Moser and his team for their constructive role in Cape Verde.

The Acting Chair (Mr. Aninat) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Cape Verde's effective implementation of the staff-monitored program in 2001, which resulted in a substantial improvement in the macroeconomic situation, as reflected in the sizable reduction in the fiscal deficit and strong increase in international reserves. Revenues increased substantially, expenditures were constrained, existing arrears were largely regularized and no new arrears were accumulated, and domestic financing of the government was reduced.

Directors supported the newly elected government's medium-term economic strategy, including its emphasis on poverty reduction. They commended the authorities for completing an Interim Poverty Reduction Strategy Paper, that is based on increased ownership by involving a wide range of groups in civil society. The government's program is consistent with

the economic strategy outlined in the I-PRSP and has an appropriate focus on poverty reduction, including specific measures to increase spending on social services. Directors encouraged the authorities to maintain their timetable for the completion of a fully-participatory PRSP, that will guide the allocation of public resources.

Directors supported the medium-term focus of the program on consolidating the fiscal position, addressing the unsustainable domestic debt situation, and encouraging private sector-led growth, with a view to achieve sustainable growth and improve the delivery of social services. Further reductions in recurrent expenditure, along with lower domestic interest costs, will be needed to raise expenditure on infrastructure and social services, while virtually eliminating the overall fiscal deficit and government recourse to domestic bank financing.

Directors underscored in particular the importance of measures to further reduce transfers to public enterprises, contain the public sector wage bill, and phase out consumer petroleum subsidies. They viewed the planned introduction of an automatic and transparent pricing mechanism for retail petroleum products as an essential step in this regard. The efforts to limit monthly stipends to university students abroad were seen as necessary. Over the medium term, the authorities should make a sustained effort to improve public expenditure management, for which they will need appropriate technical assistance. On the revenue side, Directors urged the authorities to move forward with the preparation for the introduction of the VAT and a new external tariff regime.

Directors emphasized that the establishment of an independent central bank will be key to strengthening macroeconomic stability. In this regard, they supported the government's objective of implementing a new central bank organic law by midyear, which will establish an independent central bank with price stability as its primary objective.

Directors noted that the authorities' external sector strategy appropriately focuses on reducing the country's large current account deficit over the medium term through an increase in net exports and sustainable official transfers, and, in this context, they encouraged the authorities to continue their efforts to normalize relations with official creditors. Directors considered that the exchange rate peg remains appropriate, while noting that this will require continued fiscal consolidation and an appropriately tight monetary policy. Directors also encouraged the authorities to move on with their privatization program, and to continue to implement policies aimed at enhancing external competitiveness and promoting nontraditional exports to take advantage of the opening of markets. Directors welcomed Cape Verde's expressions of support for the global fight against the financing of terrorism, and urged the authorities to put in place a blocking order on terrorist assets.

Despite improvements, the statistical system remains weak, and Directors encouraged the authorities to seek capacity-building technical assistance to improve the statistical base, particularly as it relates to the national income accounts, balance of payments and poverty statistics.

The Executive Board took the following decision:

1. The government of Cape Verde has requested a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) in an amount equivalent to SDR 8.64 million.

2. The Fund determines that the Interim Poverty Reduction Strategy Paper (I-PRSP) submitted by Cape Verde set forth in EBD/02/47, 3/22/02 provides a sound basis for the development of a fully participatory Poverty Reduction Strategy Paper (PRSP) for Fund concessional financial assistance.

3. The Fund approves the arrangement set forth in EBS/02/54, Supplement 1 (4/5/02) and decides that Cape Verde may request the first disbursement under the arrangement on the condition that the information provided by Cape Verde on the implementation of the measures specified in Table 2 attached to the letter dated March 11, 2002 is accurate.

4. Paragraph 3 above shall become effective on the date on which the Fund decides that the World Bank has concluded that the I-PRSP provides a sound basis for the development of a fully participatory PRSP for Bank concessional financial assistance. (EBS/02/54, 3/22/02)

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April 4, 2002

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SHAILENDRA J. ANJARIA  
Secretary