

## I. INTRODUCTION

1. **Over the past eighteen months, the Executive Board has reflected on the conduct of surveillance in countries with Fund-supported programs on several occasions—the 2002 biennial review of surveillance and its follow-up; the discussion on *enhancing the effectiveness of surveillance*; Board meetings on the Independent Evaluation Office (IEO) reports on prolonged use of IMF resources and the role of the Fund in recent capital account crises.<sup>1</sup> Executive Directors endorsed a number of specific steps to strengthen surveillance in general and Article IV consultations in program countries specifically.**

2. **Building on these discussions, this paper considers ways to improve the quality of the surveillance process, focusing on the question of how to bring a fresh perspective to the Fund’s analysis and policy recommendations in member countries—especially, but not exclusively, program countries:**

- First, it addresses some of the challenges the Fund faces in strengthening surveillance and, particularly, in ensuring that fresh and thorough reassessments of economic conditions and policies are regularly conducted for each member.
- Second, it brings together the main initiatives the Fund has set in motion to address these challenges. These initiatives provide an integrated and reasonably comprehensive approach.
- Third, it offers tentative considerations on progress toward implementing this approach, and points to several significant obstacles and difficulties.
- Fourth, looking toward the 2004 biennial review of surveillance, it offers for discussion some avenues for improving particular dimensions of Fund surveillance.

3. **This paper is meant to complement earlier discussions of Fund surveillance, including the March 28, 2003 Board discussion on enhancing the effectiveness of surveillance.<sup>2</sup> It does not purport to provide a comprehensive review of the framework of surveillance: for instance, the paper does not cover such important issues as surveillance over systemically or regionally important countries or the Fund’s ability to induce members to act**

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<sup>1</sup> *Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977 Decision* (PIN/02/44); *Summing Up by the Chairman—Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977 Surveillance Decision—Follow Up*; *Summing Up by the Acting Chair—Evaluation by the Independent Evaluation Office of Prolonged Use of IMF Resources; Enhancing the Effectiveness of Surveillance—Operational Responses, the Agenda Ahead, and Next Steps* (PIN/03/50); *Conclusions of the Task Force on Prolonged Use of Fund Resources* (PIN/03/49).

<sup>2</sup> *Enhancing the Effectiveness of Surveillance—Operational Responses, the Agenda Ahead, and Next Steps* (PIN/03/50).

on its policy advice, which were previously discussed by the Board. Accordingly, the avenues for strengthening surveillance presented for discussion in Section V are to be seen against the background of the areas previously identified by Executive Directors for further work and reflection.

## II. FRESHNESS OF PERSPECTIVE

4. Much of the recent discussions within the Fund about surveillance reflect **concern about our ability, with existing mechanisms, to forestall crises or to adapt programs and policies to rapidly evolving circumstances** in individual countries and global markets. These concerns are worth reviewing before assessing how they can best be addressed.

5. The crises in **emerging market countries** in recent years resulted from a combination of factors:

- These crises generally *originated* in one or more of four areas of vulnerability: unsustainable exchange rate regimes; public and external debt problems; banking sector fragilities; and large-scale currency mismatches between assets and liabilities of the public and/or the corporate sector. These weaknesses in policies and fundamentals were magnified by domestic political challenges or the uncertainty created about policy by the electoral cycle. Addressing these sources of risk has been central to the reform of surveillance.
- At the same time, crises often ignited or worsened because of (i) changes in global or regional economic circumstances, which put immediate stress on country-specific vulnerabilities, or (ii) sudden developments in international capital markets, which affected prospects for external financing. To capture these rapid changes and developments in the external environment, assess their likely impact in a timely manner, and draw appropriate policy conclusions, **effective surveillance requires a mechanism that operates at a higher-frequency than Article IV consultations and one that integrates bilateral and multilateral analysis.**

6. **Countries that do not yet have access to capital markets** face different, but equally serious, vulnerabilities. Many are highly sensitive to commodity price swings, and almost all are affected by demand in major export markets. Shifts in these exogenous influences tend not to be as rapid or capricious as those in financial markets, and their effects on those countries are likely to be more progressive.

7. **For both groups of countries, effective surveillance periodically requires a fundamental reassessment from a fresh perspective that is fully cognizant of evolving economic and political circumstances** that impinge on program design and policy feasibility. This reassessment should be informed by institutional wisdom, i.e., an appreciation of what has worked in similar circumstances elsewhere and in the past.

8. **Periodic reassessments of economic conditions and policies are necessary for all countries**, and not solely for program countries. While previous discussions have focused on concerns about bringing a fresh perspective to the policy frameworks of program countries, the need for a fresh perspective extends beyond these countries. It is important, for instance, to reassess staff's policy prescriptions for non-program countries that are experiencing a build-up of vulnerabilities to external shocks or are facing significant changes in external conditions, and for non-program countries showing a chronic inability to realize their growth potential in a sustainable way.

9. **A variety of pressures work against undertaking a thorough reassessment of strategy at frequent intervals. Reassessments can be particularly difficult in a program environment:**

- In a program context, the challenges of simply keeping a program on-track, particularly in complex cases, draw resources away from those available for strategic reviews. Rapid decisions and action are often required to respond to sudden developments; thus, the pressures of a crisis can tend to crowd out different or fresh perspectives.
- Staff (or the Board) may be disinclined to criticize and alter its own previous policy advice, i.e., there may be a problem of “capture”.
- Staff (or the Board) may be wary of “arguing with success”. A sustained record of strong economic performance may inhibit or shade analysis of evolving vulnerabilities, including those emanating from the private sector.
- In circumstances where all available options involve high risks, there may be a reluctance to subject—or to be seen to be subjecting—the current policy framework (or the program design) to a thorough scrutiny for fear of reducing confidence in the viability of this framework (or in the likelihood of success of the program).
- Pressures against an in-depth examination of a policy framework may arise when such an examination risks calling into question political commitments that constrain economic policy, such as the exchange rate regime, or delaying completion of a program review.

10. These reflections suggest that **a credible approach for Fund surveillance needs to combine relatively low-frequency mechanisms** (i.e., Article IV consultations and related forward planning exercises) and **high-frequency instruments** (i.e., the vulnerability assessment exercise for emerging market countries). In addition, to counteract the pressures described above, these mechanisms and instruments need clear **procedures** that compel the Fund to step back periodically from the press of day-to-day operations and reassess its strategy toward each member country, and stronger **analytical tools** that can provide more disciplined assessments of key questions (e.g., debt sustainability).

11. **Successful surveillance, of course, does not depend solely on the staff, but principally on country authorities.** Member countries must be willing to step back and reassess the adequacy of the policy framework in the face of changing conditions. In a program context, member countries must be ready and willing to engage on the larger issues relevant for Fund surveillance that go beyond the specific details of program reviews, even if this is inconvenient and politically uncomfortable.

### III. EVOLUTION OF SELECT DIMENSIONS OF SURVEILLANCE

12. A range of initiatives is under way to strengthen the dimensions of surveillance highlighted above. These initiatives are proceeding along four tracks: enhancing Article IV consultations, including those with program countries; developing further the vulnerability assessment exercise for emerging market countries; strengthening the internal review process; and boosting the candor and transparency of the Fund's assessments.<sup>3</sup> In each of these four tracks, these initiatives could be interpreted as providing staff with different prisms through which to analyze a member's economic situation so as to avoid tunnel vision.

#### A. Article IV Consultations

##### Analytical Requirements

13. For a large segment of the membership, **a reassessment of economic conditions and policies from a fresh perspective requires an in-depth analysis of vulnerability, including in the following areas: inadequate exchange rate regimes; public and external debt sustainability problems; banking sector fragilities; and large-scale currency mismatches between assets and liabilities.** These four areas of vulnerability have figured prominently in the origins of recent crises. In addition, a clear understanding of **political forces and constraints** is critical to an assessment of the probability of success and sustainability of reforms, or of the authorities' ability to implement needed policy adjustments in the event of external shocks or unfavorable domestic developments.

14. **Substantial work has been done, and is under way, to develop better tools, processes, and guidelines for vulnerability analysis in all Article IV consultations:**

- Guidance to staff stipulates that all Article IV consultation discussions and reports should include a candid appraisal of the appropriateness of the exchange rate regime

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<sup>3</sup> These initiatives—with the exception of the steps taken to enhance the efficiency of the internal review process, which falls under management's mandate—have been previously discussed by the Executive Board in a piecemeal fashion.

and its consistency with underlying policies, as well as a forthright assessment of the exchange rate level.<sup>4</sup>

- A strengthened framework for assessing public and external debt sustainability was adopted in June 2002. Enhancements to this framework were agreed by the Executive Board in June 2003.<sup>5</sup> Use of the framework helps to discipline assessments of debt sustainability by laying bare the assumptions on which debt projections rest and by systematically subjecting baseline projections to sensitivity tests (i.e., stress tests and alternative scenarios).
- A range of instruments have been defined to enable more continuous and effective financial sector surveillance: the Financial Sector Assessment Program (FSAP), which is the key tool for strengthening the monitoring of financial systems; focused updates; targeted assessments of key issues during Article IV consultation missions; and ongoing monitoring of financial sector developments from headquarters, including through analysis of financial soundness indicators.<sup>6,7</sup>
- Balance sheet weaknesses—particularly large scale currency mismatches between assets and liabilities—are the focus of a large volume of analytical work.<sup>8</sup> This work aims at deepening understanding of factors contributing to the emergence of balance sheet fragilities, transmission of these weaknesses across different sectors, and policies that can spur reduction of these fragilities (e.g., development of domestic bond markets, strengthened control over bank lending in foreign currencies) or limit their adverse impact (e.g., reserve buffers).
- Reports on the Observance of Standards and Codes (ROSCs) play an important role in providing disciplined diagnoses of institutional weaknesses, as well as remedies to

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<sup>4</sup> *Operational Guidance Note for Staff Following the 2002 Biennial Surveillance Review* .

<sup>5</sup> *Concluding Remarks by the Acting Chair—Assessing Sustainability* (PIN/02/69). *Sustainability Assessments—Review of Application and Methodological Refinements*.

<sup>6</sup> *Financial Sector Assessment Program—Review, Lessons, and Issues Going Forward* (PIN/03/46).

<sup>7</sup> Executive Directors strongly encouraged systemically important countries, countries with potential vulnerabilities, or those facing significant structural changes to participate in the FSAP at an early stage, while reiterating that FSAP assessments should remain voluntary. *Ibid*.

<sup>8</sup> *A Balance Sheet Approach to Financial Crisis*, WP/02/210; *The Balance Sheet Approach and its Applications at the Fund*; *Financial Stability in Dollarized Economies*; *Macroeconomic Policies in Dollarized Economies*; *The Acting Chair's Concluding Remarks—Macroeconomic Policies and Financial Stability in Dollarized Economies*; *Debt- and Reserve-Related Indicators of External Vulnerability* (PIN/00/37); and *Global Financial Stability Report*.

address these weaknesses, in a broad range of areas critical to the effective conduct of macroeconomic policies, the resilience of the financial system, and the framework for private sector activity more broadly.<sup>9</sup>

- Reporting on political economy issues in staff reports is being gradually expanded.

### **Consultations in Program Countries**

15. **A range of other measures have been taken to help ensure that Article IV consultations in program countries provide a reassessment of economic conditions and policies that is independent of the program framework.**

16. These measures have focused on three dimensions, namely **timing**, substantive **content**, and **separation from program discussions**:

- At the conclusion of the 2002 biennial surveillance review, the Executive Board endorsed guidance on timing of Article IV consultations in program countries, and adopted a decision modifying consultation cycles for program countries. This guidance stipulates that Article IV consultations in program countries are likely to be most useful before a program is negotiated, when a program has moved seriously off-track, or in between programs.<sup>10</sup> The decision on consultation cycles allows Article IV consultations to be scheduled in accordance with this principle.<sup>11</sup>
- Guidance on the substantive content of surveillance in program countries was set out in the guidance note emanating from the 2002 biennial surveillance review. The guidance note stresses that Article IV consultation in these countries should entail a comprehensive assessment of recent economic developments, a candid analysis of the short- and medium-term outlook, a thorough discussion of risks and vulnerabilities, a stock-taking of the policy strategy to date, and a candid account of the dialogue between staff and the authorities on key policy issues and the program strategy looking ahead.<sup>12</sup> The IEO analysis of prolonged use of Fund resources provided further insight into key elements of surveillance in a program context. It emphasized *inter alia* provision of realistic scenarios and meaningful sensitivity analysis;

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<sup>9</sup> *International Standards--Strengthening Surveillance, Domestic Institutions, and International Markets* (PIN/03/43). ROSCs are voluntary.

<sup>10</sup> *Operational Guidance Note for Staff Following the 2002 Biennial Surveillance Review*.

<sup>11</sup> *Biennial Review of Implementation of Fund Surveillance and of 1977 Surveillance Decision—Changes in Article IV Consultation Cycles*, DEC No. 12794-(02/76), 7/15/2002; and *Biennial Review of Implementation of Fund Surveillance and of 1977 Surveillance Decision—Follow-Up*, DEC No. 12854 (02/96), 9/12/2002).

<sup>12</sup> *Operational Guidance Note for Staff Following the 2002 Biennial Surveillance Review*.

discussions of risks to the projections, risks and the impact of policy slippages, and policy alternatives and trade-offs; and frank review of previous UFR performance.<sup>13</sup>

- Since the conclusion of the 2002 biennial review of surveillance, a few area departments have experimented with alternative models for the conduct of Article IV consultations in program countries, which involved addition of a senior staff member, separate reports, or separate Board discussions. These cases are summarized in Box 1.

17. **Preliminary evidence suggests that practice is starting to evolve in line with recent policy initiatives.** Initial feedback from staff, the authorities, and the Executive Board points to some positive developments under both “standard” and “alternative” models for the conduct of Article IV consultations in program countries (e.g., consultations timed to give the Board an opportunity to take a step back *before* the start of discussions on new arrangements, the benefits of a broader perspective brought by an additional senior staff member, and the Board’s positive reaction to the Article IV consultation with Argentina concluded in early January 2003). However, this can only be considered a beginning. A thorough review of surveillance in program countries will be conducted in the context of the 2004 biennial review of surveillance.

#### **B. Vulnerability Assessment Exercise for Emerging Market Countries**

18. **The vulnerability assessment exercise for emerging market countries, which has been progressively refined since its introduction in May 2001, has become the principal high-frequency instrument in the panoply of tools required for conducting periodic fresh assessments of members’ economic situations.**<sup>14</sup> It provides the opportunity to detect

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<sup>13</sup> See Box I in Chapter VI of *Evaluation of the Prolonged Use of Fund Resources*.

<sup>14</sup> *Approaches to Vulnerability Assessment for Emerging Market Economies*.

### **Box 1. Article IV Consultations in Program Countries—Experiments**

**Alternative approaches to the conduct Article IV consultations have been used for five members so far.** These experiments have allowed for different degrees of separation between surveillance and program activities in mission leadership, reporting, or Board discussion.

**Albania:** One mission undertook both the 2002 Article IV consultation and the first review of the PRGF arrangement. During the mission, a period of time was reserved for the consultation discussions, and the EUI's Immediate Office reviewer for Albania participated in these discussions. The mission produced a single report, which was taken as one item by the Board.

**Macedonia:** Discussions on the 2003 Article IV consultation and a request for a stand-by arrangement were conducted jointly. An EUI staff member headed the mission and led the program discussions, while another staff member—who did not participate in the program-related aspects of the mission—led the consultation discussions. The mission produced a single report. This report was discussed as one item by the Board.

**Romania:** The 2002 Article IV consultation was conducted jointly with discussions on the third review under the stand-by arrangement. As in the case of Albania, a period of time was reserved for the consultation discussions and the EUI's Immediate Office reviewer for Romania participated in these discussions. Following the mission, due to delays in completing the program review, the Article IV consultation and the review were decoupled: a separate report for the Article IV consultation was produced and discussed by the Board. A report for the program review was considered by the Board three months later.

**Argentina:** Efforts to reach agreement with the Argentine authorities on a program lasted all of 2002. Discussions with the authorities were held on numerous occasions in 2002, with the last mission for the Article IV consultation held in December. A separate Article IV consultation report was produced in December 2002 and discussed by the Board in early January 2003. Following another mission, a report on the request for a stand-by arrangement was produced and discussed later that month.

**Brazil:** The 2003 Article IV consultation and the second review under the stand-by arrangement were undertaken jointly. The mission team produced separate reports for the Article IV consultation and the second review. The Board discussed these two reports together.



incipient vulnerabilities, to reflect on rapid changes in the external or domestic environment, and to consider policy responses to alternative global scenarios. The exercise may be complemented with *ad hoc* cross-country strategic reviews, as required by circumstances.<sup>15</sup>

19. **The exercise's main features are:**

- It is **conducted at a high frequency**. The work is done every six weeks, alternating between a full-fledged exercise and an interim update. Supplementary *ad hoc* updates are undertaken as required by circumstances.
- It **combines bilateral and multilateral surveillance**. The starting points of each exercise are an assessment of the latest revisions to the global economic outlook and their implications for emerging market countries; and an assessment of conditions in international capital markets, including market access for emerging market countries and market views on individual countries' vulnerabilities.
- It **provides a platform for an independent assessment by relevant functional departments of key risks in individual countries**, such as fiscal sustainability and banking system vulnerabilities, from a cross-country perspective.
- It explicitly **assesses external financing needs** for the period ahead under alternative scenarios to help analyze liquidity risks.
- It **makes use of early warning system (EWS) models** as a cross-check against staff's views on the degree of individual countries' crisis vulnerability. While EWS models are far from perfect—in particular, they suffer from high false signal ratios—they can be used as a device to indicate possible problems warranting further investigation.

20. **The results of the vulnerability exercise feed into staff's analysis in Article IV consultations, other surveillance exercises (e.g., staff visits), requests for use of Fund resources, and program reviews.** At present, the Executive Board is informed about the results of this exercise in "country matters" and WEMD sessions, informal meetings on individual countries, and Article IV consultation and UFR staff reports.

### **C. Strengthening the Internal Review Process**

21. **The Fund's internal review process plays a key role in the assessments of economic conditions and policies in member countries.** Its main features are:

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<sup>15</sup> For example, such an *ad hoc* exercise was conducted in the wake of the September 11, 2001 terrorist attacks. It was one of key inputs into the October 5, 2001 *Statement of the Managing Director on the Situation of the World Economy and the Fund Response*.

- Functional departments, including the Research Department, provide an independent review of key issues within their areas of expertise (e.g., public debt sustainability, financial sector fragility, assessment of data quality, safeguards to Fund resources).
- PDR plays a central role in providing an independent assessment of the overall strategy recommended by the area department for each member.
- The process is designed to present Management with an integrated assessment and set of recommendations by staff for each Article IV consultation or program discussion, but also to expose Management to substantive differences of views across departments.
- The review process operates at every stage of an Article IV consultation or program discussion, from the initial definition of the main issues to be addressed and proposed policy prescriptions to the mission to the elaboration of the staff report for the Executive Board. A substantial part of the process takes place through informal exchanges between the country team and reviewing departments; the process is, thus, more than the sum of the considerable number of formal memoranda between departments and between staff and management on country documents.

22. **Management recently introduced changes to enhance further the effectiveness of the review process and clarify departmental responsibilities** These changes call *inter alia* for (a) more systematic use of early consultations between area and functional departments, with a view to forming a common understanding on the key issues to be addressed in a given member country and to bringing to bear Fund-wide expertise on these issues at an early stage; (b) greater use of lessons learned from past experiences of the membership at large, so as to enrich analysis of potential remedies to a given member's current difficulties; and (c) closer focus on strategic issues.

23. In addition to the above changes, **PDR has adopted differentiated review procedures for Article IV consultation briefs and reports for program countries.** Specifically, these documents will be reviewed by the Surveillance Operations Division (SUR), in addition to being reviewed by the Stand-By Operations Division (SBO) or the PRGF Operations Division (POD), so as to provide a second look at the conduct of these Article IV consultations to ensure that they meet the test of independent surveillance.

24. To complement the regular review process:

- Management established the **Crisis Resolution Issues Division** in PDR to bring together specialized expertise on the resolution of capital account crises and to help build and disseminate lessons from cross-country experience in these cases.

- **In complicated and high risk cases, *ad hoc* interdepartmental task forces** draw together senior staff from across the Fund with operational expertise in crisis management and resolution.
- **For each prolonged user of Fund resources, an interdepartmental *ex post* assessment and forward planning exercise will be conducted.**<sup>16</sup> The exercise will cover an analysis of the economic problems facing the country, a critical and frank review of progress during the period of Fund-supported programs, and a forward-looking assessment that takes into account lessons learned and presents a strategy for future Fund engagement.

#### **D. Candor, Transparency, and the Executive Board**

25. **Candor in staff's presentations to the Executive Board and greater transparency by members and by the Fund are important complements to efforts to improve surveillance.** Candor and transparency are essential to providing the Board with the information necessary to form an independent judgment on staff's recommendations, and to allowing the public to develop independent views on the Fund's surveillance and program activities.

26. **Management has made a number of efforts to improve the quantity and quality of information provided by staff to the Executive Board.** These efforts include encouraging staff to produce more candid reports; greater frequency of consultations with the Board in a program context, including in, but not limited to, exceptional access cases; and improvements to the quality and candor of these discussions. Narrowing the gap between staff's assessments of country vulnerabilities or program risks and presentation of these assessments in staff reports or oral presentations to the Board is important to the process of decision making by the Board. As past reviews of the Fund's transparency policy have suggested, staff faces a difficult balance between the need for confidentiality in dealing with sensitive issues in the Fund's dialogue with its members and the necessity of providing the Executive Board with all the necessary information to allow it to discharge its duties.

27. **The Fund's transparency policy and, specifically, efforts to boost publication of staff reports can play a vital role.** Publication of Letters of Intent, Memoranda of Economic and Financial Policies, Poverty Reduction Strategy Papers, and staff reports allows scrutiny of the members' policies and the Fund's economic analysis and policy recommendations in both surveillance and program contexts.<sup>17</sup> This provides an additional incentive for the institution to

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<sup>16</sup> *Conclusions of the Task Force on Prolonged Use of Fund Resources* (PIN/03/49).

<sup>17</sup> Beside publication of staff reports, efforts to spur dissemination of good quality through the data standards initiative, as well as directly through Fund statistical publications, can facilitate independent analysis by the public and, thus, stimulate freshness of perspective.

ensure that its analysis and advice are of the highest quality. Publication also allows members of the public to come to an informed view on the Fund's activities and, thus, to provide a multitude of independent perspectives on the Fund's surveillance and the programs the institution supports. As previously noted, there is inevitably a degree of tension between greater transparency, on the one hand, and, on the other hand, candor and clarity in the Fund's policy assessments and prescriptions.

#### IV. IMPLEMENTATION CHALLENGES

28. **The Fund faces significant challenges in implementing these key dimensions of surveillance more systematically across the membership.** Set against the considerations presented in Section II of the paper, these dimensions integrate the best of what is known about vulnerability assessments within and outside the Fund. Yet, partly because many of their components have been introduced recently, the Fund has some further distance to go before being able to declare that normal practice in its surveillance is sufficiently close to the desired standard.

29. Based on early experience with the framework, **the main challenges appear to be:**

- **Data provision:** Data requirements for a comprehensive analysis of crisis vulnerabilities are substantial. Despite the major gains in the past several years, the quality of disclosure of public sector liabilities and financial sector exposure is still inadequate in many countries with substantial vulnerabilities.
- **Early integration of vulnerability assessments:** An effective approach requires bringing together the analysis of various departments in their areas of expertise (e.g., capital market conditions, debt sustainability, financial sector assessment, exchange rate policy) early in a given surveillance exercise (or program design), i.e. when views on the pros and cons of alternative economic policy strategies are being reconsidered. The risk of not doing so is that views on appropriate economic policies become entrenched before all potential sources of vulnerability or stress have been considered.
- **Realism in baseline scenarios:** The risk of bias in baseline scenarios towards optimism is well understood—stemming, for instance, from assuming full implementation of corrective policies and rapid positive response from the private sector to such implementation—and hard to combat. Yet, realism of the baseline scenario is essential for a sober assessment of the viability of alternative economic strategies.
- **Analysis of alternative scenarios:** There often appears to be a reluctance on the part of both staff and the authorities to engage in—and report on—a substantive dialogue on “what-if” scenarios. This may be attributable to the fear that public disclosure of such discussions could undermine confidence and increase the probability of adverse scenarios being realized. Yet, systematic identification of major potential shocks that a

member country could face, analysis of the potential consequences of these shocks, and discussion of contingency plans for dealing with them has to be an essential component of surveillance.

- **Building more caution or greater cushions into the Fund's policy recommendations:** Experience suggests that the Fund needs to recalibrate its analysis of what constitutes a prudent level and composition of public debt, a sustainable fiscal path, and more generally a necessary level of self-insurance in a world of recurring external shocks. Making a convincing case for cautious policies when crisis risks are not imminent or vulnerabilities are not immediately apparent remains challenging. This requires strengthening further analyses of sources of vulnerabilities, channels of transmission of crises, and best policy options for crisis prevention, and incorporating fully such analyses into the Fund's operational work.
- **Follow through on recommendations of FSAP exercises and ROSCs:** As discussed during the recent reviews of the FSAP and standards and codes initiative, greater prioritization of institutional reforms to remedy weaknesses detected in FSAP assessments and ROSCs policy recommendations, as well as more focus on, and support for, their implementation, are needed.
- **Fund surveillance in low-income countries:** Efforts to bring freshness of perspective in Fund surveillance concern all member countries. Yet, apart from the timing of Article IV consultations, there has been little specific reflection on how these efforts apply to low-income countries, including countries that have made use of the PRSP approach.
- **Use of outside expertise:** The press of daily work, the time and efforts spent on bringing together staff's knowledge on a variety of issues and forging an internal consensus on policy recommendations, and the focus on the dialogue with member countries often conspire to make it difficult for Fund staff to be fully aware of, and to reflect in depth upon, such expertise.

## V. AVENUES FOR STRENGTHENING EXISTING INITIATIVES

30. Strengthening surveillance across the above dimensions will require diligent, persistent, and consistent work by the Fund in its daily operations, as well as close and active cooperation of its members. In parallel, the Fund needs to consider periodically whether further improvements to the elements of the surveillance framework described in Section III—and, generally, to all aspects of the surveillance framework—could prove helpful. In doing so, the Fund must also consider that a reasonable degree of stability of the surveillance framework facilitates its implementation. Complementing the conclusions reached by Executive Board at the March 2003 meeting on enhancing the effectiveness of surveillance, a few avenues for reflection are presented below. Depending upon the reactions of Directors, these—or other—paths could be pursued in the context of the 2004 biennial surveillance review.

31. Some Directors have asked for a detailed assessment of the pros and cons of **greater operational separation between program and surveillance activities**.<sup>18</sup> There is a range of potential options for achieving greater operational separation between program and surveillance activities, with varying implications for the present institutional and governance structure of the Fund. Among these are the following: (i) the Executive Board could require stand-alone Article IV consultations in every program country with a separate Board paper and, possibly, a separate Board discussion;<sup>19</sup> (ii) the Board could require that stand-alone Article IV consultations be conducted by separate teams from those conducting UFR discussions; (iii) the Board could require that stand-alone consultations be conducted by separate teams and that the Article IV consultation reports be sent directly to the Board by the staff team (i.e., without review by the relevant area department or PDR, or approval of Management); and (iv) the Board could require an independent assessment from outside the Fund.

32. In evaluating these and other options, a number of broad questions would need to be addressed. These questions include: (i) Would Management or the Board get better analysis and advice from a staff team that is not continuously engaged in policy debates arising from program activities in the *country* of concern, or from a staff team with less involvement in the circumstances of the *region* at issue? (ii) At what level of the Fund is there likely to be “capture” by the program framework—the mission team, the staff as a whole, Management, or the Board? And at what level should integration of views on policy design for a given member be sought? (iii) Would the burden placed on country authorities of having to engage with two separate Fund teams be justified by the potential benefits of surveillance consultations completely independent of program reviews? (iv) Would country authorities be as forthcoming with two teams? (v) Would the Executive Board be in a position to make better UFR decisions if it were given a view on programs independent of staff, or management, or both?

33. Management and staff have drawn occasionally on **outside experts to help inform strategy in specific cases**. One recent example was the panel of independent advisors that

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<sup>18</sup> *Enhancing the Effectiveness of Surveillance—Operational Responses, the Agenda Ahead, and Next Steps* (PIN/03/50).

<sup>19</sup> The practice of combining Article IV consultation reports with program discussions was developed in the early 1980s in response to a surge in requests for use of Fund resources. At the conclusion of the 1984 review of surveillance, Directors stated that “to maintain the quality of consultation work, the staff would continue to combine requests for use of Fund resources and periodic reviews with consultation reports.” At the same time, Directors “reiterated their views that consultations should not be delayed on account of discussions on the use of Fund resources.” See *The Chairman’s Summing Up at the Conclusion of the Review of the Document “Surveillance Over Exchange Rate Policies” and Annual Review of the Implementation of Surveillance*.

provided an opinion on Argentina's monetary system in the summer of 2002.<sup>20</sup> Consideration could be given to the circumstances under which the Fund could make greater use of specialized expertise from outside the institution.

34. Consideration could also be given to the **use of outside experts in the 2004 biennial review of surveillance** to ensure that the review itself benefits from an independent perspective. For instance, outside experts could be asked to provide input on the design and coverage of the review and, subsequently, to provide feedback on the review, including on the assessment of the conduct of surveillance in program countries since 2002.

35. The Fund has considered on a number of occasions the efficacy of a system of public "escalated signaling" to spur countries to act to reduce the risk of crisis. These proposals have not been adopted by the Board mainly for fear that they would precipitate the very crises they were meant to help avoid. The Board could reflect, however, on how it could best send strong messages to members on a confidential basis **where there is high concern about sustainability**. In this context, based on experiences with similar procedures in the past, **the Board could consider a more frequent, structured process for surveillance** in these cases.

36. Assessments of crisis vulnerabilities in countries with market access have evolved considerably over the past ten years. While they will undoubtedly continue to be developed, this may be an opportune time to produce an **integrated guidance note to staff on vulnerability assessments**, which would summarize best practices and focus on the connections to be made between the numerous elements to be considered (e.g., world economic outlook, supply-side factors affecting international capital flows, risks of contagion, macroeconomic policy framework, debt sustainability, financial sector assessment, currency mismatches and liquidity risks, institutional strengths and weaknesses, financing needs, etc.). This guidance could draw on the CCL eligibility framework previously discussed by Executive Directors, as well as on cross-country expertise on calibration of policies to reduce vulnerability to shocks.<sup>21</sup> As part of this, **the Fund needs to revisit its policy advice on public debt management** in member countries, with emphasis on both level and structure of debt. Consideration could be given to how the Fund could play a more active role in this area in both its surveillance and program activities.

37. There is, in staff's view, a need to **reassess surveillance in low-income countries** in light of the frameworks provided by the Poverty Reduction Strategy Papers and arrangements under the Poverty Reduction and Growth Facility. Generally, it would seem useful to re-evaluate how Fund surveillance can best contribute to the development of conditions propitious to sustained high growth in low-income countries.

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<sup>20</sup> The panel comprised Messrs. Crockett, Crow, Rojo, and Tietmeyer.

<sup>21</sup> As regards the CCL eligibility framework, see Annex III of *Review of Contingent Credit Lines*.

## VI. RESOURCE IMPLICATIONS

38. The resource implications of the initiatives discussed in Section III have been previously considered by Executive Directors in the context of recent policy reviews (e.g., the 2002 biennial surveillance review and its follow-up, the 2003 FSAP review) and discussions of IEO recommendations (e.g., the discussion of the conclusions of the task force on prolonged use of Fund resources).

39. Overall, as concerns the range of initiatives discussed in Section III, staff continues to expect that these initiatives can be pursued within the FY 2004 budget envelope and the medium-term budget framework. The FY 2004 budget explicitly allows for an increase in the share of resources devoted to bilateral and regional surveillance, including resources allocated to enable a fresh perspective on country strategies in Fund surveillance.<sup>22</sup>

40. As specifically regards Article IV consultations in program countries, experience over the past year suggests that resources may need to be drawn from other uses to the extent that fresh reassessments of economic conditions and policies require more in-depth analysis and more extensive discussions with country authorities than previously done. Resource augmentation may take various forms, including longer missions, addition of staff from the concerned area department, or—depending on the nature of issues to be addressed—addition of staff from functional departments.

41. Some of the avenues for reflection presented in Section V, particularly the options for achieving greater operational separation of surveillance and program activities, would have resource implications. If these options were to be considered further, more specific proposals would be brought to the Board that would include comprehensive costs estimates for the FY 2005 budget and a statement on how they could be financed within the Fund's medium-term framework.

## VII. ISSUES FOR DISCUSSION

42. The paper argues that bringing a fresh perspective to the Fund's analysis and policy recommendations in member countries is an issue that:

- concerns all countries—not solely program countries (although the danger of “capture” may be more imminent for UFR cases);
- needs to be addressed through a comprehensive approach combining Article IV consultations (and related forward-planning exercises) and higher-frequency multilateral instruments (the vulnerability assessment exercise for emerging market

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<sup>22</sup> *The FY 2004 Budget and the Medium-Term Framework.*



countries and *ad hoc* cross-country strategic reviews)—not solely through Article IV consultations; and

- requires reliance on both clear procedures to compel a step back from the press of daily activities and an effective use of strong analytical tools, which can deliver higher-quality policy assessments—it is not amenable solely to procedural solutions.

*Do Directors agree with these views?*

43. The paper describes the variety of initiatives under way to ensure that fresh assessments of economic conditions and policies are regularly conducted in each member country. They include various mechanisms to strengthen the analytical rigor of Article IV consultations and, in program countries, their independence from the program framework, efforts to refine further the vulnerability assessment exercise for emerging market countries, a sharpening of the focus of the internal review process, and greater candor in staff's presentations to the Executive Board and transparency vis-à-vis the public.

*Do Directors consider that these initiatives, as they are applied more systematically, will contribute sufficiently to bringing about regular fresh reassessments of economic conditions and policies in each member country?*

44. The paper indicates that a few area departments have experimented with alternative models for the conduct of Article IV consultations in program countries. These experiments involved incorporating a senior “outsider” (i.e., an individual that is not a regular member of the mission team) in the Article IV consultation mission, producing separate reports for the Article IV consultation and use of Fund resources discussions, or holding separate Board discussions.

*Do Directors consider it beneficial to pursue these experiments on a selective basis—taking into account differences in members' circumstances (including differences in constraints on their administrative resources) and departmental staff constraints?*

45. The paper highlights a number of challenges that, as suggested by preliminary experience, will likely be faced in the implementation of the set of initiatives for bringing freshness of perspective in Fund surveillance.

*How do Directors assess these challenges? Do they see other challenges to be confronted?*

46. The paper presents a few avenues for reflection for strengthening further the surveillance policy framework, including options for achieving greater operational separation between program and surveillance activities with varying implications for the Fund's governance structure.