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Abstract

The International Monetary Fund (IMF) recently adopted the "2007 Decision on Bilateral Surveillance Over Members' Policies," a landmark reform that modernizes the general principles of IMF surveillance. However, support for the reform was not unanimous, and doubts have been expressed about how the Decision would be applied in practice. The authors assess the first year of the Decision's implementation in Article IV reports. Using a questionnaire based on the key aspects of the Decision, they evaluate Article IV reports published before and after the adoption of the new Decision for a set of 24 countries. The authors find that the Decision has significantly increased the overall quality of Article IV reports, with improvements noted in emerging-market, advanced, and developing countries. Bilateral surveillance is more focused on external stability and core macroeconomic policies. Exchange rate analysis, in particular, has improved significantly. The authors note, however, that the integration with multilateral surveillance remains relatively weak and that cross-country spillovers still do not receive sufficient attention. Moreover, while most reports examine domestic stability in some detail, the link between domestic stability and external stability is not adequately analyzed. On the issue of the even-handed application of the Decision, the authors conclude that implementation has been broadly similar across country income groups, although differences remain for specific aspects of the Decision.

JEL classification: F33
Bank classification: International topics

Résumé

Le Fonds monétaire international a récemment adopté la *Décision de 2007 sur la surveillance bilatérale des politiques des États membres*, une réforme capitale qui modernise les grands principes de surveillance suivis par l'institution. Ce texte n'a cependant pas reçu de soutien unanime et sa mise en œuvre future soulevait des doutes. Pour évaluer la première année d'application de la *Décision*, les auteurs mesurent la qualité des rapports préparés au titre de l'article IV. Ils passent ainsi au crible d'un questionnaire portant sur les aspects essentiels de la *Décision* les rapports relatifs à un groupe de 24 pays parus avant et après l'adoption du nouveau texte. Celui-ci, constatent-ils, a sensiblement amélioré la qualité générale des rapports produits, des progrès s'observant pour les pays à marché émergent, les pays avancés et les pays en développement. La surveillance bilatérale est davantage axée sur la stabilité externe et les principales politiques macroéconomiques. L'analyse des taux de change s'est tout particulièrement améliorée. L'intégration de la surveillance multilatérale reste néanmoins

relativement insuffisante et l'incidence transfrontière des politiques des États membres ne reçoit toujours pas l'attention requise. Par ailleurs, si la plupart des rapports traitent assez amplement de stabilité interne, le lien entre cette dernière et la stabilité externe n'est pas examiné adéquatement. Quant à l'uniformité d'application, les auteurs relèvent que la *Décision* a été traduite dans les faits de manière globalement analogue dans toutes les catégories de pays, malgré la persistance de différences sous certains aspects.

Classification JEL : F33
Classification de la Banque : Questions internationales

1 Introduction

The challenge of maintaining the stability of the global financial system in an environment of increasing economic integration led members of the International Monetary Fund (IMF, or the Fund) to push for an improvement in the effectiveness of IMF surveillance. In June 2007, members signalled their commitment to reforming surveillance by adopting the "2007 Decision on Bilateral Surveillance Over Members' Policies" (IMF 2007a). This landmark statement (hereafter referred to as the Decision) updates the general principles of country-level surveillance, not only to ensure that they remain relevant in today's rapidly evolving global context, but also to increase the effectiveness of surveillance as the Fund's main tool in its crisis-prevention efforts. Country-level (or bilateral) surveillance is conducted largely through Article IV consultations (referring to the fourth article in the Fund's Articles of Agreement on exchange rate arrangements). In principle, these annual consultations are used to exercise "firm surveillance" over members' exchange rate policies; in practice, they consist of a comprehensive report on countries' macroeconomic conditions, policies, and outlook.

Although the Decision has the potential to improve surveillance, much will depend on how it is implemented. Indeed, many countries remain skeptical of these reforms, perhaps recalling less-than-favourable experiences with IMF surveillance in the past. They have questioned the extent to which the 2007 Decision, while promising on paper, will be put into practice.[1] Visible progress in the initial period of implementation is therefore key to increasing the chances of the Decision gaining widespread acceptance.

This paper evaluates whether and how the Decision has affected the quality of IMF bilateral surveillance in its first year of implementation. Using a questionnaire based on the key aspects of the Decision, we assess a sample of 24 Article IV reports from November 2007 to July 2008, comparing them with reports issued for the same countries before the activation of the Decision. Responses to this questionnaire are used to generate implementation scores for each country. To evaluate the impact of the Decision, we assess whether these scores significantly improved in the post-Decision sample. This survey-based information is then used to support a more general discussion of pre- and post-Decision Article IV reports. Our assessment aims to: (i) inform countries of the overall effectiveness of the Decision; (ii) provide IMF staff with guidance on areas where improvements are needed; and (iii) address concerns raised by certain countries,

1. For a sample of the concerns expressed by countries, see the International Monetary and Financial Committee statements of India (Chidambaram 2006), Belgium (Quaden 2006), Argentina (Miceli 2006), Brazil (Mantega 2006), and China (Zhou 2006).

such as regarding the even-handedness of the Decision's application. This study also aspires to complement the IMF's own internal review of surveillance, the Triennial Surveillance Review (TSR), which was carried out in the second half of 2008.[2]

We find that the overall quality of Article IV reports has improved since the adoption of the Decision. Article IV reports are more focused on external stability, and the core macroeconomic policies relevant to external stability. The quality of exchange rate analysis, in particular, has improved. Improvements in the quality of Article IV reports are seen in emerging-market, advanced, and developing countries. We note, however, that the link between domestic and external stability could be strengthened. Moreover, the integration with multilateral surveillance remains relatively weak and cross-country spillovers still do not receive sufficient attention. Broadly speaking, we find that the global or regional risks raised in either the IMF's *World Economic Outlook* (WEO) or *Global Financial Stability Report* (GFSR) are not adequately incorporated into bilateral surveillance. In addition, we find that while many reports remain focused on structural reforms, little effort is made to link these structural reforms to either domestic or external stability.

The issue of the even-handed application of the Decision is more difficult to assess. We find that aggregate implementation scores are similar across country income groups. For certain aspects of the Decision, however, such as the integration of bilateral and multilateral surveillance, there remain considerable differences in the quality of analysis in advanced, emerging-market, and developing countries. That said, these gaps have narrowed in the post-Decision sample, suggesting that the Decision has improved even-handedness. The reports of emerging-market economies (EMEs) register the biggest improvement in implementation scores in our post-Decision sample. This finding is not primarily the result of EMEs being examined with particular zeal, but rather is driven by the fact that the scores for EMEs are very low in the pre-Decision sample, giving them the greatest scope for improvement.

2 An Overview of the 2007 Decision

In 2005, IMF Managing Director De Rato and Fund staff launched the Medium-Term Strategy Review (MTSR) to reassess the way the Fund operates (IMF 2006b). Two key changes were proposed in the MTSR to reform surveillance: (i) a revision of the "1977 Decision on

2. The TSR is a periodic self-assessment process during which the IMF staff evaluates its surveillance performance. Until recently, a surveillance review was typically carried out every two years (the last one being in 2004), but the frequency has been decreased to three years. The first TSR was carried out in the fall of 2008.

Surveillance over Exchange Rate Policies" (IMF 1977), and (ii) introduction of the "Statement on Surveillance Priorities (SSP)."[3]

The new Decision revises the original 1977 version. The old Decision was designed for the period following the collapse of the Bretton Woods system, and was increasingly ill suited to guide surveillance in the current environment of widespread floating exchange rate regimes and highly integrated financial markets. It focused exclusively on surveillance over exchange rate policies, although, in practice, surveillance migrated into other areas that were not directly related to maintaining external stability. The Decision was expected to be revised with experience, but it remained almost unchanged since its adoption; consequently, a large gap developed between the desired surveillance outcomes based on the Decision and the actual conduct of IMF surveillance. In fact, one of the main findings of the Independent Evaluation Office's 2007 report (IEO 2007) was that, over the 1999–2005 period, the IMF was not as effective as it needs to be in fulfilling its core responsibility of surveillance over the international monetary system and members' exchange rate policies. It also became clear that IMF surveillance was not following best practice.[4] The revised Decision rectifies this situation by establishing the following principles and standards for effective surveillance:

1. **External stability is the objective of surveillance.**[5] The maintenance of external stability reflects the original intent of Article IV obligations. External stability occurs when a country's current and capital account positions are not in excessive disequilibrium, thereby making the country less vulnerable to abrupt changes in capital flows or exchange rates. In other words, external stability refers to a balance-of-payments position that is not likely to generate disruptive exchange rate movements. External stability is a forward-looking concept, and demands an assessment of future risks and vulnerabilities. The Decision also tries to bring greater transparency and objectivity to real exchange rates (RER) assessment. Notably, the notion of RER "fundamental misalignment" is introduced, as is exchange rate "manipulation."[6] In addition, the Decision revises the list of principles for the Guidance of Members' Exchange Rate Policies and provides an associated list of indicators that, when triggered, suggest the need for deeper discussions, and perhaps special consultations, between the Fund and the member in question (see Appendix B). A fundamentally misaligned currency is a key indicator.

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3. The SSP is a periodic statement drafted by the IMF Board to provide the Fund with a mandate to carry out, and report on, economic and operational priorities for surveillance over the course of a three-year period (corresponding to the TSR cycle). More generally, the SSP should be viewed as a mechanism to help implement the 2007 Surveillance Decision. The SSP was first used in the 2008 TSR. See IMF (2008) for details, and Lavigne and Schembri (2009) for an analysis of the SSP.
4. See, for example, Crow, Arriazu, and Thygesen 1999.
5. See paragraphs 4 and 5 of the Decision (IMF 2007a).
6. The Decision specifies that "manipulation" is carried out through intervention policies that generate an undervalued exchange rate, which increases net exports.

2. **Domestic stability promotes external stability.**[7] The Decision clarifies that policies aiming for the domestic objectives of sustained growth and price stability (which are Article IV objectives as well) are consistent and compatible with the maintenance of external stability.
3. **Surveillance must focus on policies that are critical to external stability.[8]** The revised Decision redefines the focus and scope of IMF surveillance, broadening its purview beyond exchange rates to domestic macroeconomic and financial policies, while limiting the scope of Fund analysis to core policies directly related to external stability.[9] In analyzing these policies, the Decision stresses the importance of taking a medium-term approach, examining policy objectives, implementation, and contingency plans. Moreover, surveillance should concentrate on policy outcomes, which are objective and measurable, rather than their intent, which is subjective and difficult to evaluate.[10]
4. **Bilateral surveillance must be well-integrated with multilateral surveillance.[11]** The Decision specifies that bilateral surveillance must take into consideration regional and global issues, and should be properly integrated into multilateral surveillance. In particular, attention should be paid to international spillover effects and the interactions between national policies.
5. **Surveillance should be candid and even-handed.** The Decision indicates that surveillance should be candid and even-handed, taking into consideration country specificities as well as the level of development.
6. **Surveillance is co-operative.** The revised Decision also underscores the co-operative nature of surveillance, which must be based on dialogue and persuasion rather than the strict policing of obligations.

This study aims to assess the extent to which Article IV reports respect points 1–4 above. These aspects of the Decision should be readily visible in Article IV reports, making them relatively straightforward to assess. Points 1–4 will henceforth be referred to as the four core aspects of the Decision.

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7. See part I A.6 of the Decision (IMF 2007a).
8. See paragraphs 5 and 11 of the Decision (IMF 2007a).
9. Two aspects are key: first, the Decision broadens the focus of surveillance beyond exchange rates to include the consistency with and between exchange rate, monetary, fiscal, and financial sector policies. Second, the Decision limits the scope of surveillance to these four core policies, and even then examines them only insofar as they have a significant bearing on external stability. The narrowed scope is intended to rein in Fund surveillance from areas beyond the IMF's mandate, such as structural and institutional reforms, and concentrate IMF resources on what it does best: namely, short- to medium-term macroeconomic analysis.
10. This is key for the assessment of spillover effects stemming from local policies, where the original intent of authorities is largely irrelevant in terms of the effects on other members. An important corollary of this principle is that the Decision recognizes the importance of exchange rates for facilitating adjustment and maintaining external stability, but removes the requirement that IMF surveillance attempt to infer "intent" to manipulate exchange rates for balance-of-payments purposes. Indeed, the focus of surveillance should be on the real consequences, intended or not, of a member's policies on external stability.
11. See paragraph 10 of the Decision (IMF 2007a).

The last two aspects (5 and 6) are not formally examined, because they are difficult to assess exclusively with written reports. Indeed, a proper evaluation of those aspects would require in-depth interviews with IMF staff and country authorities, which is beyond the scope of our study.[12] However, we can assess whether our results for the four core aspects suggest that the Decision was applied even-handedly across country income groups (namely, advanced, emerging-market, and developing countries). Admittedly, this approach considers a limited aspect of even-handedness, which in theory would demand that countries in similar circumstances be treated in a similar manner. Nevertheless, even a limited assessment of this key issue is relevant, because many emerging-market authorities have expressed concern that the Decision could be used as a tool to justify disproportionate focus on their economies.

3 Methodology

We have developed a checklist of questions that is used to assess the extent to which Article IV reports conform to the principles and standards of the Decision (see Appendix A). The questions are based on the Decision, and are designed to determine whether the above-noted four core aspects are addressed.[13] To isolate the effects of the Surveillance Decision, the checklist of questions is applied to the Article IV reports of the same countries both before and after the adoption of the Decision. This means that 48 reports have been reviewed in all (24 before the Decision and 24 after). A comparison of the results for these two subsamples will highlight whether the Decision has had a notable impact on the quality of surveillance.

Our sample includes the following 24 countries and regions: Algeria, Bahrain, Brazil, Canada, the Caribbean, Colombia, Ecuador, Egypt, the European Union, France, Germany, Hong Kong, India, Israel, Japan, Mexico, Myanmar, Namibia, Nigeria, Russia, Saudi Arabia, Serbia, the United States, and Zambia. These countries were selected from a total population of 100 reports that were issued between November 2007 and July 2008.

Our selection of the start date was determined by the fact that Article IV missions take, on average, about three to four months to complete, and it would not have been valid to include consultations that were already under way (or on the verge of beginning) when the Decision was approved by the Executive Board of the IMF at the end of June 2007. However, we noted that, in many cases, the Decision was implemented in fairly short order. This means that waiting for the

12. It should be noted that certain general aspects of surveillance assessment, such as timeliness, precision, and appropriateness of advice, are not examined here, since these issues are not specifically addressed in the Decision.
13. Appendix A provides details on the sections of the Decision to which the questions relate.

end of 2008 to get a wider sample would mean that, by then, the base year of comparison (before the Decision) would need to be 2006 for countries that had reports coming out in the July–December 2008 period. This would be problematic, since we want a similar base year for all countries, to make the comparison as even-handed as possible. In addition, to ensure the timeliness of our assessment, our sample had to end in mid-summer, before the 2008 TSR. Note, however, that our sample is broadly representative of the Fund membership, and includes half of the G-20 countries.

The checklist has a simple "yes/no/partially" response format. "Not applicable" is also a valid response for some questions. The responses yes, no, and partially are given the numerical values of 1, 0, and 0.5, respectively, in order to calculate the implementation score for each question. These results are then aggregated into policy-relevant group averages. For expositional clarity, we express the implementation scores as percentages ranging from 0 to 100 per cent; if, for example, all questions for a country were answered with a "yes," the report would get a 100 per cent score on the checklist. We then compare these scores for Article IV reports before and after the adoption of the Decision, in order to assess its overall implementation.

We also use the Wilcoxon signed-rank tests to test whether the implementation scores in the post-Decision sample are significantly higher than those in the pre-Decision sample, a result which should suggest that the Decision is being implemented and is having a positive impact on surveillance. This test is the non-parametric analogue to the *t*-test for correlated samples, and applies to two-sample designs involving repeated measures, matched pairs, or "before" and "after" measures. It tests the null hypothesis that there is no systematic difference within pairs against alternatives that assert a systematic difference (either one-sided or two-sided).[14] In this study, we apply a one-sided alternative hypothesis that the post-Decision scores are higher than the pre-Decision ones.

The test procedure is straightforward. It begins by ranking, from lowest to highest, the differences between the values in each pair without regard to sign. The cases in which there is zero difference between the values in each pair are eliminated from consideration, since they provide no useful information. Tied ranks are included where appropriate. Then, each rank is re-assigned the positive or negative sign that was determined by the difference between pairs of observations in the first step. The sum of the positive ranks (R^+) and of the negative ranks (R^-) is

14. The null hypothesis is that the *median* difference between pairs of observations is zero. Note that this is different from the null hypothesis of the paired *t*-test, which is that the *mean* difference between pairs is zero, or that of the sign test, which is that the number of differences in each direction is equal.

calculated. For a two-tail test, the smaller of R^+ and R^- is called T. This T is the statistic that may be compared with the critical values in the appropriate statistical table. For one-tailed tests, T will take the value R^+ or R^-, depending on the specification of the alternative hypothesis. In other words, if the null hypothesis was true, then we would expect the rank sums for positive and negative ranks to be the same; i.e., to have as many positive as negative differences. For the difference to be significant (i.e., to reject the null hypothesis), the calculated T must be less than or equal to the tabulated value. Note that, when the number of pairs is large ($n \geq 10$), the Wilcoxon test statistic has a sampling distribution that is approximately normal, close enough to allow for the calculation of a *z*-ratio, which can then be referred to the unit normal distribution. A positive aspect of the Wilcoxon signed-rank test is that it is a very powerful test. If all the assumptions for the parametric tests were met, this test would have about 95 per cent of the power of the parametric alternative.

Although we have striven to be as rigourous as possible, we consider our results to be indicative, serving to complement and frame our overall assessment of the Decision's implementation. Thus, we combine the test results with a simple analysis of group averages (where formal tests are not applicable), and a qualitative assessment of the reports, to produce an overall evaluation of how the Decision has affected surveillance and where improvements are required.

4 Overall Results

We find that the quality of Article IV reports has unambiguously improved since the adoption of the Decision. When considering aggregate implementation scores (i.e., all questions combined), the implementation scores in the post-Decision sample are significantly higher than those in the pre-Decision ones. This is true for the entire sample, regardless of the country income level, type of exchange rate regime, or presence of an IMF program (Table 1). Wilcoxon signed-rank tests corroborate these findings (Table 2).

The issue of even-handedness is challenging to assess. As noted, the overall scores have improved across all countries, be they EMEs, developing countries, or advanced economies (Chart 1).[15] In aggregate, similar post-Decision implementation scores for EMEs and advanced countries suggest that the Decision was implemented broadly symmetrically across countries.[16] However, in the disaggregated results we find considerable differences in the quality of

15. Charts 1–4 depict the average results before and after the Decision's implementation. The first and second bars of every set represent the pre- and post-Decision scores, respectively.
16. While the scores for developing countries were somewhat lower, this may be due to our relatively small sample size for this country group.

surveillance across income groups for specific aspects of the Decision. For instance, the link between domestic macroeconomic policies and external stability is better addressed for EMEs than for advanced countries; however, multilateral issues are better integrated in Article IV reports of advanced economies than in those of EMEs or developing countries. These differences narrow in the post-Decision sample, suggesting that the Decision has had a positive effect on even-handedness.

The biggest improvement in the implementation scores occurs among the EMEs, while developing and advanced countries experience more incremental improvements (Chart 1). This finding is not primarily the result of EMEs being examined with particular zeal, but rather is driven by the fact that scores for EMEs are very low in the pre-Decision sample, giving them the greatest scope for improvement. Conversely, the main reason that the scores for advanced countries have not improved by as much as those for EMEs is that the former had fairly high implementation scores before the Decision.

Broadly speaking, an interesting finding is that countries with the highest post-Decision scores also tend to have good pre-Decision ones. This indicates that the quality of surveillance does not depend only on overall surveillance guidelines, but also on country-specific factors, such as the degree of co-operation between the IMF team and the local authorities. Supporting this observation is the fact that countries with IMF programs have better implementation scores than countries without, both before and after the Decision's application (Chart 2).[17]

4.1 Results for the core aspects of the surveillance decision

4.1.1 Domestic stability[18]

In general, we find that the Fund staff have always maintained relatively high standards in terms of analyzing domestic stability, and it is in this area that the highest pre-Decision scores are recorded. Even so, there is an increased focus on domestic stability in reports published after the Decision (Chart 3). All three country income groups show an increase in their implementation scores for domestic stability, and they are at a generally comparable level of analysis (Table 1, second column). While the average post-Decision scores for domestic stability are similar (73 per cent for advanced countries, 71 per cent for EMEs, and 63 per cent for developing

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17. There could be two reasons for this. First, staff expertise and interaction with country authorities are generally higher in program countries, leading to more intense surveillance. Second, the IMF could have more sway in these countries, and thus be more successful in terms of drafting Article IV reviews that are consistent with the Decision.
18. Though external stability is the focus of the Decision, we first examine domestic stability, because it is viewed as a prerequisite for external stability in the legal text.

countries), the greatest improvement is in EMEs (from 51 per cent to 71 per cent). This is reflected in the fact that they are the only group whose Wilcoxon signed-rank test results show that the post-Decision scores are significantly higher than the pre-Decision ones (Table 2, second row). The small sample sizes for advanced countries and developing countries partly explain why these countries do not show evidence of significant improvement in the test scores for the individual core areas. There are simply not enough changes in the pre- and post-Decision samples to generate reliable test statistics.

Since the adoption of the Decision, there is evidence of a greater focus on how core macro policies interact to affect domestic stability. For instance, the interdependence of policy stances is more frequently addressed. EMEs have experienced the greatest improvement (e.g., the Article IV reports of India, Egypt, and Brazil are notably better post-Decision in this respect). Further, one area that has improved considerably but still requires significant work is the discussion of real financial linkages and their effects on domestic stability. Although most post-Decision reports describe the financial environment to a much greater extent than the pre-Decision ones, they often lack empirical analysis on how the credit disruption will impact real activity.[19] Moreover, it is not clear to what extent the increased emphasis on financial developments is due to the Decision or simply due to the ongoing financial turmoil. We suspect that the latter factor has played an important role, because our sample of developing countries, which was largely unaffected by the turmoil, does not register an improvement in the average responses to the question related to this issue (Appendix A, Aspect 1, question 3).

Furthermore, we find that surveillance (in our sample) could have benefited from a better discussion of the overall compatibility of medium-term policy frameworks, although it is not specifically an element of the Decision. Policy frameworks (e.g., inflation targeting or a fixed exchange rate regime) are taken as given, and discussions focus on how to best implement policy within the regime's constraints. There is not much analysis of the suitability of the regimes, how they interact with other policy frameworks, or how to make the transition between regimes. Nor is there enough analysis of how country-specific structural factors, such as the state of financial development or the extent of capital mobility, affect a country's policy choices. Yet, these issues are of great practical importance to policy-makers, and at least some discussion of policy frameworks is important for evaluating the overall coherence of policies in achieving domestic and external stability.

19. One notable exception to this is the Canadian Article IV.

4.1.2 External stability

We find that the largest increase in implementation scores is in the area of external stability. The focus on this objective has become greater in most Article IV reports, and the current and capital account factors that affect external stability are discussed more fully. The analysis of exchange rate policies, in particular, is much more substantial in the post-Decision sample.

Again, improvements are seen across the board, with the greatest change occurring in EMEs, which have higher scores than other country income groups, on average (71 per cent, compared with 58 per cent for advanced countries and 50 per cent for developing countries, as reported in Table 1). This is not attributable, however, to a greater focus on exchange rate regimes in EMEs, since advanced countries also score comparably high in this respect. Rather, reports of EMEs generally feature a better overall discussion of external stability and how it is affected by macro-critical policies. Reports of advanced countries do not, on average, adequately analyze the links between domestic and external stability, nor do they explain whether the combined effects of country policies are consistent with the promotion of external stability. Indeed, their post-Decision scores for questions 1 and 2 are not notably higher than their pre-Decision scores. The results of the Wilcoxon signed-rank tests also show that the post-Decision scores for external stability are significantly higher than the pre-Decision ones for EMEs only (Table 3, row 3).

We also find improvement in the analysis of the various risks and vulnerabilities to external stability (Appendix A, Aspect 2, question 3). Most of the improvement occurs in EMEs (developing countries actually register a lower score in the post-Decision sample, and advanced countries improve marginally, but from a fairly high pre-Decision level). Whether this is a sign of undue focus on EMEs is unclear, because EMEs have traditionally been more prone to external difficulties than advanced countries, suggesting some justification for greater focus on risks to external stability. Moreover, the types of risks analyzed are not particularly explicit and certainly do not suggest any sort of crisis scenarios. Indeed, in many reports the risks are included only in the debt sustainability annex, with little or no explanation provided in the main text.

There has been a significant enhancement in the quality of exchange rate analysis. In most post-Decision reports, exchange rate trends and developments are clearly addressed, which is a net improvement over the pre-Decision sample. For both fixed and flexible exchange rate regimes, the post-Decision scores are significantly higher than the pre-Decision ones (Table 2). Interestingly, countries with flexible exchange rates fare better than those with fixed regimes, in terms of their overall implementation scores (Chart 4). IMF staff may find it easier to candidly assess flexible exchange rate policies, since these generally allow countries to run consistent external and internal policies. Moreover, assessments of over- or undervaluation in flexible exchange rate regimes do not necessarily reflect negatively on the authorities, unless these deviations are caused by policy-driven macro imbalances, or RER adjustment is being induced by government intervention. Fixed exchange rate policies pose more difficult problems, particularly in the current conjuncture, where pegs of many large-reserve-accumulating countries have come under significant pressure for appreciation. However, it is precisely in these episodes that candid policy advice is required.

Two additional observations should be noted with respect to the treatment of exchange rates. First, we observe that the IMF staff rely on equilibrium exchange rate models to determine the extent of RER over- or undervaluation. These models have large confidence bands and at times generate ambiguous results. Moreover, in some cases, the staff's evaluation does not appear to be consistent with the fact that some of the exchange rate policy "indicators of concern" are being triggered.[20] For instance, for many oil exporters and large-reserve accumulators, the staff sometimes judge that the RER is correctly valued, despite evidence of some of the "indicators of concern," such as large current account imbalances or protracted, one-sided sterilized intervention, being triggered. This potential inconsistency is rarely addressed in Article IV reports.

Second, it is difficult for our study to evaluate accurately the extent to which the Fund correctly labels countries as having "fundamentally misaligned" real exchange rates, or as being "currency manipulators." Neither label has yet been accepted by the Executive Board of the IMF in any Article IV report, and there have been extensive delays in the consultation processes of countries with potentially misaligned currencies. Indeed, a fear of market stigma and potential protectionist backlashes have led countries to resist signing-off on Article IV reports containing these labels. The absence of these Article IV reports in our restricted study window introduces a selection bias into our sample, precluding definitive quantitative analysis. However, the very existence of the bias indicates that this aspect of the Decision is not being properly implemented. To rectify this weakness in the Decision's application, it may be worthwhile to consider alternative approaches to assessing RERs. Instead of relying on politically charged labels related to assessments of over- or undervaluation, we suggest that surveillance needs to focus on whether core policies are allowing the RER to adjust in response to external imbalances. This approach stresses the importance of RER movements, rather than their level per se, because it is the change in RER

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20. See Appendix B for the list of indicators.

that is critical to resolving external stability pressures. The focus on adjustment mechanisms would allow more room for nuance and flexibility in RER evaluations, and would not necessitate the estimation of controversial equilibrium exchange rates. Moreover, by linking the RER to core policies, surveillance advice would be more transparent and straightforward.

4.1.3 Scope

The Decision appears to have improved the focus and scope of bilateral surveillance (Chart 3). The results of the Wilcoxon signed-rank tests show that the post-Decision scores are significantly higher than the pre-Decision ones for questions related to this issue (Table 3, row 4). We find that the reports are more focused on key macroeconomic policies relevant to external stability; i.e., monetary, fiscal, exchange rate, and financial sector policies. We also find evidence of some improvement in terms of assessing the overall consistency of policies in a medium-term context – though, as mentioned before, often not addressing the appropriateness of policy frameworks.

There is one notable area of weakness: structural reforms need to be better linked to domestic and external stability. For euro area countries (France and Germany, in our sample), the Decision does not appear to have a noticeable impact on the scope of Article IV reports.[21] In both cases, the reports remain focused on the domestic reform agenda, making little effort to link these structural reforms to either domestic or external stability. Although these reforms are undoubtedly important, these issues merit discussion in Article IV reports only if the relevance to external stability is well justified. For developing countries this is also an issue. Though it is understandable that the Fund would have much to say about structural reforms in developing countries, because of its direct involvement in them through its lending programs, a complete discussion of the reforms should be reserved for its program reports, and the Article IV reports should focus more on how the reforms relate to external stability.

4.1.4 Integration of bilateral and multilateral surveillance

The integration of bilateral and multilateral surveillance is the least successful element of the Decision's implementation. While there is a better discussion of the overall regional and global context in the post-Decision sample, there remain many reports that fail to mention other countries. This is particularly the case for developing countries. Advanced countries fare best in this respect, which may be attributable to the fact that their economies are more integrated into the global system than either EMEs or developing countries. Broadly speaking, we find that the

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21. The low scores of the euro area countries are enough to cause the implementation score for advanced countries to decline for this aspect of the Decision (Table 1, third column group).

Article IV reports do not address the global or regional risks raised in the WEO or the GFSR in a systematic manner at the country level.

The analysis of international spillover effects is an important element of the Decision. Yet, with the exception of a few cases, the Article IV reports do not pay much attention to spillover effects originating from other countries, and very few reports analyze the effects of domestic policies on other members. With the exception of Japan (IMF 2006a) and the United States (IMF 2007b, pre-Decision), systemically important countries in our sample do not receive the attention, in terms of international spillover effects, that would be warranted by their role in the global economy. The IMF must improve its analysis of spillover effects if it is to leverage its comparative advantage in multilateral surveillance and provide the information necessary to foster international co-operation on key economic issues.

4.2 Limitations of our methodology

Our methodology has some drawbacks. First, the approach contains significant elements of subjectivity. This is unavoidable, since assessing the quality of Article IV reports requires a certain degree of judgment. To reduce subjectivity, the checklist consists of 14 questions that are answered in a simple “yes/no/partially” format. Perhaps at the expense of not capturing country-specific nuances, the checklist approach ensures comparability of answers across time and countries. Each report was assessed by a single evaluator, in consultation with country experts at the Bank of Canada and the Canadian Department of Finance. Wherever possible, our results were cross-checked with the responses to the questionnaires filled out independently by country analysts.

Second, we recognize that the “partially” response may be chosen more often than either “yes” or “no,” since certain aspects of the Decision are typically neither completely implemented nor completely ignored. However, removing the partially response would introduce an even greater distortion, and using a more graduated ranking scale would increase subjectivity.

Third, our sample size is restricted. As explained above, this is largely determined by the limited window of opportunity for evaluating the implementation of the Decision against a consistent baseline year. To address this issue, we have gathered questions in our checklist into the four core aspects of the Decision and calculated implementation scores for each (i.e., an implementation score for domestic stability, external stability, focus on core policies, and integration with multilateral surveillance). This allows the sample size to be expanded, though at the expense of precision with respect to the question asked (e.g., we look at the average of the four external stability questions, as opposed to the average response to a given question). We also consider the overall implementation scores, meaning the average of all the questions combined.

Finally, our study assumes that any change in the implementation scores is primarily attributable to the implementation of the Decision. An econometric investigation that would take into account all the factors influencing the quality of surveillance is beyond the scope of this investigation, and, given the admittedly subjective nature of the data, not warranted. We hope that the comparison of Article IV reports for the same countries from one year to the next is sufficient to isolate the effects of the Decision and to control for other factors that could influence the quality of surveillance. However, it is clear that developments such as the global financial turmoil that began in August 2007 could have had a bearing on the quality of surveillance (especially the financial sector surveillance). We have tried to account for this particular shock in our questionnaire responses.

5 Conclusion

This study evaluates the implementation of the 2007 Surveillance Decision. As part of this exercise, we have assessed Article IV reports published before and after the adoption of the new Decision for a set of 24 countries. We find that the Decision has significantly increased the overall quality of Article IV reports. Improvements are seen across the board in emerging-market, advanced, and developing countries. We find that Article IV reports are more focused on external stability and the core macroeconomic policies relevant to external stability.

The issue of even-handedness is more difficult to assess. The even-handed application of the Decision demands that countries in similar circumstances be treated in a similar manner. This is fine in principle, but, in practice, countries are rarely in similar circumstances, especially across income groups. However, overall implementation scores are worth considering, since these may give an indication of equality of treatment that abstracts from country-specific details. In aggregate, we find that EMEs and advanced countries have very similar overall implementation scores. Moreover, the sizable gap between these two groups that existed in the pre-Decision sample has all but disappeared in the post-Decision sample, suggesting that the Decision has improved even-handedness.

At a more detailed level, however, there remain significant differences between country groups. EME reports register the most progress in our post-Decision sample, primarily because this group has the most scope for improvement. The implementation scores for most aspects of the Decision are fairly comparable across income groups, but EMEs do register significantly higher scores in the area of external stability, while advanced countries fare better on the integration of multilateral surveillance and the analysis of spillovers. Developing countries generally score worse than EMEs and advanced countries on most fronts, but because of our limited sample size and the very different developmental challenges facing those countries compared with more industrialized economies, we are hesitant to draw firm conclusions on surveillance for developing countries.

Although the implementation of the Decision has proceeded favourably so far, our investigation has revealed scope for improvement in several areas. A cursory list of priorities for improvement would be as follows. First, the link between domestic macroeconomic policies and external stability needs to be strengthened, especially in advanced countries. Second, the integration of multilateral surveillance in the bilateral reports could be improved, with more attention being given to cross-border spillover effects. Third, the treatment of structural reforms needs to be better linked to domestic and external stability. Finally, the Fund's framework for evaluating exchange rate policies, which focuses on assessing the extent of over- or undervaluation and attributing the politically charged label "fundamentally misaligned," is not being applied effectively and may need to be revised.

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Table 1
Implementation Scores by Country Groups

	Total average	Domestic stability			External stability				Focus on core policies			Multilateral			
Question:		**1**	**2**	**3**	**1**	**2**	**3**	**4**	**1**	**2**	**3**	**1**	**2**	**3**	**4**
Advanced countries															
pre-Decision	58	81	69	31	50	38	56	50	94	69	81	56	56	44	31
Average		60			48				81			47			
post-Decision	65	94	63	63	56	38	63	75	88	63	88	75	63	63	19
Average		73			58				79			55			
Emerging markets															
pre-Decision	35	79	42	33	21	33	33	17	71	33	54	21	17	25	4
Average		51			26				53			17			
post-Decision	62	96	67	50	79	54	71	79	92	71	83	33	33	54	4
Average		71			71				82			31			
Developing countries															
pre-Decision	39	63	75	38	38	50	50	50	63	38	50	13	13	13	0
Average		58			47				50			10			
post-Decision	45	75	75	38	50	63	38	50	75	38	75	25	13	13	0
Average		63			50				63			13			
Fixed exchange rates															
pre-Decision	31	65	50	30	20	30	30	30	70	40	45	10	5	10	5
Average		48			28				52			8			
post-Decision	51	85	60	30	60	50	50	70	85	70	75	25	15	35	0
Average		58			58				77			19			
Flexible exchange rates															
pre-Decision	53	91	64	36	45	45	55	36	82	55	77	41	45	41	23
Average		64			45				71			38			
post-Decision	71	100	77	73	82	55	77	82	95	68	91	55	59	59	20
Average		83			74				85			48			
Non-program countries															
pre-Decision	39	73	50	30	28	33	35	30	73	45	60	28	25	23	15
Average		51			31				59			23			
post-Decision	58	90	63	48	60	43	60	70	85	63	83	45	38	48	10
Average		67			58				77			35			
Program countries															
pre-Decision	64	100	88	50	63	63	88	50	100	50	75	50	50	63	0
Average		79			66				75			41			
post-Decision	73	100	88	75	100	88	75	88	100	63	88	50	50	63	0
Average		88			88				84			41			

Note: The figures represent the implementation scores expressed as percentages.

Table 2
Wilcoxon Signed-Rank Tests Based on Pooled Data for All Questions

H_0: No systematic difference between pre- and post-Decision scores
H_A: Post-Decision scores are higher than pre-Decision scores

Sample	Test statistic (*z*-value)	No. of obs[2]
All countries	-7.91***	336 (145)
Advanced countries	-2.20**	112 (50)
EMEs	-7.95***	168 (83)
Developing countries	-1.73**	56 (12)
Fixed exchange rates	-6.39***	154 (63)
Flexible exchange rates	-5.31***	154 (69)
Non-program countries	-7.49***	280 (132)
Program countries	-2.52***	56 (13)

Notes: 1. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.
2. Figures in parentheses refer to the actual number of observations used by the test; i.e., the total number of pairs minus the ones with zero difference between pre- and post-Decision observations.

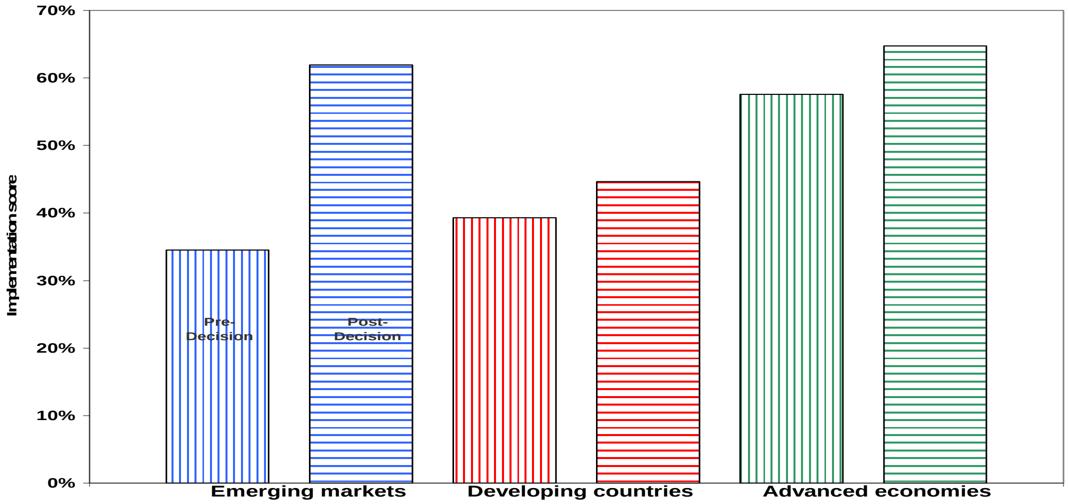
Table 3
Wilcoxon Signed-Rank Tests for Particular Aspects of the Decision

H_0: No systematic difference between pre- and post-Decision scores
H_A: Post-Decision scores are higher than pre-Decision scores

	All countries	EMEs	Advanced	Fixed exchange rates	Flexible	Non-program
Domestic stability	-3.38***	-2.78***	-1.70	-2.43***	-2.40***	-3.37***
No. of obs[3]	72 (25)	36 (15)	24 (9)	33 (10)	33 (12)	60 (22)
External stability	-5.26***	-5.54***	-1.34	-4.18***	-3.96***	-4.81***
No. of obs.	96 (61)	48 (36)	32 (18)	44 (31)	44 (26)	80 (53)
Core policies	-3.63***	-3.77***	0.06	-3.45***	-2.15	-3.38***
No. of obs	72 (27)	36 (18)	24 (6)	33 (12)	33 (11)	60 (25)
Multilateral surveillance	-3.21***	-3.21***	-1.21	-2.54***	-1.82**	-3.22***
No. of obs	96 (32)	48 (14)	32 (17)	44 (10)	44 (20)	80 (32)

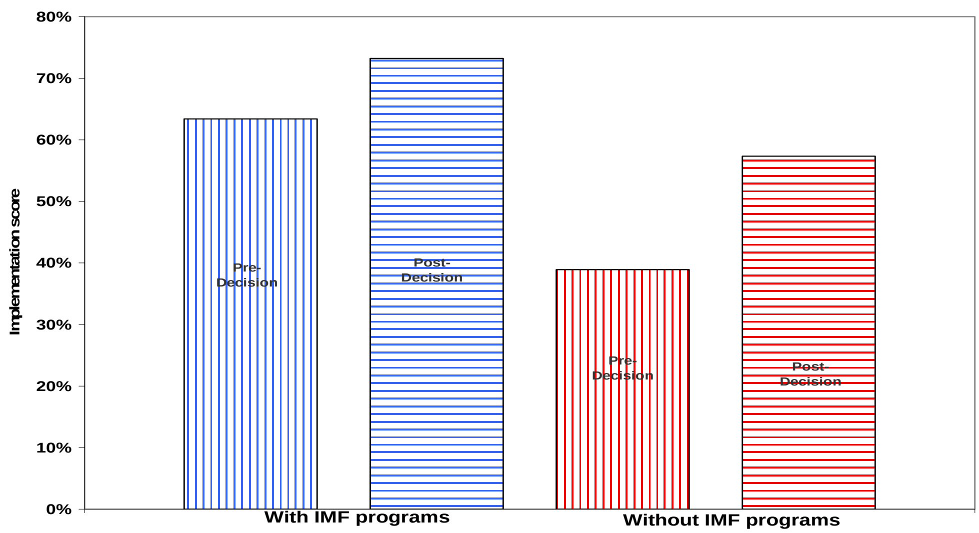
Notes: 1. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.
2. For the group of developing and program countries, the number of observations was not sufficient to run the tests.
3. Figures in parentheses refer to the actual number of observations used by the test; i.e., the total number of pairs minus the ones with zero difference between pre- and post-Decision observations.

Chart 1
Implementation Scores for Emerging, Developing, and Advanced Economies



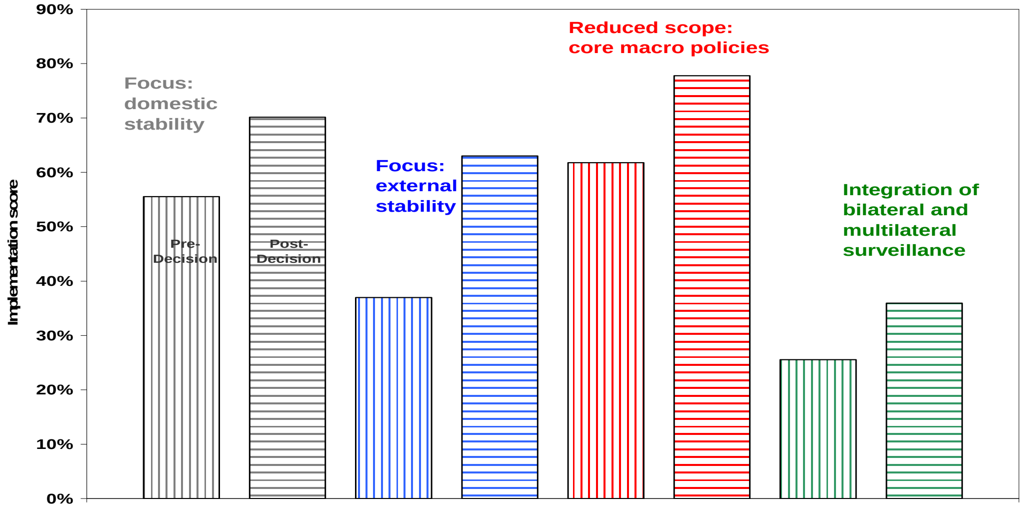
Notes:
1. For each category, the vertical and horizontal shaded bars represent the pre-Decision and the post-Decision scores, respectively.
2. The implementation score in each category is the average score across all countries in the sample.
3. Emerging markets include Algeria, Bahrain, Brazil, the Caribbean, Colombia, Ecuador, Egypt, India, Mexico, Russia, Saudi Arabia, and Serbia. Developing countries include Myanmar, Namibia, Nigeria, and Zambia. Advanced economies include Canada, the European Union, France, Germany, Hong Kong, Israel, Japan, and the United States.

Chart 2
Program Countries



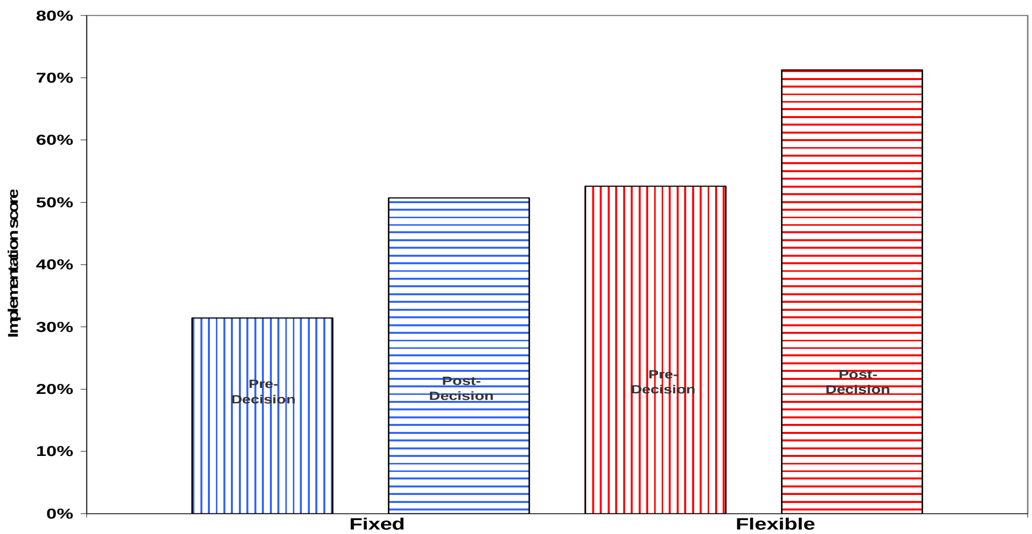
Notes:
1. For each category, the vertical and horizontal shaded bars represent the pre-Decision and the post-Decision scores, respectively.
2. The implementation score in each category is the average score across all countries in the sample.
3. Countries with IMF programs include the Caribbean, Colombia, Nigeria, and Zambia.

Chart 3
Implementation Scores for All Countries



Notes:
1. For each category, the vertical and horizontal shaded bars represent the pre-Decision and the post-Decision scores, respectively.
2. The implementation score in each category is the average score across all countries in the sample.
3. The sample includes Algeria, Bahrain, Brazil, Canada, the Caribbean, Colombia, Ecuador, Egypt, the European Union, France, Germany, Hong Kong, India, Israel, Japan, Mexico, Myanmar, Namibia, Nigeria, Russia, Saudi Arabia, Serbia, the United States, and Zambia.

Chart 4
Exchange Rate Regimes



Notes:
1. For each category, the vertical and horizontal shaded bars represent the pre-Decision and the post-Decision scores, respectively.
2. The implementation score in each category is the average score across all countries in the sample.
3. Countries with fixed exchange rates include Algeria, Bahrain, Ecuador, Egypt, Hong Kong, Myanmar, Namibia, Nigeria, Saudi Arabia, and Zambia. Countries with flexible exchange rates include Brazil, Canada, Colombia, the European Union, India, Israel, Japan, Mexico, Russia, Serbia, and the United States.

Appendix A

Checklist for Implementing the 2007 Surveillance Decision

Country Reviewed: ________________________________

Please provide one answer only per question.

Aspect 1: Domestic stability is central to the promotion of external stability

- **Members have pledged to maintain policies that aim to foster (i) orderly growth with reasonable price stability, and (ii) economic and financial conditions that do not tend to produce erratic disruptions.**
- **Surveillance will assess whether a member's domestic policies are directed toward the promotion of domestic stability.**

(Part I A.6) In the conduct of their domestic economic and financial policies, members are considered by the Fund to be promoting external stability when they are promoting domestic stability—that is, when they (i) endeavor to direct their domestic economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to their circumstances, and (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions. The Fund in its surveillance will assess whether a member's domestic policies are directed toward the promotion of domestic stability.

Questions:

1. Does surveillance provide an adequate analysis of domestic stability? (e.g., current analysis, outlook, risks)

   Yes ___ ; No ___ ; Partially ___

2. Are exchange rate, monetary, fiscal, and financial sector policies adequately analyzed in relation to domestic stability? (e.g., policy consistency, mutual coherence, interactions between policies)

   Yes ___ ; No ___ ; Partially ___

3. Is there an adequate discussion of the linkages between financial conditions and domestic stability? (e.g., are real financial linkages discussed?)

   Yes ___ ; No ___ ; Partially ___

Comments: ____

____

Aspect 2: Objective of External Stability

- **The objective of surveillance is maintenance of external stability.**

The objective of the IMF is to promote a stable international monetary system. According to the Decision, *"systemic stability is most effectively achieved by each member adopting policies that promote its own 'external stability'—that is, policies that are consistent with members' obligations under Article IV, Section 1… External stability refers to a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements" (para. 4).* Consequently, *"…in its bilateral surveillance the Fund will focus on those policies of members that can significantly influence present and prospective external stability"* (para. 5).

Questions:

1. Is there a general discussion of external stability? (e.g., the current and capital account factors affecting external stability, the link between external and domestic stability, country-specific circumstances)

   Yes ___ ; No ___ ; Partially ___

2. Does the Fund evaluate whether the combined effect of country policies is consistent with the promotion of external stability? (e.g., does the Fund evaluate whether policies favour gradual external adjustment, such that disruptive exchange rate movements are unlikely?)

   Yes ___ ; No ___ ; Partially ___

3. Is there an analysis of the risks and vulnerabilities associated with the country's external stability? There should be a forward-looking dimension.

   Yes ___ ; No ___ ; Partially ___

4. Does the Fund adequately assess the issue of real exchange rate adjustment? (e.g., is there an analysis of the need for RER adjustment, the required policy changes, and the possible consequences of action/inaction?)

   Yes ___ ; No ___ ; Partially ___ ; Not applicable

Comments: ____

____

Aspect 3: Focus on core macroeconomic policies

- **Focus on macroeconomic policies relevant to external stability: monetary, fiscal, exchange rate, and financial sector.**
- **Other domestic policies are looked at only if they "significantly influence present or prospective external stability." This is the proximity principle.**
- **Emphasis on assessment of medium-term policy frameworks.**

According to the Decision, *"exchange rate policies will always be the subject of the Fund's bilateral surveillance with respect to each member, as will monetary, fiscal and financial sector policies… Other policies will be examined in the context of surveillance only to the extent that they significantly influence present or prospective external stability."* (para. 5). Moreover, *"the Fund's assessment and advice in the context of bilateral surveillance will, to the extent possible, be placed in the context of an examination of the member's medium-term objectives and the planned conduct of policies, including possible responses to the most relevant contingencies"* (para. 11).

Questions:

1. With respect to the core policy areas, are discussions focused on issues relevant to domestic and/or external stability?

   Yes ___ ; No ___ ; Partially ___ ; Not applicable

2. Is the proximity principle being respected?

   Yes ___ ; No ___ ; Partially ___

3. Does surveillance take a medium-term approach to policy analysis, assessing policy frameworks when appropriate? (e.g., discussion of medium-term objectives, instruments, policy reaction strategies)

   Yes ___ ; No ___ ; Partially ___

Comments: ____

____

Aspect 4: Integration of multilateral surveillance

- **Integrate bilateral and multilateral surveillance.**
- **Presents analysis of potential spillovers from the international economy to the member and from the member to other economies.**

According to the Decision, *"the Fund's assessment and advice in the context of bilateral surveillance will be informed by, and be consistent with, a multilateral framework that incorporates relevant aspects of the global and regional economic environment, including exchange rates, international capital market conditions, and key linkages among members. The Fund's assessment and advice will take into account the impact of a member's policies on other members to the extent that the member's policies undermine the promotion of its own external stability."* (para. 10).

Questions:

1. Is bilateral surveillance placed in a regional or global context in a manner that is relevant and helpful to policy-makers?

   Yes ___ ; No ___ ; Partially ___ ; Not applicable

2. Are key multilateral risks and/or scenarios discussed in a bilateral context?

   Yes ___ ; No ___ ; Partially ___

3. Are international spillovers affecting the country (but originating from other members) analyzed and discussed?

   Yes ___ ; No ___ ; Partially ___ ; Not applicable

4. Are the international spillover effects generated by the country (and affecting other members) analyzed and discussed?

   Yes ___ ; No ___ ; Partially ___ ; Not applicable

Comments: ____

____

Appendix B

Principles for the Guidance of Members' Exchange Rate Policies under Article IV, Section 1

Exchange rate principles for members

14. Principle A sets forth the obligation contained in Article IV, Section 1(iii). Principles B through D constitute recommendations rather than obligations of members. A determination by the Fund that a member is not following one of these recommendations would not create a presumption that that member is in breach of its obligations under Article IV, Section 1.

A. A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.

B. A member should intervene in the exchange market if necessary to counter disorderly conditions, which may be characterized *inter alia* by disruptive short-term movements in the exchange rate of its currency.

C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

D. A member should avoid exchange rate policies that result in external instability.

Indicators

15. In its surveillance of the observance by members of the Principles set forth above, the Fund shall consider the following developments as among those which would require thorough review and might indicate the need for discussion with a member:

(i) protracted large-scale intervention in one direction in the exchange market;

(ii) official or quasi-official borrowing that either is unsustainable or brings unduly high liquidity risks, or excessive and prolonged official or quasi-official accumulation of foreign assets, for balance of payments purposes;

(iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or

(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance of payments purposes, of monetary and other financial policies that provide abnormal encouragement or discouragement to capital flows;

(v) fundamental exchange rate misalignment;

(vi) large and prolonged current account deficits or surpluses; and

(vii) large external sector vulnerabilities, including liquidity risks, arising from private capital flows.