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BP/08/11

Integrating Macroeconomic and Financial Sector Analyses within IMF Surveillance: A Case Study on IMF Governance

Biagio Bossone

Address. 700 19th Street, N.W., Washington D.C. 20431, U.S.A. Telephone. +1 202 623 7312 Fax. +1 202 623 9990 Email. feedback@ieo-imf.org Website. www.ieo-imf.org

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Integrating Macroeconomic and Financial Sector Analyses within IMF Surveillance:

A Case Study on IMF Governance

Prepared by Biagio Bossone

Revised
May 2008

Abstract

In response to the financial crises of the 1990s the IMF developed substantial capacity on financial sector issues. Integrating financial sector and macroeconomic analyses into a new macro-prudential framework was to strengthen the Fund's role in surveillance. This study examines how the bodies responsible for the governance of the Fund articulated the new integrated framework. It shows a global governance decision making process flowing from the world's largest economies, which set strategic directions, to the Fund, which elaborated and executed operational agendas. The Fund brought its quasi-universal membership to agreement on a new mechanism for surveillance, implemented it, and it adapted it over time. The experience highlights several issues in Fund governance that require attention, and provides recommendations for increasing the effectiveness of the Fund's financial sector surveillance.

JEL Classification Numbers: F53, F55, F59

Keywords: Governance, Executive Board, Financial sector surveillance, G-7, Interim Committee, IMFC, Management, Managing Director

Author's E-Mail Address: biagiobossone@yahoo.com; feedback@ieo-imf.org

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ABBREVIATIONS

AML	Anti-Money Laundering
BCBS	Basle Committee on Banking Supervision
BIS	Bank for International Settlements
CFT	Counter the Financing of Terrorism
FATF	Financial Action Task Force
FSAP	Financial Sector Assessment Program
FSS	Financial sector surveillance
FSSA	Financial system stability assessments
G-7	France, United States, Great Britain, Germany, Japan, Italy, Canada, and the European Community
G-10	Belgium, Canada, France, Italy, Japan, Netherlands, UK, USA, and the central banks of Germany and Sweden and later Switzerland
G-11	Jordan, Croatia, Ecuador, Georgia, El Salvador, Honduras, Indonesia, Morocco, Pakistan, Paraguay, Sri Lanka, and Tunisia
G-20	European Community and 19 of the world's largest economies
G-22	22 systemically relevant countries that coordinated to advance the reform of the global financial system; superseded by the G-20 and G-33
G-24	24 developing countries that coordinate their positions on international monetary affairs and development
G-33	33 developing countries that coordinate their positions on trade and economic issues
GDDS	General Data Dissemination Standard
IC	Interim Committee
IMFC	International Monetary and Finance Committee of the Board of Governors
MAE	Monetary and Exchange Affairs Department (IMF)
MD	Managing Director
OFC	Offshore financial centers
ROSC	Reviews of Standards and Codes
SDDS	Special Data Dissemination Standard

EXECUTIVE SUMMARY

During the 1990s, in the aftermath of the Mexican and East Asian crises, the IMF developed substantial capacity on financial sector issues, integrating financial sector and macroeconomic analyses into a new macro-prudential framework to provide the basis for strengthening the Fund's role in surveillance.

This case study focuses on how the bodies responsible for governance of the Fund articulated the new integrated framework. This required significant involvement from the Fund's governing bodies. Assessing how these bodies interacted in creating and implementing the new framework yields important insights from which to assess the Fund's governance overall. The study shows a global decision-making process flowing from the world's largest economies—which set strategic directions as they recognized the importance of financial sector issues for global economic stability—to the Fund as the agency responsible for elaborating and executing operational agendas based on those strategic directions.

The Interim Committee (predecessor to the International Monetary and Financial Committee (IMFC)) called on the organization to deliver an appropriate response to the new challenges. The Fund's Executive Board was responsible for ensuring that the Fund would execute its new mandate and deliver the expected results. Fund management (and staff), in conjunction with the Board, was responsible for developing the appropriate response, including by setting up and adapting the operational framework. Board and management needed to make sure that the response was acceptable to the Fund membership.

The process underpinning the development of financial sector surveillance (FSS) was more inclusive than past international agenda-setting processes. In 1997, the G-10 recognized the importance of broad consultation to develop an international strategy to strengthen financial systems, and the desirability of wide endorsement of the strategy. Developing countries supported the strategy, although they often voiced important concerns. A key feature of the new agenda that resulted from the need for a broad consensus was the voluntary nature of the exercise, which relied on peer-pressure, imitation, and incentives, rather than new obligations, to expand its reach.

In introducing an integrated FSS framework, the Fund brought its quasi-universal membership to agreement on a surveillance mechanism, implemented it, and adapted it over time. The Board was central to the establishment of the framework that was acceptable to, and eventually owned by, the membership. Management handled the design and operational aspects of the process and its implementation, and made sure that the framework would evolve in line with members' needs, taking on board lessons from experience.

The experience highlights several issues that require attention. The Board proved unable to master the sophistication of the new integrated framework to the extent needed to provide forward-looking oversight and broad vision. The Board was more effective as an agency of the shareholders, ensuring execution of agreed mandates, than as a collegial body of administrators working to shape a vision and develop a diagnostic capacity. Seldom did the Board initiate or propose action radically different from what management recommended. The IMFC gave the development of the FSS political legitimacy, yet its role raises governance questions, in particular concerning its value added to the strategy-making process vis-à-vis the Board.

To strengthen the effectiveness of the IMF's governing bodies in ensuring high quality financial sector surveillance, the study recommends that the Fund:

- Clarify the functions of the IMFC. If changes are implemented, their impact on the overall governance structure should be carefully considered. In particular, if the Committee were to take a more direct role in assessing Fund performance and in holding the Fund accountable, other significant changes would need to be considered, including:
    - granting executive directors greater independence from their capitals, while making it explicit that they owe primary loyalty to the institution;
    - separating more distinctly the roles and responsibilities of the Board and management; and
    - having the Board and management report separately to the IMFC. These changes would require that the dual function of the MD be reconsidered.
- Strengthen the capacity of the Board, including by:
    - beefing up the Board's financial sector skills;
    - strengthening liaison with national financial supervisory and regulatory agencies; and
    - establishing a Board Committee on Financial Sector Policy to prepare for full Board meetings and enhance the Board's capacity to oversee and provide guidance on FSS.

I. Purpose and Scope of the Case Study[1]

1. During the 1990s, in the aftermath of the Mexican and East Asian crises, the IMF developed substantial capacity to work on financial sector issues. Integrating financial sector and macroeconomic analyses into a new macro-prudential framework was to provide the basis for strengthening the Fund's role in surveillance.[2]

2. This case study focuses on how the bodies responsible for governance of the Fund articulated the new integrated framework. This went well beyond the boundaries of a technical task, to the heart of the relationship between the Fund and its diverse membership, and required significant involvement from the Fund's governing bodies. Assessing how these bodies interacted in creating and implementing the framework therefore yields important insights from which to assess the Fund's governance structure overall.[3]

3. The study focuses on the role and interactions of the Fund's Executive Board, member countries, the IMFC, and management in establishing and implementing the framework for FSS.[4] The study does not assess the soundness of the framework, nor attempt to judge the decisions that were taken to shape it and to make it operational. It rather evaluates the *process* leading to those decisions, and how the Fund's governance system has facilitated (or otherwise) this process.

4. The study spans the period from 1995 to early 2007, which covers all the main events that led to the integration of financial sector analysis into Fund surveillance. The preparation of the study benefited from interviews with key stakeholders, complemented by desk research. The stakeholders interviewed are among those who played key roles in designing and/or implementing the Fund's FSS framework; they include former members of the Executive Board, Fund management and staff, officials of member governments, and international policy experts. Desk research was used to select the basic documentation for the

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[1] The preparation of this case study benefited from very helpful advice and coordination assistance by Leonardo Martinez-Diaz. Jeffrey Scott Levine and Roxana Pedraglio provided excellent advice and research assistance. All have offered comments on previous versions of this paper. Comments were also received from participants at the *IEO Workshop: Evaluation of IMF Governance*, April 18–19, 2007, Washington DC. The author is particularly grateful to Larry Promisel for his help in the preparation stage of the study. He is also grateful to Domenico Lombardi, Luigi Passamonti, and Marie-Thérèse Camilleri for helpful comments and suggestions, and wishes to thank the officials who made themselves available for interview.

[2] This case study assumes readers' familiarity with IMF surveillance. Information on Fund surveillance is available on the IMF's website at www-int.imf.org/depts/pdr/. The governance-related aspects of Fund surveillance are analyzed in Bossone (2008a).

[3] For a description of the functions and responsibilities of the Fund's governing organs, see Van Houtven (2006), and Mountford (2008).

[4] "Fund management" denotes the Managing Director, the First Deputy Managing Director, and two Deputy Managing Directors.

analysis, including IMF public and internal documents as well as communiqués and public statements of relevant intergovernmental organizations.

5. The study is organized as follows. Section II traces how the international financial policy agenda has evolved since the mid-1990s, leading the Fund to expand its surveillance mandate into financial sector issues, and focuses particularly on the role played by the international financial community. Section III describes the Fund's response in setting up the new analytical framework that has since become integral to Fund surveillance. This section also identifies the challenges that the Fund encountered in developing the framework, and examines the roles played by management and the Executive Board. Section IV analyzes how the global governance context affected the Fund's development and implementation of the integrated framework, and evaluates the performance of the Fund's organs of governance in integrating financial sector supervision within the institution's core mandate. Section V offers recommendations and conclusions.

II. Integrating Financial Sector Analysis into Fund Surveillance: Pressure from the International Community

6. By the early 1990s, the Fund had already extended the scope of its surveillance beyond the traditional boundaries of macroeconomic analysis (Guitian, 1994; IMF, 1999a) as a result of a number of factors, including the Fund's involvement in the Latin American debt crisis during the 1980s, its support for structural adjustment in developing countries, and its emerging role in the transformation of the former socialist states from planned to market economies. These factors had led the Fund to begin monitoring international capital markets as part of its multilateral surveillance, and to prepare itself for assisting member countries on institutional and structural economic reform programs, including in the financial sector.

7. Yet the Fund did not become involved in financial sector issues until after the Mexico crisis, when policymakers in major industrial countries realized that the globalization of capital flows and the growing importance of emerging market economies required greater attention to issues of financial sector stability.[5] This section describes how new mandates in international financial policy evolved; the responses of the Fund are detailed in Section III.

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[5] Even before the crisis, views were emerging within the Fund in support of a broader surveillance role, encompassing national financial sector systems (Guitian, 1994). Later on, drawing lessons from Mexico for Fund surveillance, the Fund's Masson and Mussa (1995) noted that:

> "…in the case of Mexico, weaknesses in the banking and financial sector appeared to have played a significant role both in developments leading up to the devaluation and in the severity of the crisis that followed the devaluation. For the IMF, the implication is that surveillance should focus particular attention on the soundness of the financial sector, both under normal circumstances and under a scenario in which the economy might be subjected to strong adjustment pressures. Early diagnosis and correction of weaknesses in the financial sector might do much to lessen the severity

(continued)

8. Early in 1995, the finance ministers and central bank governors of the Group of Seven (G-7) industrial countries agreed to explore ways to enhance the ability of international financial institutions to monitor and respond to financial and economic instability.[6] A few months later, in preparation for the Halifax summit, the G-7 issued a document (G-7, 1995) that focused unprecedented attention on financial sector stability issues. They called on the Fund to establish benchmarks and procedures for financial data transparency from member countries, and to improve its surveillance activities by monitoring financial and banking sector developments more closely. They also encouraged the Group of Ten (G-10) to intensify their work on financial system safeguards and standards, and called on the Basle Committee on Banking Supervision and the International Organization of Securities Commissions to cooperate in this area.

9. The heightened concern with financial sector stability issues led the G-7 leaders to conclude at the 1995 Halifax summit that "closer international cooperation in the regulation and supervision of financial institutions and markets is essential to safeguard the financial system and prevent an erosion of prudential standards,"[7] and, a year later at the Lyon summit, to make progress toward adopting prudential safeguards in international financial markets, increasing cooperation among regulatory and supervisory authorities, and strengthening the Fund's ability to deal with financial system challenges.[8] In 1997, reacting to the G-7 initiative, a working party consisting of representatives of the G-10 and emerging market economies developed a strategy for fostering financial stability in countries experiencing rapid economic growth and undergoing major changes in their financial systems (G-7, 1997).[9] The Basle Committee on Banking Supervision, in cooperation with a group of key emerging market economies, released the Core Principles for Effective Banking Supervision, which provided a blueprint for enhanced banking supervision and a focal point for the effort to strengthen financial sectors worldwide.

> of losses associated with a country's necessary efforts to correct maladjustments in its balance of payments." (p. 29.)

However, it took the 1997 East Asian crisis and the subsequent crises in Eastern Europe and Latin America for consensus to emerge among Fund economists on the importance of the financial sector as a source of instability (Rowe, 2007).

[6] See G-7 Finance Ministers' and Central Bank Governors' Statement, Toronto, February 3–4, 1995, G-8 Information Center, University of Toronto. www.g7.utoronto.ca/.

[7] Halifax Summit Communiqué, June 16, 1995.

[8] See Lyon G-7 Summit, "Finance Ministers' Report to Heads of State or Government on International Monetary Stability," June 28, 1996.

[9] The strategy's main objectives were to promote the establishment, adoption, and implementation of sound norms, principles, and practices in the conduct of business in the banking, financial, and corporate sectors.

10. The pressure from the G-7 reverberated within the Fund's key advisory body—the Interim Committee (IC) which acknowledged the need for the Fund to play an evolving role in an environment of increased globalization and capital markets integration.[10] The Committee's Declaration on Partnership for Sustainable Growth, adopted in the Fall of 1996, acknowledged that Fund surveillance needed to pay more attention to members' financial policies, the soundness of their financial sectors, and the need for better prudential regulation and risk management practices.[11]

11. Following the East Asia financial crisis, the debate intensified about how best to preserve international financial stability. The G-7 carried forward the work begun in Halifax on strengthening the international financial system, and in their May 1998 report to leaders (G-7, 1998a) they presented detailed proposals to strengthen national financial systems and corporate governance: to improve risk analysis in financial institutions; develop internationally accepted principles for auditing, accounting, and disclosure in the corporate sector; and improve the supervision of large internationally active financial groups. They recommended the Fund increase its collaboration with banking supervisors and to promote the Basle Committee's Core Principles on Effective Banking Supervision. They also noted the urgent need for a mechanism of multilateral surveillance of national financial, supervisory, and regulatory systems, encompassing such areas as banking and securities, the corporate sector, and bankruptcy law.

12. Meeting in April the same year, finance ministers and central bank governors from 22 systemically important economies (the G-22, also referred to as the "Willard group") identified three key areas of the international financial architecture where action was needed: transparency, domestic financial systems, and financial crisis management. Working parties were formed to study these issues further.[12] In one of the resulting studies, they recommended that, in the context of Article IV consultations, the Fund prepare and publish a transparency report "that summarizes the degree to which an economy meets internationally recognized disclosure standards."[13]

13. The G-7 endorsed this view and called on the Fund (in cooperation with international standard-setting bodies) to monitor financial sector standards and codes of best practice,

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[10] See Communiqué of the Interim Committee of the Board of Governors of the International Monetary System, issues of October 8, 1995; April 22, 1996; September 29, 1996; and April 28, 1997; Washington, DC.

[11] See Communiqué of the Interim Committee of the Board of Governors of the International Monetary System, September 29, 1996, Washington, DC.

[12] See Reports on the International Financial Architecture, October 1998 <www.imf.org.external/np/g22>.

[13] See Report of the Working Group on Transparency and Accountability, October 1998 <www.bis.org/publ/othp01b.pdf >.

publish the results of its surveillance, and cooperate with other organizations to help countries meet the new standards and codes.[14]

14. At its 1998 meeting, the Interim Committee considered steps to strengthen domestic financial systems by developing supervisory and regulatory frameworks, consistent with internationally accepted practices and higher standards for bank and non-bank financial entities.[15] In 1999, further important steps were taken to strengthen international cooperation in financial market supervision and surveillance, with the establishment by the G-7 finance ministers of the Financial Stability Forum and their invitation to counterparts from systemically important countries to join in a group for informal dialogue.[16] These initiatives created new opportunities for policymakers from industrial and emerging economies, supervisors and regulators, and representatives from international organizations and standard-setting bodies to discuss issues of mutual concern.

15. The G-7 call for anchoring the assessment of standards and codes in the Fund's Article IV process in April 1999[17] and in 2000, the IMFC (as the IC was now called) agreed that country (Article IV) consultations provided the right framework within which to organize and discuss with national authorities the implications of assessments of standards and codes. In countries that participated in the Financial Sector Assessment Program (FSAP), reports on country-level financial system stability assessments (FSSA) would serve to inform Article IV consultations.

16. The Fund's major shareholders, particularly the G-7, then turned their attention to the need to protect the credibility and integrity of the global financial system by fighting money laundering and corruption, and restraining harmful activities from offshore financial centers and tax havens.[18] The IMFC embraced these issues, and requested the Fund (and the World Bank) to collaborate with the Financial Action Task Force (FATF) in reviewing standards

[14] See Declaration of the G-7 Finance Ministers and Central Bank Governors, Washington, DC, October 30, 1998.

[15] See Communiqué of the Interim Committee of the Board of Governors of the International Monetary System (henceforth, "IC Communiqué"), issues of April 16 and October 4, 1998, Washington, DC.

[16] See Statement of G-7 Finance Ministers and Central Bank Governors, Washington, DC, September 25, 1999. The new group was the "G-20," and replaced the groupings that had been established at the initiative of the G-7 (i.e., the G-22 and the G-33). For a concise discussion of the making of the international financial architecture, see Trichet (2007).

[17] The Statement of G-7 Finance Ministers and Central Bank Governors encouraged "the Fund to develop a system of surveillance of all relevant codes and standards, centered on the IMF Article IV process" (Washington, DC, April 26, 1999). On the following day, the IC, "[i]n the context of IMF surveillance…encouraged the IMF to develop the process to encompass the standards and codes relevant to international financial stability." (IC Communiqué, Washington, DC, April 27, 1999).

[18] See Communiqué of G-7 Finance Ministers and Central Bank Governors, Tokyo, January 22, 1999.

and procedures.[19] Following the terrorist attacks of September 11, 2001, the Fund's FSS mandate was broadened to include combating the financing of terrorism.

17. Since 2001, shareholders' attention to the Fund's financial sector surveillance has mostly centered on the implementation and effectiveness of the adopted framework, with emphasis on the frequency and coverage of assessments and updates and on follow-up action. More recently, interest has arisen in better integrating surveillance of the financial sector with that on international capital markets.

III. Integrating Financial Sector Analysis into Fund Surveillance: Response from the Fund

18. The Fund has responded to its new mandates and the Board, management, and staff have worked together to put in place a strong and coherent FSS framework. The volume of Fund work on the financial sector has increased dramatically, as reflected in an increase in the numbers of staff and consultants employed in the departments dedicated to financial sector work, from 116 in 1995 to 284 in 2005.[20] As a share of total staff time, the time devoted to financial sector and capital market issues increased from 15.5 percent in fiscal year 2001 to close to 19 percent in 2005.[21]

19. This section describes the institutional response of the Fund, as reflected in the decisions taken by the Executive Board on financial sector issues. Since the new surveillance agenda also required a significant shift in the Fund's organizational culture, the second part of the section looks at the roles played by management and the Board.

A. Changes in Fund Policy, Practice, and Structure

20. The Board is responsible for deciding on policy matters on behalf of members. Issues are elaborated by the staff at the technical and operational level, and management submits proposals based on those elaborations to the Board for deliberation. Board decisions are the result of interactions between executive directors, member governments, management, and staff. Management often plays a key role in helping build consensus, by bridging differences across the Board through "back and forth" interlocutions until common ground is found. Many such iterations are informal, and not captured in official records or minutes.

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[19] See IC Communiqué, Washington, DC, April 29, 2001.

[20] The figure for 1995 refers to the Monetary and Exchange Affairs Department, while the figure for 2005 includes personnel in the Monetary and Financial Systems Department and the International Capital Markets Department. (Source: IMF Human Resources Department.)

[21] See "Report of the Review Group on the Organization of Financial Sector and Capital Markets Work at the Fund," Annex II. November 2005.

21. The Fund's initial response to the concerns that the Mexican crisis raised came in 1996, when the Board agreed on measures to extend surveillance to the financial sector.[22] The first of these measures was to improve transparency by facilitating the availability of timely and reliable economic and financial data from member countries. The Special Data Dissemination Standard (SDDS) was established for members having or seeking access to international capital markets.[23] This decision was not achieved without lengthy and difficult Board discussions. Some members were averse to the very idea of the Fund moving into standard setting, and pressure from the G-7 was key to achieve the result.[24]

22. The real lead-up to radical change in the focus of Fund surveillance began when the Fund closely examined the links between banking system soundness, macroeconomic stability, and structural policy in a context of a liberalized capital account. As the importance of such links came to be better appreciated, the Board—especially its members from industrial countries—started pushing the Fund to take a stronger role in promoting and assisting the improvement of prudential systems, and urged that stabilization policies be complemented by stronger supervision of banking systems and by progress in financial sector development and liberalization. The Board also agreed that the Fund should encourage

[22] A year earlier, the Executive Board had indicated that there "should be more emphasis in surveillance on financial markets for members for which such issues were particularly relevant." IMF (1995: 42). In the 1995 Biennial Review of Surveillance, the Fund's staff recognized the importance of informing the Executive Board of country financial market developments, including, where appropriate, regulatory changes and their systemic implications, and assessments of capital markets developments where financial market issues were particularly relevant for macroeconomic performance. In discussing the review, executive directors agreed that financial market issues deserved more attention in Fund surveillance, but subsequently, in discussing the provision by members of statistical data for strengthening surveillance, only some executive directors supported the proposal to broaden the list of data to include monthly accounts of the banking system. (See "Biennial Review of the Implementation of the Fund's Surveillance Over Members' Exchange Rate Policies and of the 1977 Surveillance Decision," SM/95/22, January 26, 1995; "Statement by the Managing Director on Strengthening Surveillance," BUFF/95/15, February 15, 1995; "Summing Up by the Chairman—Biennial Review of the Implementation of the Fund's Surveillance Over Members' Exchange Rate Policies, and of the 1977 Surveillance Decision," SUR/95/24, February 27, 1995; and "Summing Up by the Chairman—Strengthening Fund Surveillance—Provision of Statistical Data by Members," SUR/95/34, April 7, 1995).

[23] See "Summing Up by the Acting Chairman—Standards for the Dissemination of Economic and Financial Statistics to the Public by Member Countries: Progress Report and Implementation of the Special Data Dissemination Standard (BUFF/96/43, April 5, 1996).

[24] Apparently, this was the original intention of Fund management. During 1996, a meeting took place secretly at the Bank for International Settlements (BIS)—as recounted by a direct witness in an interview for this study—between top officials from the Fund, the BIS, and the Basle Committee on Banking Supervision (BCBS). At this meeting, the Fund called on the BCBS to come up with proposals for a new international banking standard, indicating its readiness to take the task upon itself otherwise. The BCBS eventually accepted the job, in collaboration with supervisors from emerging market economies.

members to adopt appropriate prudential standards not only for the external oversight of banks but also for market discipline and internal bank governance.[25]

23. In the context of the 1997 biennial review of surveillance, the Board expressed its approval of the increased attention being accorded to financial and banking sector issues. The staff was requested to inform the Board of its assessments of macroeconomic issues arising from developments in a member's financial system, through Article IV consultation reports and, where the developments were urgent and serious, at informal country-matters sessions.[26] The Board agreed that the Fund had an important role to play in alerting members to weaknesses in their banking systems and in their legal and regulatory infrastructure.

24. The Board also agreed that the Fund should encourage and monitor the adherence of member countries to international supervisory and prudential guidelines but Board members concurred that the Fund would need to exercise caution in its assessments, so as not to take on a role of a rating agency or to become involved with detailed issues relating to individual financial institutions. This reflected concerns expressed by several executive directors, especially directors representing developing countries and emerging market economies.

25. The events in East Asia added to the general sense of urgency on the need to broaden the scope of Fund action, including by extending the purview of surveillance on financial sector issues. In 1998, a review by the Fund of the Asian crisis showed that the Fund needed to develop more expertise in financial sector analysis, and suggested that surveillance could encourage members to adapt their practices in line with international standards.[27] The Board agreed that the Fund should intensify its work, in cooperation with other organizations to help members design better banking and financial systems, and it supported an internal resource build-up to improve Fund assistance in this area (IMF, 1998a; IMF, 1998b).

26. The proposals to strengthen the Fund's FSS role became a major focus of the Board's attention, as reflected by the Board's work program for 1999.[28] Priorities were to examine the health of domestic financial sectors, and to identify the links among macroeconomic policies,

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[25] See "Summing Up of the Acting Chairman—Bank Soundness and Macroeconomic Policy" (BUFF/96/29, March 15, 1996).

[26] See "Summing Up by the Chairman—Biennial Review of the Implementation of the Fund's Surveillance Over Members' Exchange Rate Policies and of the 1977 Surveillance Decision" (SUR/97/38, April 3, 1997); "Transmittal of Fund Documents to Other International Organizations" (Executive Board Meting 97/30, March 28, 1997); and "Summing Up of the Acting Chairman—Toward a Framework for Sound Banking" (BUFF/97/36, April 3, 1997).

[27] See "Concluding Remarks by the Acting Chairman—Financial Sector Crisis and Restructuring—Lessons from Asia" (BUFF/99/112, September 10, 1999).

[28] See *IMF News Brief* 99/38, July 2, 1999. This course was supported by the conclusions of the external evaluation of surveillance commissioned by the Board and discussed in September 1999.

the real economy, and structural and developmental issues in the financial sector. The Board indicated that the staff assessments of risks to the macroeconomy originating in the financial sector would be used in IMF program design (IMF, 2000a: Chapter 4).

27. In May 1999, the managements of the Fund and World Bank agreed to launch the Financial Sector Assessment Program (FSAP) to assess the financial systems of member countries and assist them to strengthen those systems as needed.[29] While some Board members (notably those representing emerging market economies) were reportedly uncomfortable with the Fund examining domestic financial systems, the Board eventually endorsed the FSAP.[30] In an interview for this study, a former executive director indicated that emerging market countries were concerned that the Fund's assessments of domestic financial systems would lead to an indictment of their domestic financial housekeeping. They thought that this was not the Fund's responsibility and that the Fund was not equipped to do this work. They also feared they would eventually be subjected to undue pressure from leading countries on financial sector policy changes. The Board agreed that members' participation in the program would be voluntary.

28. Consensus on the Board emerged on the need for the Fund to play a greater role in disseminating international principles and good practices for sound financial systems. But agreement was difficult to reach on the practical modalities for assessing members' observance of standards. In 1999, the Fund began to experiment with reports on the observance of standards and codes (ROSCs), as an instrument to assess members' voluntary compliance with internationally-accepted principles of sound financial policy, and to recommend how implementation could be further improved. By April 2000, substantial progress had been made both in assessing the observance of standards and in identifying vulnerabilities (IMF, 2000b). By end-2000, the Board agreed to extend the Fund's assessments to offshore financial centers, so that global surveillance would not be weakened by a lack of reliable data on their activities (IMF, 2000c). In 2001, the Board also agreed on a list of international standards and codes relevant to Fund surveillance and on modalities for discussing members' observance in the context of Article IV surveillance. The Board identified principles for the conduct of ROSCs, including provisions to ensure that these assessments would also be done for industrial countries.[31]

29. These discussions were not easy. Some Board members from developing countries and emerging market economies expressed concerns about the process of designing and

[29] See "IMF—World Bank Financial Sector Assessment Program (FSAP)" (SM/99/216, May 21, 1999). This report was submitted to the Board for information and was discussed by the Board in October 1999.

[30] See "Financial Sector Assessment Program—Progress Report" (SM/99/226, and Sup.1, 9/13/99).

[31] See "Summing Up of the Acting Chairman—Assessing the Implementation of Standards—A Review of Experience and Next Steps" (SUR/01/13, February 9, 2001).

assessing standards. They stressed the importance of ensuring that all members would have a role in guiding the work on standards, and indicated that regular reviews by the Board of the modalities under which assessments take place, and of the list of standards used, would be vital to that aim. They objected to a proposal that would formally link assessments of standard-compliance with Fund surveillance, on grounds that this would undermine the voluntary character of the assessments and transform them into an obligation for members.

30. In early 2001, responding to a request by a number of major shareholders, the Fund started discussions on how to support global efforts to fight money laundering.[32] Many Board members raised questions on the consistency of the new mission with the Fund mandate, citing inconclusive evidence on the macroeconomic impact of financial system abuse. Board members from developing countries and emerging market economies feared that conditionality could be extended to anti-money laundering measures. Anticipating the Fund's collaboration with the Financial Action Task Force (FATF) to carry out the assessments, some Board members expressed concern about the inconsistency between the Fund's cooperative culture and FATF's non-cooperative approach. The Board agreed that the Fund would be responsible for assessing compliance with financial standards that are macroeconomically relevant and pose significant risk to countering money laundering, and that the Fund should provide members with technical assistance to comply with standards. The Board also determined that the Fund should not be involved in law enforcement issues, and that the FATF process was to be made consistent with the ROSC process.

31. By end 2001, the anti-money laundering (AML) agenda had been expanded to incorporate measures to combat the financing of terrorism (CFT). Designing and implementing the combined AML/CFT agenda required the Board's close engagement. The Board set principles to guide the Fund's role in this area (IMF, 2003: Chapter 2), and agreed that AML/CFT assessments would be included in all FSAPs and offshore financial centers assessments (IMF, 2004: Chapter 2).

32. The Fund also sought to strengthen multilateral surveillance of financial systems with the establishment, in 2001, of the International Capital Markets Department and the Capital Markets Consultative Group to enhance the institution's capacity to keep current with financial market developments through regular contacts with major market participants.[33] The new department helped the Fund address systemic issues related to capital market developments, and to provide early warning of potential stress in financial markets. It was charged with producing the semiannual *Global Financial Stability Report*, the Fund's flagship document designed to identify vulnerabilities in the global financial system.

[32] See "Enhancing Contributions to Combating Money Laundering" (EBM/01/38, April 13, 2001).

[33] See "Report of the Managing Director to the IMFC on the IMF in the Process of Change," April 16, 2001.

33. The years after 2001 saw continued Board scrutiny of the Fund's work on the financial sector. Now that the components of the FSS framework were in place, a significant amount of Board time went into progress reviews of assessment programs, stocktaking exercises,[34] discussions of improving diagnostic and policy tools, and evaluations of FSS modalities. The Board called for streamlining and prioritizing of assessments, ensuring follow-up action, and achieving more continuous surveillance, especially of systemically important countries. In 2002, the Board recognized the need to bring the coverage of financial sector issues up to par with that of other areas of surveillance.[35] In 2004, noting that this had not yet been achieved, the Board pressed staff to make use of all available options to bring the necessary expertise to bear.[36] In 2005, the Board supported steps to strengthen follow-up monitoring of financial systems, and encouraged a more systematic participation in Article IV consultations by financial sector specialists. The Board also saw potential in undertaking regional financial exercises for regions with substantial cross-border links.[37]

34. Further strengthening of FSS, through better coverage of financial sector issues in Article IV consultations, better analyses of vulnerabilities, and integration of macroeconomic and financial market analysis, became a core objective of the Medium-Term Strategy that the Fund introduced in September 2005.[38]

35. Since 2001, management has undertaken various reviews of the FSS framework through external experts and internal task forces (as described below). Recently, management merged the International Capital Markets Department and the Monetary and Financial Systems Department into the Monetary and Capital Markets Department, to serve as the center of all aspects of financial, capital markets, and monetary work in the Fund. A Financial Sector Steering Committee, chaired by the Managing Director, was established to oversee the internal changes, coordinate financial sector work, and ensure the close involvement of Fund management in financial sector issues.

36. Work is currently underway to better integrate financial issues into Article IV surveillance. The internal task force set up for this purpose has reported on its findings, and

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[34] For example, see "The Acting Chair's Summing Up—The Standards and Codes Initiative—Is It Effective? And How Can It Be Improved?" (BUFF/05/125, August 3, 2005).

[35] "Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Overview and Extension of Deadline for Review" (Minutes of the Executive Board Meeting 02/38, April 5, 2002).

[36] See "The Chairman's Summing Up—Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision" (SUR/04/80, August 2, 2004).

[37] The Board discussion is summarized in IMF Public Information Notice (PIN) No. 05/47, April 6, 2005.

[38] See "The Managing Director's Report on Implementing the Fund's Medium-Term Strategy," April 5, 2006.

advised on ways to increase the analytical sophistication of the FSS framework.[39] The Fund's current challenge is to understand more deeply the interactions between financial markets and the macroeconomy, the role of the financial sector in causing or amplifying shocks, the nature of vulnerabilities, and their interaction with potential trigger events.

B. Changing the Fund's Culture

37. Absorbing new functions, adapting the organization to new tasks and responsibilities, and maintaining quality output puts the IMF under considerable strain. Yet the single most challenging problem was—and remains, to some extent—changing the culture of the institution.

38. The Fund understands that integrating financial-sector analysis and traditional macroeconomics into what is today termed "macro-prudential surveillance" is not just a matter of adding new functions to old ones but requires the organization to analyze and assess new combinations of elements for which no blueprint is readily available. At the time the Fund was asked to extend surveillance to this new area, a clear vision was not uniformly held within the institution. Some considered FSS as essentially a process of observing and reporting on members' compliance with standards and codes of good practices. Others insisted that financial sector surveillance required a more comprehensive—macro-prudential—type of assessment, through composite analyses of various indicators and qualitative assessments of country financial risks and vulnerabilities, considered in their interrelations with macroeconomic developments. This more holistic view is much more demanding and risky to implement—especially given the lack of agreement on a model for determining the vulnerability of a financial system, or on a set of universally-accepted macro-prudential indicators.[40] Fund management supported the holistic approach. Operationally, this translated into new power configurations within the organization, with traditionally less prominent units gaining a louder voice.

Actions by management: seeking expert opinions

39. The substantial expansion of the Fund's mandate within a short period meant that the organization had to grapple with new responsibilities, new demanding tasks, the creation of new skills and adaptation of old ones, internal adjustments, and increased workloads. Fund staff became intensely engaged in developing new and more sophisticated forms of macro-prudential analysis. This work brought up the recognition of new frontiers of FSS, which demanded knowledge and vision beyond those required by the existing framework.

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[39] See "Report of the Taskforce on Integrating Finance and Financial Sector Analysis into Article IV Surveillance" (SM/07/57, February 9, 2007).

[40] See "Macro-prudential Indicators. Seminar discusses ways to assess soundness of financial system to improve surveillance," *IMF Survey*, September 27, 1999, pp. 296–97.

40. Fund management sought advice from experts on how to approach and structure the work. In 2001, the Managing Director appointed a panel of external experts, led by John Lipsky, to provide an independent perspective on how the Fund should organize its financial sector and capital markets work. Their evaluation noted that Fund staff had not given enough priority to incorporating financial sector issues into the Fund's work. It also noted an inadequate level of expertise and support to area departments on financial sector issues, and a weak link between the Fund's multilateral surveillance of capital markets and its core bilateral surveillance.[41] The Lipsky report was followed by a review by an internal working group, chaired by then FDMD Stanley Fischer, which examined the implications of the report's recommendations.[42]

41. A year later, the Managing Director established a review group, chaired by Arminio Fraga, to take stock of the activities of the Monetary and Exchange Affairs (MAE) Department and evaluate the their adequacy in attaining the Fund's overall policy objectives. The Fraga report identified unevenness in the quality of FSS, lack of continuity in team assignments, instances of inconsistent advice, and insufficient expertise within some sections of the headquarters staff.[43] The report observed that the new surveillance functions were not well integrated with traditional ones. It also observed a considerable overstretching of the Fund's resources, due to an overambitious agenda and an underestimation of how the new mandates would affect the organization. The Managing Director convened a task force, chaired by Jack Boorman, to advise on how to respond to the recommendations of the Fraga report.[44]

42. In 2005, the Managing Director asked a committee led by William McDonough to conduct a comprehensive review how the Fund performed its work on financial sector and capital market issues. The McDonough report found the Fund to be insufficiently attuned to the impact of financial sector developments on policy formulation, implementation, and effectiveness, and advised that the Fund needed to build the skills to interact with domestic policymakers and market participants.[45] Further, it noted that the FSAPs were not yet sufficiently integrated with other Fund work—a conclusion that was confirmed by the IEO evaluation of the FSAP (IEO, 2006). The Committee saw a need to modify the Article IV

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[41] "Report of the IMF Financial Sector Review Group," January 16, 2001.

[42] "Report of the Working Group to Review the Fund's Financial Sector Work" (FO/DIS/OI/22, March 1, 2001).

[43] See "Review of the Monetary and Exchange Affairs Department, November 4, 2002" (FO/DIS/03/10, February 11, 2003).

[44] "Report of the Task Force on the Review of the Monetary and Exchange Affairs Department," December 17, 2002.

[45] See "Report of the Review Group on the Organization of Financial Sector and Capital Markets Work at the Fund," November 2005.

template in order to place financial issues squarely at the center of the Fund's country work, especially in systemically important countries. Their report also noted that the emphasis given to financial sector issues outside of crisis cases depended heavily on mission chiefs' preferences, and that member countries did not perceive staff as possessing sufficient expertise and authority on capital market issues. The committee called for

> "…**a fundamental change of orientation and mindset for all involved: area departments, functional departments, Fund management and the Executive Board**. Achieving such a change will require clear direction from the top as to what is expected." (p. 10. Emphasis in the original text.)

43. Following the McDonough report, management asked Leslie Lipschitz and Raghuram Rajan to lead a task force charged with examining how the Fund can improve its analysis of financial issues and better integrate it into Article IV Surveillance.[46] The task force set out a broad framework on how to integrate finance into Article IV surveillance, and developed several proposals relating both to content and process. In particular, the task force stressed the importance of better understanding the channels of interaction between the macroeconomy and the financial sector, and indicated a number of organizational issues that required the attention of management.

Relative passivity of the Board

44. What role did the Board play in helping the Fund to get over its "growing pains" and move up to the new frontiers of FSS? The Board seems to have taken a back seat in this regard. To be sure, in the context of the 2004 Biennial Review of Surveillance, the Board noted that the coverage of financial sector issues, while improved, was not yet on par with the coverage of other areas.[47] But Board discussions yielded little more than exhortations to do more.[48] No requests were made to management for a plan of action with a timetable.

45. The Board's passivity may be indicative of governance weaknesses. The Board is well placed to monitor management and staff: it has continuous access to management and staff; it has ample opportunities to engage in technical discussions, program evaluations, and stocktaking exercises on any issue; and it has direct contacts with member countries as the ultimate receivers of Fund services. The Board could have exploited this position when overseeing FSS, but it did not. It could have raised several of the problems that were

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[46] See "Report of the Taskforce on Integrating Finance and Financial Sector Analysis into Article IV Surveillance" (SM/07/57, February 9, 2007).

[47] See "The Chairman's Summing Up—Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision" (SUR/04/80, August 2, 2004).

[48] "Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision" (Minutes of Executive Board Meeting 04/72-1, September 29, 2004).

identified by the external experts, but it did not. It could have solicited feedback from members on the quality of FSS; it could have identified emerging problems and asked management to address them; and it could have questioned staff on the adequacy of the analytical framework. If it had felt that it lacked enough capacity to deal with a new and complex function, it could have mobilized external expertise, as management did. Board members asked questions about some of those problems, but only after the external experts had pointed to them. Section IV explores why the Board was not more proactive.

IV. Integrating Financial Sector Analysis into Fund Surveillance: How did Governance Work?

A. Global Governance and Fund Governance

46. The history of the Fund's financial sector surveillance shows a decision-making process flowing from the world's largest economies, which set strategic directions, to the Fund as the agency responsible for elaborating and executing those directions. The record shows the G-7 countries taking the lead in the mid-1990s, and keeping a strong grip on the process to set up an international policy framework for financial system stability, as they recognized the increasing importance of financial sector issues for global economic stability.

47. The global nature of the problem, and the recognition that the emerging market economies were an essential part of the solution, led the G-7 to facilitate the creation of new institutional spaces where the governments of systemically relevant (industrial and emerging) countries could cooperate and agree on financial sector strategies and policy agendas. This translated into demands for new types of intervention from the Fund (and other organizations).

48. The Interim Committee (and its successor, the International Monetary and Financial Committee (IMFC)) accepted the new demands and called on the organization to deliver the appropriate responses. The Board functioned was responsible for ensuring that the Fund executed its new mandates. Fund management (and staff), in interaction with the Board, was responsible for developing the appropriate response, including by setting up, adapting, and implementing the operational framework. Board and management needed to make sure that the responses would be acceptable to the Fund membership.

49. Four elements complete this global governance picture. First, interactions between the global players are not unidirectional: executive directors advise their governments on Fund-related strategy and policy, and Fund shareholders reach agreements on agendas after the Fund has elaborated operational proposals. Second, the Managing Director, in the dual capacity as chair of the Board and chief executive officer of the Fund, enjoys direct contacts with member governments, so that inputs and feedback can be shared without the Board's intermediation. Third, the Fund has an incentive to work with shareholders to expand the institution's mandates and influence. Fourth, management plays a key role in communicating and articulating to world opinion the Fund's position on international monetary and financial

policy issues. These elements may combine and empower Fund management to pursue initiatives more proactively than is possible for the Board.

50. As pointed out by a former senior Fund official interviewed for this study, there are instances when Fund management succeeds in persuading major shareholders to take ownership of certain initiatives and work through international forums to encourage their adoption. Many observers, for instance, recognize that former MD Michel Camdessus played an important role, following the 1994-95 Mexican crisis, in directing the attention of the international community to the need to pay greater attention to financial sector issues.

51. The global governance process underpinning the development of the FSS agenda was more inclusive than past international agenda-setting processes. In 1997, the G-10 recognized the importance of using a consultative process to develop the international strategy to strengthen financial systems, and the desirability of a wider endorsement of the strategy by the international community.[49] Developing countries supported the strategy, although they often voiced important concerns.[50] A key feature of the new agenda, which resulted from the need for a broad consensus, was the voluntary nature of the financial sector surveillance exercise: peer pressure, imitation, and incentives—as opposed to new obligations—were to be relied on to expand the reach of FSS.[51]

B. How Did the Fund's Organs of Governance Perform?

52. The process leading to the creation and implementation of the FSS framework since the mid-1990s has been a major accomplishment. The Fund has proven its ability to bring its quasi-universal membership to agree on a complex mechanism of surveillance, to implement it, and to adapt it over time. Given this success, one should conclude that the IC/IMFC, Executive Board, and management have performed their functions well. However, it is worth making a number of observations with respect to each individual governing body, taking into account the weaknesses discussed above.

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[49] See Communiqué of the Ministers and Governors of the Group of Ten, Washington, DC, 28 April, 1997. www.bis.org/press/p970509.htm.

[50] See Caracas Declaration II of the Group of Twenty-Four (G-24), February 7–9, 1998. <www.g24.org/> Concerns ranged from their exclusion from the decision-making process to the asymmetric treatment they receive under FSS vis-à-vis the advanced countries, and the fear that FSS would translate into conditionality for use of Fund resources. They were also concerned that assessments of standards compliance would not take sufficient account of their different level of financial sector development, and that the Fund's role in AML/CFT activities would not be consistent with its mandate and core areas of expertise (see Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development, Communiqué, 1995—2007 issues).

[51] On the political economy underpinning this feature, see Bossone (2008a).

Interim Committee/International Monetary and Financial Committee

53. As an advisory body of the Board of Governors, the IMFC might be expected to set strategic directions for the Fund. But the Committee is not organized to perform such a duty effectively. On financial sector issues, the strategy for the Fund has been set outside the Committee. Typically, the IMFC endorses new Fund mandates after the Board and management have worked out the operational modalities. The role played by the IMFC on FSS raises important governance issues.

54. The resolution establishing the IMFC does not assign the Committee formal responsibilities either to oversee the activity of the Fund or to hold the Fund accountable for the results of its activities. During the process of integrating FSS into surveillance, the IMFC periodically noted the progress achieved by the Fund, and agreed on the next steps to be taken. Because of the close coordination between executive directors and their national authorities, the positions taken by individual IMFC members at the Committee meetings overlapped (if not coincided with) with those held by their executive directors at the Board

55. The IMFC's review of reports submitted by the Managing Director after Board endorsement does not provide the Committee with elements with which to distinguish the views of management from those of the Board. Neither does it provide benchmarks against which the Committee can assess the Fund's performance, nor mechanisms through which it could hold the Board and management accountable.

56. Though it is possible to conceive of assigning to the IMFC the task of assessing the Fund's efficiency and effectiveness the same is not as easy with respect to accountability. The Fund's philosophy of working by consensus through iterative interactions between its organs of governance tends to blur the separation of responsibilities that would be needed for each governing body to be held individually accountable for its acts and performance.

Management

57. Fund management (and staff) has been the critical source of the Fund's success in the FSS story. Management not only successfully led the organization to set up and implement the FSS framework on a very compressed time schedule but also dealt proactively with the many challenges raised by the new mandates. This may be stated without judging the merit of individual management decisions, which are not for this study to evaluate.

58. In 2001, management initiated a series of reviews of FSS-related activities without engaging the Board upfront. Management may have preferred this line of action on the grounds that the organizational issues were its own prerogatives. However, it would be wrong to conclude that management kept the Board out of the loop. Management made the reviews available to the Board for information. It was up to the Board to request additional discussions if they deemed that further analysis was necessary.

Executive Board

59. The Board was not the originator of the FSS framework (this role was played by policymakers in major shareholding countries). And it was somewhat slow in understanding the emerging relevance of financial sector issues for macroeconomic stability and in accepting the recommendation of management to expand country surveillance to financial sector issues. But the Board was central to the establishment of the new framework and to its operation in a way that was acceptable to the membership. As noted, the Board has since had some lapses of oversight, perceptive capacity, and strategic vision. The Board has a number of strengths and weaknesses that deserve consideration.

Strengths

Strong consensus building and peer pressure

60. The Board (interacting with management) was deeply involved in elaborating the new surveillance framework. The Board was where Fund members could think through, and agree on, the operational modalities of the new framework and provide guidance to the institution, especially on issues which required broad consensus. The long-term nature of the design and implementation process of the FSS agenda facilitated the use of established internal channels, where the Board discharged its oversight responsibility both in form and substance. Coordination within groups of executive directors took place on sensitive issues, and divergences were resolved in the Board through consensus. When groups of directors pushed for specific initiatives, the Board was the essential forum to reach consensus on them.

Effective monitoring

61. The Board conducted periodic reviews of financial surveillance, the FSAP, and the standards-implementation initiatives. It has closely and continually overseen the status of work through progress reports based on staff analyses. In the process, it has supported changes and incremental innovations, providing recommendations and advice.

62. The Board had an important responsibility in ensuring that the Fund would have enough resources to carry out the new mandates effectively, without impairing its other core activities. Considering the increased pressure on Fund staff and resources associated with carrying out the new mandates, the Board accommodated expansionary budgets in 1999 and 2000,[52] thereafter gradually tightening budget constraints with the aim of inducing efficiency

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[52] The concern was felt that staff was undergoing severe stress that was affecting both morale and work quality, as explained in a dramatic and provocative statement to the Board by the Chair of the Staff Association Committee ("Administrative and Capital Budgets for FY 2001," EBM/00/44, April 25, 2000).

savings.[53] A reform of the budget was called for, and a "zero real growth" rule eventually introduced, as the Board recognized its responsibility both for having assigned new mandates without regard to cost implications.

Effective feedback to/from capitals

63. Board members are in contact with and advise the governments of the countries they represent. They may also serve as an effective communication channel of inside knowledge between the Fund and the authorities. Their role helps international agreement to take shape around Fund-related policy agendas and initiatives.

Strong feedback mechanisms between the Board and management

64. The daily relationship of the Board with management facilitates the search for Fund policies and products that take into account specific demands and concerns of member countries. This is of great importance especially for those Fund members with less voting power (and voice). These feedback mechanisms were active in those instances when—as recalled by officials interviewed for this study—some countries showed themselves skeptical about the Fund's involvement in specific FSS activities.[54]

Weaknesses

65. There are limitations on the Board's ability to exploit its potential for collegial work and to maximize the benefits from the continuity of action that is made possible by its permanent resident status. These limitations may partly explain the Board's failures to recognize the institution's "growing pains" in integrating financial with macroeconomic surveillance, and the need for the Fund to extend and strengthen its FSS.

66. The FSS history shows that the Board is more effective in its role as an agency of the shareholders, ensuring execution of the Fund's mandates, than as a collegial body of administrators working together to shape a vision and develop a problem-perception capacity, and making best use of their information potential.

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[53] Due to the new resource demands imposed by the FSS-related activities, Fund technical assistance operations in the financial sector declined in 2000–01, and recovered thereafter (IEO, 2005).

[54] An example relates to the FSAP. When the FSAP pilot program was launched in 1999, some executive directors engaged actively in persuading their authorities to join the voluntary exercise, and executive directors representing industrial countries made the case with their authorities that leading by example—by requesting an FSAP at that early stage—might encourage the participation of developing countries.

Weak communications and "collegiality" among executive directors .

67. Executive directors consider themselves primarily as representatives of the countries that elect or appoint them. This narrows their space to work cooperatively.[55] Directors do not normally undertake efforts to shape common positions on Board issues. The may coordinate their positions within specific groups of countries (e.g., G-7, G-11, G-20, or the European Union) or across ad-hoc issue-specific country coalitions, but such coordination exercises do not reflect any intention to work collegially at the Board level.

68. The Board's work is driven by the staff, as instructed and controlled by management. Swamped by a heavy routine, directors cannot invest much time going beyond the information reported to them by the staff.[56] The Board broadly works within the limits set by management. Staff papers and reports to the Board (after careful filtering and distillation by management) identify content issues, provide basic information, and formulate recommendations on which the Board deliberates or provides guidance. On FSS related issues, the Board itself has seldom initiated new action or proposed courses of action radically different from what management recommended.[57]

69. Several former senior Fund officials who held key responsibility in the FSS area noted that most Board members lack previous experience with corporate boards or top managerial positions, and tend to be too acquiescent to management. On country financial sector issues, the interviewees recalled the Board accepting to be addressed by area department staff selected by management, rather than questioning the real experts. On technical aspects, Board members were described as being too keen to agree with staff and unwilling or unprepared to ask tough questions.[58] The interviewees reported that the Board had never asked management about which structures the Fund could put in place to improve

[55] If the Board were to function in such a capacity, new institutional solutions would be needed to make such an organ collegially accountable toward the international community. For proposals, see De Gregorio and others (2004), and Portugal (2005).

[56] More useful, perhaps, are the informal discussions that IMFC members hold at breakfast and at the luncheon following the plenary session. Unfortunately, no written records or communiqués are available for a systematic evaluation of these discussions.

[57] For example, in the context of the 2004 biennial review of surveillance, the Board noted that the coverage of financial sector issues, while improved, was not yet at par with coverage in other main areas. As is usually the case, this observation directly drew from the staff report (see "Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Overview," SM/04/212, July 2, 2004). It would not be typical for the Board to draw a similar observation from alternative sources (including its own comparative evaluation of Article IV reports), and probably the Board would not have arrived at this observation had it not been reported by the staff.

[58] The curricula vitae of the executive directors and their staffs, during 1995–2006, show a small and stable share of new officials with financial sector backgrounds. While the cv format available provides very limited details, the criteria adopted to qualify professional backgrounds as relevant to the financial sector were deliberately unrestrictive.

FSS.[59] The generally passive attitude of the Board may also partly result from its chairmanship by the Fund's chief executive officer. Executive directors may be reluctant to challenge the Managing Director as a matter of practice. At the same time, when management submits proposals to the Board for deliberation, the Managing Director is hardly in as good a position to challenge management as if s/he were chair of the Board only. The Managing Director, in other words, chairs the same body that is expected to hold him/her accountable for the performance of management and staff.

Ineffective use of information

70. The weaknesses noted above limit the Board's capacity for oversight and vision. They constrain the Board's ability to probe into the work of management and staff ahead of time, questioning information, and cross checking it with alternative sources. Executive directors do not systematically integrate the information available to them (including from member countries, informal exchanges with staff, and external studies and advice) either to inform exchanges within the Board or to prepare discussions with staff and management.[60] "Tunnel vision" may tend to form around staff-management views, depriving the institution's governance of the benefits of a truly dialectic process of issues analysis—which a resident Board in continuous session should in principle be able to afford. The Board's poor preparedness for the FSS challenges discussed earlier may owe much to these factors. These governance shortcomings are of consequence when issues present new challenges. The Board's failure to recognize those challenges is illustrative of its ineffective use of its privileged access to information and feedback from members as receivers of Fund services, which diminishes its oversight capacity.

71. On the issues that triggered the FSS external reviews, management and the Board may have deliberately kept at each other's arms' length, on the grounds that the underlying issues were a management prerogative. In fact, those issues did have strategic relevance and bore implications for the effectiveness of Fund surveillance—an area where the Board holds a key responsibility. As a result, the Board failed to spot the significant gaps affecting the FSS framework.

[59] Reportedly, Board members generally lacked adequate knowledge of financial sector issues. Staff members often expressed disenchantment at the scant attention given to these issues by the Board at meetings. The interviewees recalled important Board sessions where Board members read questions out of scripted statements, but were unable to follow up on issues for which they were supposed to provide oversight. A Fund staff member interviewed, confirmed that Board discussions of FSSAs are not very deep. These opinions are consistent with the findings of the IEO (2006) evaluation of the FSAP.

[60] Several observers hold that the Board does not have the resources to monitor staff effectively (for useful references, see Cottarelli, 2005: 9). The present case study holds, however, that the Board falls short of collecting and using optimally the information to monitor and engage staff effectively.

V. Conclusions and Recommendations

72. IMF governance has been effective in ensuring that financial sector analysis has become integral to the institution's surveillance function, as requested by shareholders. The process started in the second half of the 1990s and accelerated following the East Asian crisis, as part of a rapidly evolving international financial policy agenda. The years after the crisis saw the intense implementation and continual adaptation of the new surveillance framework.

73. The Board exercised vigilant oversight throughout the process, ensuring that the Fund would progress rapidly and effectively in executing the agenda, and helping strengthen the consensus of Fund members on the need to act cooperatively. However, the Board showed itself unable to keep up with the increasing sophistication of the new framework, at least to the extent needed to provide needed oversight. Management (and staff) handled successfully the design and operational aspects of the process and its implementation, and made sure that the framework would evolve in line with the needs of members, taking on board lessons from experience and new knowledge. The IMFC gave political legitimacy and ownership to the process, by endorsing the strategy guiding it and the solutions to set up and run the framework, but did not have a leading role in the process.

74. The following recommendations on the role of the Fund's governance actors, and especially those concerning the Executive Board, propose narrowly-focused and specific solutions aimed at improving the effectiveness of FSS.

A. International Monetary and Financial Committee

75. There is a need to reconsider the functions of the IMFC. If the Committee is intended to play a role in setting strategic directions for the Fund, it should organize itself differently.[61] If, instead, the Committee's intended role is to grant "political" legitimacy and ownership to Fund initiatives, it should be made clear what role would the Board play in this regard.

76. If changes to the functions and responsibilities of the IMFC are contemplated, their possible impact on the Fund's overall governance structure should be carefully considered. In particular, if the Committee were to take a more direct role in assessing Fund performance and in holding the Fund accountable for its performance, several other significant changes would need to be considered, including:

- granting executive directors greater independence from their capitals, while making it explicit that they owe primary loyalty to the institution;

[61] For a discussion of this topic, including a review of existing related proposals, see Kenen and others (2004).

- separating the roles and responsibilities of the Board and management much more distinctly; and
- having the Board and management report separately to the IMFC. These changes would also require that the dual capacity of the Managing Director be reconsidered.

77. All this would affect the Fund's traditional mode of operation by consensus.

B. Management

78. The main issue emerging from this review on management's interaction with the other governing bodies in the context of the FSS framework is that it did not engage the Board sufficiently in the review of important implementation aspects after 2001. While the responsibility for this limited involvement rests primarily with the Board itself, it is fair to say that in the Fund's highly interactive Board-management setup, a call for an upstream and deeper engagement of the Board in the process could usefully have come at the initiative of management. Looking forward, effective use of Board committee work on financial sector issues (see below) would resolve or prevent these problems.

C. Executive Board

79. Integrating financial sector analysis into Fund surveillance required more than simply adding a new set of instruments to an old toolkit. Drawing meaningful indications from financial system stability assessments in the context of Article IV consultations is not just a question of discussing those findings *in addition* to the usual macroeconomic considerations. It is rather a matter of *combining* the former and the latter and trying to make sense of their two-way interrelations. This was a hard challenge for the staff and management of an institution so deeply engrained in a macroeconomic-based culture, and it was at least as hard a challenge for executive directors.

80. The Board seems to have lagged somewhat behind in catching up with the requisites of the new task: Board discussions often constituted a poor platform to discuss financial sector assessments; quality failures of FSS often went undetected by the Board; and ideas to push the envelope of the FSS framework have come from sources other than the Board. The major limitations of the Board in overcoming this challenge are directors' inadequate knowledge of financial sector issues. These factors limit the potential capacity for "multiple eyes" oversight that is offered by the Board's resources, contacts, and information access.

81. Looking forward, the Board should consider taking the following steps.

Beef up the Board's financial sector skills

82. Executive directors should strengthen their office capacity on financial sector issues. While it would be ideal if the Fund could count on the regular presence in the Board of at

least some directors with a strong financial policy background, it would be important at a minimum that directors could rely on the advice of financial policy experts within their offices. In offices where personnel are selected by national authorities, directors should agree with the authorities on the adoption of selection criteria to ensure a regular presence of staffs with the needed skills. This measure could be complemented by Fund internal training programs and technical briefings for directors' offices on financial sector issues.

Strengthen liaison with national financial supervisory and regulatory agencies

83. Executive directors' offices have direct contacts with the international and monetary affairs departments of the financial institutions in the countries they represent. Extending their liaisons with national financial supervisory and regulatory agencies would provide them with greater access to financial sector knowledge and expertise.

Establish a Financial Sector Policy Committee

84. Organizing the Board's work on financial sector issues through a dedicated committee would have a number of advantages. First, a committee could undertake upstream work in more depth and technical detail than is possible for the full Board, and thus prepare the ground for better Board deliberations. Second, by enabling the Board to engage early in the work processes, a committee would enhance the Board's capacity to oversee and provide guidance on relevant issues. Finally, a committee would maximize the Board's capacity to address issues of the quality of FSS and follow-up services through a better organized information search process and a more systematic use of the Board's information potential.

85. Such a committee, chaired and staffed by executive directors, would closely and regularly oversee the Fund's financial sector work, on behalf of the Board and in preparation for Board deliberations. Its oversight could span such tasks as monitoring work progress on the analytical framework, reviewing financial sector conditionality in Fund-supported programs, and discussing critical financial system stability assessments or warning signals from financial markets in a timely manner. The committee would report to the Board, inform the Board of its findings, and recommend action for full Board consideration. It would hold regular meetings with management and staff, based on a work program and agenda agreed with the Board. The committee could summon any staff to refer on specific issues. The committee could consult national authorities on issues concerning FSS quality, and could avail itself of external advisory services and expertise as necessary.

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