

## THE IMF AND CRISIS PREVENTION – THE LEGAL FRAMEWORK FOR SURVEILLANCE

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### INTRODUCTION

1. The international community is currently devoting a great deal of attention to the reform of the international financial institutions and, in particular, the International Monetary Fund. I would like to focus on the blueprint for reform (known as the Medium-Term Strategy or “MTS”) that is currently under discussion within the Fund. I will focus on one particularly important aspect of that strategy, the reform of Fund surveillance under Article IV of the Fund’s Articles. I will look at these issues from the perspective of a lawyer working within the Fund.

2. My presentation will be organized as follows. I will first provide a brief overview of the Fund, its structure, purposes and principal activities. I will then examine the principal features of Article IV of the Fund’s Articles and the role of Fund surveillance before turning to recent efforts to reform Fund surveillance. Finally, I will examine the lessons which this reform effort teaches us from a legal perspective.

### BACKGROUND – THE STRUCTURE AND PURPOSES OF THE FUND

3. Let me begin with a few important points on the Fund’s purposes, structure and operations. First, the Fund is an international organization whose members are “countries” or states under international law. There are currently 185 member countries of the Fund. It was established in 1945 by a multilateral treaty, the Articles of Agreement.

4. Second, the Fund’s decision-making framework is based upon a system of weighted voting that is meant to roughly reflect the relative strengths of countries in the global economy. Countries with larger economies

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command more votes and, for example, the United States has the largest number of votes allotted to it, approximately seventeen percent of the total voting power in the institution. This is the system which is employed in the Fund Executive Board which is composed of twenty-four Executive Directors who are either appointed or elected by the Fund's members. The Fund staff is headed by a Managing Director, currently Rodrigo de Rato of Spain and about to be Dominique Strauss-Kahn of France.

5. Third, the Fund was established in order to fulfill a specific mandate which is reflected in the Fund's purposes as set out in the Articles of Agreement. At the risk of oversimplifying, the Fund's central purpose is to promote international monetary and financial stability, and more specifically the stability of the system of exchange rates between different currencies. As many readers know, exchange rates for different currencies in the financial markets move and the Fund's role is to seek to ensure that they will move in a stable and predictable manner that reflects sound economic fundamentals. The Fund is therefore concerned with macroeconomic stability and, unlike the World Bank, is not a development agency.

6. Fourth, in fulfilling this mandate, the Fund plays both a financial and a regulatory role. It performs its financial role by providing financial assistance to countries that are experiencing balance of payments difficulties, to help them resolve these problems without undermining the stability of the international monetary system or their own or international prosperity. It performs a regulatory role, in particular, by engaging in "surveillance" over countries' economies and economic policies. This regulatory role is essentially a form of crisis prevention that seeks to ensure that countries pursue economic policies that will contribute to the stability of the global system of exchange rates. In terms of staff time and resources, this is the most important thing we do.

#### **THE REFORM OF THE FUND – THE MEDIUM-TERM STRATEGY**

7. Surveillance has also been the recent subject of a comprehensive reform and I would like to turn now to this issue. As a starting point, I should note that surveillance reform is only one piece of a much larger reform program that is currently under discussion in the Fund. It is called the Medium-Term Strategy or MTS and is designed to help the institution respond to the new, emerging challenges of the global economy. With globalization increasing the links between countries, the Fund's role as a regulator has taken on increasing importance, in order to prevent balance of payments crises through effective surveillance. At the same time—at least for now—there is less call on the Fund's lending role.

8. Key features of the MTS include a reform of the Fund's governance structure to strengthen the voting power of key emerging market economies (particularly in Asia) and of the poorest developing countries to reflect changes

in the global economy. Moreover, the MTS contemplates a reform of the Fund's income model to depart from the Fund's traditional approach of financing its operations primarily through the income it generates from its lending operations. The current small volumes of lending have pointed to a fundamental flaw in the traditional approach, which relies on the income from variable levels of lending to fund permanent activities targeted at reducing the need for such lending.

9. While these issues are currently under discussion, the most important feature of the MTS to have been adopted so far is the reform of surveillance and, in particular, the reform of the Fund's legal and policy framework for bilateral surveillance under Article IV. Other aspects of the surveillance framework have also been modified but time does not permit a discussion of these. Rather, I will focus on the reform of bilateral surveillance but, but to do this, I must first walk you through the principal features of the Fund's surveillance model. Before proceeding, let me warn you that this aspect of the Fund's legal framework is particularly complex and, some may think esoteric. I will try to hit the high points.

#### OVERVIEW OF ARTICLE IV

10. Let me start with a bit of history. Article IV of the Fund's Articles sets out the principal obligations for both members and the Fund in the area of exchange rates. The philosophy behind the provision is to ensure the stability of the global system of exchange rates: it is necessary to establish "rules of the game" in this area that members would be required to observe and the Fund would enforce. In this manner, every country and the Fund would play its part in ensuring the stability of the global system of exchange rates.

11. While Article IV has always set out rules of the game in this area, these rules have changed over time. The original Article IV, put in place in 1945, enshrined something called the par value system. It effectively required each member of the Fund to declare and maintain a fixed exchange rate for its currency, expressed in terms of gold, and to ensure that every purchase and sale of foreign currency on its territory took place within a designated band around that par value. The Fund enforced countries' adherence to these rules and Fund concurrence was required before a country could change its par value. Stability was therefore ensured through a rather strict system of fixed exchange rates in which exchange rates changed relatively rarely.

12. While this system worked well for a number of years, it broke down in the early 1970s and was ultimately replaced by the more flexible system of floating exchange rates with which we are all familiar. In 1978, as part of the Second Amendment of the Fund's Articles of Agreement, Article IV was completely rewritten and replaced with a new framework of obligations for members and a new role for the Fund called "surveillance."

13. Before we look at the specific provisions of Article IV, let me emphasize two points about the revised Article IV. First, it recognized that the

exchange rates of countries' currencies are primarily determined by the economic policies which countries implement, both their exchange rate policies and their domestic economic and financial policies. Second, it is recognized that there is nothing wrong with a country's exchange rate moving in line with economic fundamentals as long as countries pursue sound economic policies. Exchange rate movements would be stable and predictable as long as countries kept their economic houses in order.

14. The new Article IV therefore established a framework of obligations for members that were more flexible than those contemplated under the par value system and which focused less perhaps on exchange rates themselves and more on the policies of members that give rise to those exchange rates. Let me now examine its principal features.

15. First, members no longer have to maintain a fixed exchange rate or par value for their currency and are given enormous latitude in choosing how the exchange rate for their currency will be determined. While they can no longer tie their exchange rate to the price of gold, Article IV allows them to choose any other type of arrangement, including having a floating rate, a fixed rate, or something in between.

16. Second, members have to observe a set of obligations set out in Article IV, Section 1 that seek to ensure that members will follow economic policies that contribute to the stability of the global system of exchange rates. Specifically, they are required to "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." In addition to observing this general obligation of collaboration, they must observe four specific obligations that are examples of the general obligation but are not exhaustive of its content.

17. Two of these obligations deal with members' exchange rate policies, that is, policies of members that are specifically directed at the level of the exchange rate such as the intervention policies of the central bank. They require members to 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" and to follow exchange policies that are compatible with the undertakings under Article IV, Section 1.

18. The other two obligations deal with members' domestic economic and financial policies. They require members to (i) endeavor to direct their 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. While the inclusion of these provisions in Article IV marked the first time that the Fund's Articles established obligations respecting domestic (as opposed to exchange rate) policies, they were formulated as "soft" obligations. Unlike the "hard" results-oriented

obligations respecting exchange rate policies, these provisions only require members to make their best efforts to achieve certain results.

19. Third, the Fund also has a role to play under the revised Article IV. In particular, it must oversee the compliance of each member's compliance with these obligations and exercise "firm" surveillance over members' exchange rate policies, given their importance under Article IV. The Fund's assessment of compliance with these obligations takes the form of "bilateral surveillance" which the Fund engages in which respect to each of its 185 members. To facilitate this process, members are required to consult with the Fund. Surveillance is mandatory both for the Fund and its members.

### **THE PRACTICE OF SURVEILLANCE**

20. If this is bilateral surveillance in theory, how does it work in practice? It is important to note that the practice of surveillance is governed by a series of general policy decisions adopted by the Fund's Executive Board. Secondly, it is important to note that, in practice, surveillance has evolved in a manner that bears only little resemblance to the compliance assessment referred to in Article IV.

21. The surveillance process has evolved into a policy dialogue in which the Fund seeks to persuade the authorities of member countries to follow appropriate economic policies and, where a member is implementing inappropriate policies, to change them before they lead to a crisis. On a regular basis (usually annually), the Fund discusses economic developments and policies with the authorities of each of its members and communicates its views to the member on its policies and on those areas that may be a cause for concern. These discussions or "Article IV consultations" start off as discussions between the IMF staff and the country authorities, and culminate in a meeting of the Fund's Executive Board on the member's policies.

22. In the past few years, there has been a growing recognition that Fund surveillance was not working perfectly and had tended to lose focus. In discussing economic policies with members, surveillance often focused on policies that had little impact on exchange rates. Moreover, it was argued by some that surveillance did not pay sufficient attention to members' obligations under Article IV. For example, some accused the Fund of being "asleep at the wheel" in not dealing with alleged cases of exchange rate manipulation by some countries.

23. A central pillar of the Medium Term Strategy has therefore been to make Fund surveillance more effective and to put in place a new legal and policy framework that will ensure that Fund surveillance will focus on the core issues of Article IV and, in particular, on policies that are relevant for exchange rates. These reform efforts have recently reached fruition with the adoption in June 2007 of a new Executive Board decision which provides a comprehensive legal and policy framework for the conduct of surveillance. It replaces an older decision adopted in 1977 which was badly in need of

amendment. To use a domestic law analogy, if Article IV represents the constitutional framework for surveillance, the 2007 Surveillance Decision is the legislative framework which ensures its effective implementation.

#### THE 2007 SURVEILLANCE DECISION – PRINCIPAL FEATURES

24. The adoption of the 2007 Surveillance Decision was a major step forward in the reform of Fund surveillance. It was the result of extensive discussions within the Fund and its membership lasting more than one year on how surveillance could be made better. The new decision introduces a number of important changes in the conduct of surveillance. Let me review them briefly.

25. First, the decision seeks to provide clear guidance on what the Fund is supposed to focus on under Article IV, i.e., the stability of the system of exchange rates. For this purpose, the decision makes a new concept, i.e., “external stability,” the central organizing principle of surveillance. External stability is defined as “a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements” and is based on the chapeau obligation of Article IV, Section 1, which aims at “a stable system of exchange rates.” It essentially recognizes that each member can most effectively contribute to the objectives of Article IV if it implements economic policies that contribute to the stability of its own economy and exchange rate.

26. In the context of surveillance, the Fund should only discuss policies that can significantly influence present or prospective external stability. This will typically mean that the Fund will focus on members’ exchange rate policies, and their monetary, fiscal, and financial sector policies (both their macroeconomic aspects and macro economically relevant structural aspects). Other policies may be discussed but only to the extent that they significantly influence present or prospective external stability.

27. Another important reform concerns members’ exchange rate policies. While the Fund is legally required under Article IV to provide guidance to members on how to conduct their exchange rate policies in a manner that is consistent with their obligations under Article IV, the Fund had provided relatively little guidance in this area. This guidance had taken the form of “principles for the guidance of members’ exchange rate policies,” which the Fund’s Executive Board had adopted as part of the 1977 Surveillance Decision. There were three such principles, but it was generally recognized that they were incomplete.

28. The 2007 Surveillance Decision therefore established a new principle for the guidance of members’ exchange rate policies. It provides that members “should avoid exchange rate policies that result in external instability.” Given its rather expansive scope, it provides much more comprehensive guidance to members on the conduct of their exchange rate policies than what the Fund had provided in the past.

29. What is important to note about this new principle is the legal technique that was employed for its formulation. While it guides members on what they need to do to comply with their exchange rate obligations under Article IV, it is not cast in terms of an obligation itself. The reference to “should” rather than “shall” means that members are not *required* to avoid the conduct referred to in the principle.

30. This principle represents a “soft law” technique which the Fund has employed in giving content to members’ obligations under Article IV and in guiding members on what to do to comply. While the Fund could simply have clarified that certain conduct is required of members in order to comply with the “chapeau” obligation to collaborate, it has, as an alternative, chosen to issue “recommendations” setting out one possible way in which a member may comply with its obligation. The practical effect of these recommendations is that a member can ensure its compliance with Article IV by observing all of these recommendations (and other principles set out in mandatory terms). However, if a member does not comply, it will not necessarily be found in breach of obligation – rather, it simply loses the benefit of the “safe harbor” which observance of the recommendations provides.

31. In addition to providing guidance in the form of this new recommendation, the new Decision also provided guidance on the meaning of Article IV, Section 1 (iii) of the Fund’s Articles, the obligation of members to 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.

32. The new Surveillance Decision provides guidance on the meaning of this provision that will facilitate its application to future cases. While time does not permit a detailed analysis of this provision, it is important to note that only certain types of exchange rate manipulation are prohibited. Specifically, members are only prohibited from manipulating exchange rates for the purposes of preventing effective balance of payments adjustment or to gain an unfair competitive advantage over other members. Thus, to find a member in breach of this provision, it is necessary for the Fund to determine the purpose of the member’s policies and the intent of the member in engaging in exchange rate manipulation.

33. Within this more comprehensive framework, the 2007 Surveillance Decision establishes certain safeguards that seek to provide assurances to members that surveillance, although more anchored on the obligations of Article IV, will not become a compliance or “box-ticking” exercise. The first of these is an explicit recognition that dialogue and persuasion will continue to be the hallmarks of surveillance under Article IV and that the Article IV process will continue to focus primarily on policy discussions relevant for the objectives of Article IV.

34. Second, the decision recognizes the difficulties inherent in assessing compliance with obligations that relate to such a sensitive and complex area as

exchange rates and exchange rate policies. Accordingly, it explicitly states that in assessing members' observance of the exchange rate principles, the Fund must give the member the benefit of any reasonable doubt.

35. Third, even in cases where the Fund finds that a member is not observing an exchange rate principle, the decision recognizes that it may not be possible for a member to bring itself into observance overnight. Changes in exchange rates and exchange rate policies can have far-reaching effects and may need to be implemented over time. The 2007 Decision explicitly states that, in informing the member as to what policy adjustment should be made to address a case of nonobservance, the Fund will take into consideration the disruptive impact that excessively rapid adjustment would have on the member's economy.

#### **THE SURVEILLANCE DECISION – LESSONS FOR INTERNATIONAL LAWYERS**

36. The new Surveillance Decision represents a milestone for the Fund and the development of its legal framework. While it is perhaps too early to tell what effect it will have on the conduct of surveillance, it provides some important lessons for the role which international law can play in the reform of an international organization. Let me highlight a few.

37. First, international law matters. The Fund operates on the basis of the rule of law and, accordingly, the law and the legal framework constitute an effective instrument of institutional reform. In redesigning the framework for surveillance, enormous attention was paid to the scope of members' obligations and the Fund's responsibilities under Article IV to ensure that whatever is put in place is firmly grounded in the Articles of Agreement. Stated bluntly, the Fund's membership would only accept an enhanced role for the Fund in the area of surveillance if it can be demonstrated that that role is firmly grounded in the legal framework that the drafters of the Articles put in place and members have signed on to.

38. Second, rules matter. In setting out rules of the game governing the subject of exchange rates, Article IV is only one of many examples of the manner in which a rules-based system has moderated international behavior. While the rules set out in Article IV have changed since the Fund's establishment, it is important to remember that there have always—since 1945—been rules that countries have had to comply with and the Fund has had to enforce. Having agreed rules of the game whose compliance is overseen by an international organization with near universal membership makes the game a lot easier and safer to play.

39. Third, certain types of rules may work better than others. Given the enormous complexity and sensitivity involved in issues of exchange rates and exchange rate policies, it may not always be the case that rules taking the form of hard obligations strictly enforced by an international organizations are the most effective means of achieving international cooperation. It may prove difficult to articulate rules that can effectively be applied or that members are

prepared to accept. This has led to the Fund to rely upon soft law techniques in establishing and applying the rules of the game. The use of “recommendations” has been a particularly effective tool in achieving the broadest possible support amongst the Fund’s membership in the development of new exchange rate principles. While some might argue that Fund surveillance would be more effective if it placed greater reliance upon the development and enforcement of hard obligations, the effectiveness of recommendations in building an international legal framework cannot be denied.

40. Any rules-based system also involves rules governing process. In many ways, the rules governing the process for the conduct of surveillance discussions between the Fund and its members have been as important as the rules respecting member behavior which the system is designed to enforce. By requiring the Fund to engage in surveillance over members’ policies and by requiring members to consult with the Fund for this purpose, Article IV has required the Fund to put in place a framework for continued consultations with each of its members. This consultation process is crucial to ensuring effective cooperation between countries in promoting a stable system of exchange rates, the more so in a framework based on dialogue and persuasion.

41. In any rules-based system that assesses compliance with obligations, due process matters. This is particularly important in the Fund’s legal system because the Fund itself is responsible for assessing the compliance of its members with their obligations under the Articles. In performing this role, the Fund is, in a sense, the prosecutor, judge and jury and there is no form of appeal for members to a third-party tribunal outside the institution. This has caused the Fund to exercise great care in putting in place appropriate safeguards that ensure effective due process. In particular, the Fund’s Executive Board has typically adopted general policy decisions which are designed to provide clear guidance to members on the meaning of their obligations before it seeks to enforce compliance with those obligations. This is a central purpose of the principles for the guidance of members’ exchange rate policies under Article IV and is key for the effective application of the rules of the game.

42. Fourth, legal and institutional reform is often a difficult and complex process involving a wide range of different actors and competing interests. While the new surveillance decision could have been adopted by the Fund’s Executive Board by a majority of votes cast and therefore could have been adopted by the number of votes allotted to the principal industrialized countries, Fund management recognized the importance of obtaining the broadest possible support for the decision. This inevitably meant making various changes to the draft decision proposed by Fund staff to bring different groups of members on board. At the end of the day, the decision was adopted by a very high majority reflecting a very broad cross section of the Fund’s membership.

43. The new Surveillance decision represents an important milestone in

the history of the Fund and its continued evolution to meet the changing needs of the international community. These are challenges which the Fund will continue to be ready to meet and, in meeting them, international law will continue to have an important role to play.