Chapter 2

Chapter 2 *Promoting financial and macroeconomic stability and growth through surveillance*

The IMF monitors the international monetary and financial system to ensure that it is functioning smoothly and to identify vulnerabilities that could undermine its stability. To the same end, it oversees economic policies in its 185 member countries, offering members analysis and advice and encouraging them to adopt policies that promote financial and macroeconomic stability and sustained growth. The IMF's surveillance activities at the global and country levels are complemented by periodic assessments of regional developments, including the economic policies pursued under formal regional arrangements such as monetary unions. This combination of oversight and advice is known as surveillance (Box 2.1).

During FY2007, the IMF introduced several innovations in its surveillance work. It experimented with a new forum—multilateral consultations—where countries, or entities composed of groups of countries, can work together on common issues. The first multilateral consultation was set up by the IMF to help its members address the risks posed by current global imbalances. The IMF also devoted more attention to cross-country spillovers; increased its emphasis on regional developments in an effort to achieve a better understanding of how these affect individual countries as well as the global economy; sharpened the focus of its Article IV consultations, placing a greater emphasis on exchange rate and financial sector issues; and strengthened its outreach efforts, to promote good policies and build consensus around them (see Chapter 5 for more information on IMF outreach).

Going beyond changes in the day-to-day implementation of surveillance, the Executive Board worked to strengthen and modernize the IMF's surveillance framework. The Medium-Term Strategy (MTS) calls for more emphasis on the original goal of IMF surveillance—assessing the consistency of exchange rate and macroeconomic policies with national and international stability. In FY2007, the Executive Board reviewed the IMF's 1977 Decision on Surveillance over Exchange Rate Policies, which—together with Article IV of the Articles of Agreement—is the main statement guiding surveillance, and considered ways to clarify surveillance priorities.

The IMF also took steps to better integrate financial sector analysis into Article IV consultations and regional surveillance and to identify links between the financial sector and the macroeconomy. Supporting these efforts is the new Monetary and Capital Markets Department (MCM), which was created in early FY2007 (Box 2.2). As part of the reorganization of the IMF's financial sector work in FY2007, responsibility for work on issues related to anti–money laundering/combating the financing of terrorism (AML/CFT) was centralized in the IMF's Legal Department, which shares responsibility with MCM for policy and operational questions regarding the integration of AML/CFT into financial sector work.

Box 2.1 Surveillance activities

The IMF's Executive Board conducts surveillance at the global, country, and regional levels. Global surveillance is carried out through the Board's reviews of world economic and financial market developments and prospects. The staff's *World Economic Outlook* (WEO) and *Global Financial Stability Report* (GFSR), which are usually prepared twice a year, provide major inputs to the Board's discussions and are subsequently published. The Board also holds informal discussions of world economic and financial market developments. Another important instrument of global surveillance is the *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER), which the Fund has published since 1950.[1]

When a country joins the IMF, it makes a commitment under Article IV of the IMF's Articles of Agreement to seek to pursue policies conducive to orderly economic growth and price stability and to avoid manipulating exchange rates for unfair competitive advantage. It also commits to providing the IMF with data about its economy. The IMF is mandated by Article IV to conduct surveillance to oversee members' compliance with these obligations, and it does so through regular (usually yearly) staff visits—known as Article IV consultations—to member countries.[2] (Informal staff visits often take place between consultations.) The IMF staff team collects economic and financial data and discusses with government and central bank officials economic developments since the previous consultation, as well as the country's exchange rate and monetary, fiscal, financial sector, and structural policies. Often, the team also meets with other groups such as legislators, trade unions, academics, and financial market participants. It prepares a summary of its findings and policy advice, which it leaves with the national authorities, who have the option of publishing it. On return to IMF headquarters, the staff team prepares a report describing the economic situation and the talks with the authorities and evaluating the country's policies. The report is submitted to the Executive Board for review and discussion. A summary of the Board's views is transmitted to the country's government. Through this kind of peer review, the global community provides policy guidance and advice to each of its members, and the lessons of international experience are brought to bear on national policies. If the member country agrees, the full Article IV consultation report and a Public Information Notice (PIN), which summarizes the Board discussion, are published on the IMF's Web site, in line with the IMF's transparency policy (see Chapter 5).

Supplementing these systematic and regular Board reviews of individual member countries are Executive Board assessments of economic developments and policies in member countries borrowing from the IMF, as well as frequent informal sessions at which the Board discusses developments in individual countries. On a voluntary basis, countries may also choose to participate in the joint Fund-Bank Financial Sector Assessment Program (FSAP) or to request Reports on the Observance of Standards and Codes (ROSCs; Box 2.3).

1 *Appendix II, "Financial operations and transactions," to this* Report *contains a brief summary of members' exchange rate regimes in Table II.9, "De facto classification of exchange rate regimes and monetary policy framework." The Appendix can be found on the CD-ROM and on the IMF's Web site, at* www.imf.org/external/pubs/ft/ar/2007/eng/index.htm.

2 *The IMF's Articles of Agreement can be found at* www.imf.org/external/pubs/ft/aa/index.htm.

Box 2.2 Monetary and Capital Markets Department

Following up on the recommendations in the November 2005 report of the External Review Group on the Organization of Financial Sector and Capital Markets Work at the Fund (experts commissioned by IMF management), the Monetary and Capital Markets Department (MCM) was created in early FY2007.[1] MCM, a merger of the International Capital Markets and the Monetary and Financial Systems departments, centralizes the responsibilities, functions, and expertise of those two departments within a new organizational structure and serves as a resource for other Fund departments.

MCM is responsible for policy, analytical, and technical work relating to financial sectors and capital markets, and monetary and foreign exchange systems, arrangements, and operations. Its principal tasks are to identify potential risks to global financial and macroeconomic stability and their implications for individual countries; assess the vulnerability or soundness of countries' monetary and financial systems and the effectiveness of member governments' oversight of these systems; promote safeguards for the prevention of financial crises and contribute to the operation of the international architecture of risk mitigation and management; and support capacity building in member countries. MCM's capacity-building activities are described in Chapter 4.

1 *See Press Release 06/21, at* www.imf.org/external/np/sec/pr/2006/pr0621.htm.

Implementing Surveillance

Surveillance focused on several key issues in FY2007, including heightened volatility in financial markets; the potential spillovers and risks associated with a disorderly unwinding of global imbalances; the possible impact of the slowdown in the U.S. housing market on the global economy; and the effect of high prices for oil and other commodities on both importing and exporting countries. The analytical tools used in the preparation of the *World Economic Outlook* and the *Global Financial Stability Report* were applied to capture cross-country spillovers and draw policy lessons.

Global surveillance

World Economic Outlook

In its August 2006 and March 2007 discussions of the *World Economic Outlook* (WEO), the Executive Board welcomed the continued strong, broad-based expansion of the global economy during calendar year 2006, noting that activity in most regions met or exceeded expectations. Executive Directors believed that the global expansion would slow only modestly in 2007 and 2008 and that inflationary pressures would remain contained. They were generally of the view that the market turbulence of February and March 2007 represented a correction after a period of asset price buoyancy that did not require a fundamental revision in the positive global economic outlook.

At the time of the March 2007 discussion, risks to the global economy—the ongoing correction in the U.S. housing market, persistently higher financial market volatility, the chance of a reversal of the decline in oil prices, and the possibility of a disorderly unwinding of large global imbalances—were still seen as tilted to the downside but appeared to be more evenly balanced than they had been six months earlier. The key question in assessing these risks is whether the world economy will remain on a sound growth trajectory even if the U.S. economy slows more sharply—that is, whether global prospects might decouple from the United States, especially in view of the limited impact of the recent cooling of U.S. activity.[10]

Global Financial Stability Report

At their March 2007 discussion of the *Global Financial Stability Report* (GFSR), Executive Directors agreed that global financial and macroeconomic stability continued to be underpinned by solid economic prospects, although downside risks had increased somewhat in a few areas. A number of market developments warranted increased attention, reflecting a shift in underlying financial risks and conditions since the Board's discussion of the previous GFSR in August 2006. While none of the identified short-term risks constituted, in and of itself, a threat to financial and macroeconomic stability, adverse events in one area could lead to a reappraisal of risks in other areas, with possible broader implications for the economy. The market turbulence of February and March

10 The full summings up of the Board discussions on the WEO are on the CD-ROM.

2007 validated this assessment and served to remind market participants that such reevaluations could occur quite rapidly. Macroeconomic risks as well as risks faced by emerging markets had eased marginally since the previous GFSR, but market and credit risks had risen, albeit from relatively low levels, and large capital inflows to a number of emerging market countries posed challenges to policymakers. The risks of a disorderly unwinding of global imbalances had also eased somewhat but remained a concern.

Hedge funds were playing a constructive role in improving market efficiency and stability, but the Board cautioned that their size and complex risk structure could lead to increased transmission or amplification of shocks. While observing that the increased diversity of assets, source countries, and investor types contributed to a globalized financial system that, by allowing capital to flow freely, should enable a more effective diversification of risks, enhance the efficiency of capital markets, and support financial and macroeconomic stability, the Board underscored the importance of gradual and carefully sequenced liberalization of financial markets. They welcomed the GFSR's contribution to financial sector surveillance, including in encouraging national legal, regulatory, and supervisory systems to adjust to the more globalized financial environment. Executive Directors favored improved mechanisms for multilateral collaboration, specifically for strengthening supervisory coordination, including through better application of well-established international standards and further work on crisis management and resolution arrangements.[11]

First multilateral consultation

In his April 2006 Report on Implementing the Fund's Medium-Term Strategy, the IMF's Managing Director proposed that existing IMF surveillance arrangements be complemented by a new vehicle—multilateral consultations—that would foster cooperation by appropriate groups of countries on policy actions to address challenges to the global economy and individual members. The proposal was endorsed by the International Monetary and Financial Committee (IMFC), the ministerial-level committee that provides the IMF with policy guidance (see Chapter 5, "How the IMF is run").

The IMF's first multilateral consultation has given its five participants—China, the euro area, Japan, Saudi Arabia, and the United States—a forum for discussing global imbalances and how best to reduce them while sustaining robust global growth. The Executive Board will review the experience with the first multilateral consultation in FY2008.

Commodity prices

Because fluctuations in both oil and nonfuel commodity prices have important policy implications, the IMF has been increasing its coverage of these markets in multilateral surveillance. The Board has consistently advised oil-importing countries, for example, on the importance of market-based pricing—that is, putting an end to subsidies and allowing the pass-through of oil prices to consumers. A chapter in the September 2006 WEO was devoted to nonfuel commodities—metals as well as food and other agricultural commodities—while considerable attention in both the September 2006 and the April 2007 WEO was given to the analysis of the oil market and the effects of oil price changes on the global economy. In their discussions of the WEO, Executive Directors recognized the possibility that inflationary pressures could revive as resource utilization constraints start to bind. They observed that sharply rising prices of nonfuel commodities, particularly metals, had underpinned strong growth in many emerging market and developing countries and advised

Worker in oil field, Zhangaozen, Kazakhstan

11 The full summings up of the Board discussions on the GFSR are on the CD-ROM.

Box 2.3 ROSCs and Data Standards Initiatives

Reports on the Observance of Standards and Codes (ROSCs). Member countries can request ROSCs, assessments of their observance of standards and codes, in any of the following 12 areas: accounting; auditing; anti–money laundering and combating the financing of terrorism (AML/CFT); banking supervision; corporate governance; data dissemination; fiscal transparency; insolvency and creditor rights; insurance supervision; monetary and financial policy transparency; payments systems; and securities regulation. The reports—about 76 percent of which have been published—are used to help sharpen Fund and World Bank policy discussions with national authorities and to strengthen national capacity to participate in, and benefit from, the globalized economy. They are also used in the private sector (including by rating agencies) for risk assessment. Participation in the Standards and Codes Initiative continues to grow. As of end-April 2007, 811 ROSC modules had been completed for 137 countries, or 74 percent of the Fund's membership, and most systemically important countries had volunteered for assessments. More than 380 of the ROSCs were on financial sector standards. Of these, about one-third were related to banking supervision, and the others were fairly evenly distributed across the other standards and codes.

Special Data Dissemination Standard (SDDS). Created in 1996 by the Executive Board, the SDDS is a voluntary standard whose subscribers—countries with access to international capital markets or seeking it—commit to meeting internationally accepted norms of data coverage, frequency, and timeliness. SDDS subscribers provide information about their data compilation and dissemination practices (metadata) for posting on the IMF's Dissemination Standards Bulletin Board (DSBB).[1] Each subscriber is also required to maintain a Web site that disseminates the actual data and that is electronically linked to the DSBB. SDDS subscribers began disseminating prescribed data on external debt in September 2003; data for 58 countries are published in the World Bank's *Quarterly External Debt Statistics* (QEDS). Moldova and Luxembourg became subscribers in FY2007, raising the number of SDDS subscribers to 64 as of April 30, 2007.

General Data Dissemination System (GDDS). The Executive Board established the GDDS in 1997 to help IMF member countries improve their statistical systems. The 88 participants in the GDDS at end-April 2007 provide metadata describing their data compilation and dissemination practices, as well as detailed plans for improvement, for posting on the IMF's DSBB. Between the Executive Board's sixth review of the Data Standards Initiatives in November 2005 and April 30, 2007, eight countries and territories began participating in the GDDS. Of the 94 countries and territories that have participated in the GDDS since it was introduced, 6 have graduated to the SDDS.

To complement the SDDS and GDDS, IMF staff have launched the **Statistical Data and Metadata Exchange (SDMX)** initiative and the **Data Quality Assessment Framework (DQAF).** The SDMX, which is being developed in collaboration with other international organizations, aims to make electronic exchange and management of statistical information among national and international entities more efficient by providing standard practices, coherent protocols, and other infrastructural blueprints for reporting, exchanging, and posting data on Web sites. The DQAF is an assessment methodology that was integrated into the structure of the data ROSCs following the fourth review of the Data Standards Initiatives in 2001.

1 *The Web site address is* dsbb.imf.org/Applications/web/dsbbhome.

these countries to save or invest current revenue windfalls to support future growth in noncommodity sectors. They also stressed the risk of a reversal of the recent decline in oil prices given continuing geopolitical tensions and limited spare production capacity.

The international community is working to improve the quality and transparency of oil market data. In this context, the IMF is increasing the provision of metadata in the General Data Dissemination System and the Special Data Dissemination Standard (see "Standards and codes, including data dissemination" on page 26 and Box 2.3 above). In responding to extensive demand for better data, the IMF is sharing its expertise in data-quality assessment with other international organizations and collaborating with major oil exporters in resolving oil-related data issues. The IMF has also participated in training on the Joint Oil Data Initiative (JODI).[12]

Country surveillance

In FY2007, the Board completed 134 Article IV consultations (see CD-Table 2.1 on the CD-ROM). Country surveillance is becoming more focused on identifying the most important risks facing members and on topics that are core to the IMF's mandate. As an approach for cases in which it appeared useful to concentrate on a few key issues, and in keeping with the MTS's calls for enhancing the efficiency of Fund procedures, the IMF experimented with streamlined consultations with 10 countries during FY2007 to allow additional resources to be devoted to areas of priority work. The Board plans to review the IMF's experience with the streamlined consultations early in FY2008.

As discussed in detail below, considerable work was undertaken in FY2007 to modernize the framework for IMF surveillance and to integrate the analysis of developments in the financial sector and capital markets more fully into country surveillance. Recent efforts have also focused on a deeper examination of cross-country spillovers. As demonstrated by a stocktaking of the quality of exchange rate surveillance (see below), these efforts are gradually bearing fruit.

The IMF's Global Fiscal Model[13] has been used in the context of country surveillance, notably to evaluate the broader impacts of fiscal policy changes—including fiscal consolidation, tax reform, and social security reform—in a number of industrial and emerging market countries. The WEO's analysis of the impact of a slowdown in the U.S. economy on the rest of the world used a variety of econometric and modeling approaches to assess cross-country spillovers.

Regional surveillance and outreach

Since members of currency unions have devolved responsibilities over monetary and exchange rate policies—two central areas of Fund surveillance—to regional institutions, the IMF holds discussions with representatives of these institutions in addition to its Article IV consultations with the unions' individual members. In response to guidance by the Executive Board under the Medium-Term Strategy, IMF staff also conduct other regional surveillance activities, including the production of semiannual regional economic outlooks (REOs), dialogues with various regional forums, and research on issues in which countries in the same region share an interest; and more systematically apply relevant findings of regional surveillance in conducting Article IV consultations. Selected papers and reports increasingly focus on regional spillovers and cross-country experiences.

During FY2007, the IMF's Executive Board discussed developments in the Central African Economic and Monetary Community (CEMAC), the Eastern Caribbean Currency Union (ECCU), the euro area, and the West African Economic and Monetary Union (WAEMU).[14]

12 *Following a period of exceptional volatility in oil prices in the 1990s, in 2001 six international organizations—Asia-Pacific Economic Cooperation (APEC), Eurostat, the International Energy Agency (IEA), Organización Latinoamericana de Energia (OLADE), OPEC, and the United Nations Statistics Division (UNSD)—launched the initiative, originally called the Joint Oil Data Exercise, to raise awareness of the need for more data transparency in oil markets. More information can be found on JODI's Web site, at* www.jodidata.org/FileZ/ODTmain.htm.

13 *The Global Fiscal Model (GFM) is a multicountry general equilibrium model developed at the Fund based on the New Open Economy Macroeconomics (NOEM) tradition, but designed to examine fiscal policy issues. It is particularly suitable for studying temporary or permanent changes in taxes or expenditures, whether occurring rapidly or gradually (as in the case of age-related expenditure pressures). The multicountry feature of the GFM allows the analysis of international spillover effects as changes in government debt influence world interest rates. The GFM also permits practitioners to assess the macroeconomic effects of a number of alternative fiscal-consolidation strategies.*

14 *The summings up of these Board discussions can be found on the CD-ROM and on the IMF's Web site: PIN 06/90, "IMF Executive Board Concludes 2006 Discussion on Common Policies of Member Countries with CEMAC,"* www.imf.org/external/np/sec/pn/2006/pn0690.htm; *PIN 07/13, "IMF Executive Board Concludes 2006 Regional Discussions with Eastern Caribbean Currency Union,"* www.imf.org/external/np/sec/pn/2007/pn0713.htm; *PIN 06/86, "IMF Executive Board Discusses Euro Area Policies,"* www.imf.org/external/np/sec/pn/2006/pn0686.htm; *and PIN 07/55, "IMF Executive Board Concludes 2007 Consultation with West African Economic and Monetary Union,"* www.imf.org/external/np/sec/pn/2007/pn0755.htm.

CEMAC. At their July 2006 discussion, Executive Directors commended CEMAC's positive macroeconomic performance in 2005, which was due in part to oil windfalls and improved implementation of macroeconomic policies. Per capita income in most CEMAC members remains low, however, and these countries face significant challenges in meeting the Millennium Development Goals. The Board urged the authorities to take advantage of improved macroeconomic and financial conditions to address long-standing structural issues that are critical for raising non-oil growth and employment and reducing poverty. They also noted the potential for regional integration to increase market size and foster growth and called for a renewed focus on the promotion of trade. CEMAC participated in an FSAP (see below), which found that financial sector soundness had improved but that important challenges remained. Executive Directors urged CEMAC countries to further strengthen financial and macroeconomic stability and accelerate reforms, particularly as the financial sectors in the region are among the least developed in the world.

ECCU. The Board welcomed the resurgence in economic activity in recent years, driven by tourism, preparations for the Cricket World Cup, and a pickup in private investment. ECCU's quasi-currency-board arrangement has resulted in a long period of price stability, and the currency appears competitive. The challenge will be to sustain the growth momentum in 2007 and beyond. The ECCU countries, which are oil importers, continue to face significant obstacles, including elevated world energy prices and a heavy public debt burden, and exporters of sugar and bananas will need to adjust to the erosion of trade preferences. Further regulatory, administrative, and legal reforms are needed to remove impediments to private business activity. Executive Directors urged continued strengthening of the supervisory and regulatory environment that supports financial market development.

Euro area. Growth has picked up and broadened in the euro area, the reformed Stability and Growth Pact is regaining traction over fiscal policies, fiscal outcomes have been better than originally projected, and progress has been made in the reform of product and services markets and financial integration. However, the Board saw risks tilting to the downside for 2007 and beyond. Productivity growth continues to be sluggish, employment and consumption continue to lag, oil prices are volatile, and global imbalances remain unresolved. Executive Directors underscored the need for accelerated fiscal consolidation and further structural reforms that aim at strengthening incentives to work and invest.

WAEMU. The overall economic situation in WAEMU was challenging in 2006. Inflation fell sharply despite higher prices for fuel imports, and foreign reserve levels remained adequate, but average growth declined to 3.4 percent and the current account deficit widened. Progress on policy convergence, economic integration, and structural reforms has been slow, and growth and deeper regional integration are hampered by macroeconomic shocks, structural weaknesses, and, in some countries, sociopolitical problems. However, WAEMU is stepping up efforts to remove these obstacles. In 2006, it embarked on trade reform and instituted an ambitious reform program for 2006–10. Given that the region's financial sector is unintegrated and shallow, the Board welcomed the authorities' request for a regional FSAP.

Regional Economic Outlooks (REOs) are produced semiannually for sub-Saharan Africa, Asia and the Pacific, the Middle East and Central Asia, and the Western Hemisphere.[15] Upon publication of the REOs, the IMF organizes press conferences or seminars at headquarters or in the field. Area department staff often go on road shows to present REO findings at different venues to diverse audiences in the region in question. The Middle East and Central Asia Department, for example, organizes outreach activities in association with its REOs twice a year in Dubai, Central Asia, and North Africa.

Intensified outreach has contributed to wider dissemination of the findings of IMF studies and stimulated debate on regional issues. In addition to the activities undertaken in connection with the publication of the REOs, the Fund organizes regional conferences and seminars either on its own or in collaboration with regional entities. (For examples, see the section on outreach in Chapter 5.)

15 *The full text of these reports can be found on the IMF's Web site, at* www.imf.org. *There are plans to publish a* Regional Economic Outlook *for Europe beginning in the fall of 2007.*

The Bovespa stock exchange, São Paulo, Brazil

Financial sector surveillance and the Standards and Codes Initiative

For countries to reap the full benefit of cross-border capital flows, which have increased dramatically over the past two decades, their financial sectors must be resilient and well regulated. In 1999, the IMF and the World Bank introduced a joint initiative, the FSAP, to provide member countries, on a voluntary basis, with a comprehensive evaluation of their financial systems. The FSAP, a cornerstone of financial sector surveillance, provides the basis for the IMF's Financial System Stability Assessments (FSSAs)—assessments of risks to macroeconomic stability stemming from the financial sector, including the latter's ability to absorb macroeconomic shocks.

Regional FSAPs can be undertaken for currency unions, notably where significant regulatory and supervisory structures are at the regional level. As described above, a regional FSAP—for CEMAC—was completed in FY2007, and WAEMU requested an FSAP. In addition, the IMF has undertaken regional financial sector projects in Central America, the Maghreb, and the Nordic-Baltic region.[16]

With a total of 123 initial assessments now completed or under way, the IMF and the World Bank are increasingly focusing on FSAP updates. The core elements of updates include financial stability analysis, factual updates of the observance of standards and codes included in the initial assessment,[17] and reexamination of key issues raised in the initial assessment. Updates usually require only a single visit by an IMF–World Bank team (initial assessments require two)—and a smaller team—and hence are typically less resource-intensive than initial assessments.

In FY2007, 18 FSAPs were completed, of which 6 were updates;[18] another 53 (of which 30 are updates) are either under way or agreed and being planned.

16 *See Box 3.4, "Regional financial integration in Central America," in the IMF's* Annual Report 2006, *at* www.imf.org/external/pubs/ft/ar/2006/eng/index.htm.
17 *Factual updates describe developments that are relevant to compliance with standards and codes but do not reassess the ratings in the initial FSAP.*
18 *These numbers refer to FSSAs discussed by the Board during FY2007.*

Work is progressing on incorporating a financial sector component into the IMF's Global Economy Model.[19] The IMF is also studying both the implications of growing international financial integration for national fiscal policies and the linkages between the financial sector and fiscal institutions and policy.

Standards and codes, including data dissemination

In the wake of the Asian crisis of 1997–98, during their discussions on strengthening the international financial architecture, Executive Directors stressed the need to develop and implement internationally recognized standards and codes of good practice that would foster financial and macroeconomic stability at both the domestic and the international levels. The result was the launch of the Standards and Codes Initiative in 1999. The IMF and the World Bank evaluate member countries' policies against international benchmarks of good practice in three broad areas—transparent government operations and policymaking, financial sector standards, and market integrity standards for the corporate sector—and issue Reports on the Observance of Standards and Codes (ROSCs; see Box 2.3), which are intended to help countries strengthen their economic institutions, to inform the work of the IMF and the Bank, and to inform market participants. Following up on the Executive Board's review of the Standards and Codes Initiative in FY2006 and the recommendations of the MTS, the Initiative has been strengthened, with clearer country prioritization of ROSCs and updates, better integration of ROSCs with surveillance and technical assistance, and greater clarity of ROSCs. Several standards have been revised in recent years, and the revised standards are now being used as the basis for assessments. For example, in April 2007, the Board endorsed the new Basel Core Principles[20] standard and methodology released in October 2006.

Since the Asian crisis of 1997–98, the analysis of balance sheet vulnerabilities has become an increasingly important part of country risk assessment at the IMF.

Underpinning assessments of fiscal transparency in 86 countries under the Standards and Codes Initiative is the IMF's *Code of Good Practices on Fiscal Transparency,* which was revised during FY2007, after a broad public consultation process. The Code, launched in 1998, is a central element in the IMF's efforts to help members implement standards in the areas of transparency and good governance. Fiscal transparency leads to better-informed public debate about fiscal policy, makes governments more accountable for policy implementation, and strengthens government credibility, thereby strengthening countries' capacity for sound macroeconomic policymaking, public debt management, and budget preparation.[21] A major aim of the revised Code is to fully integrate issues related to resource-revenue transparency, drawing on experience gained from use of the IMF's 2005 *Guide on Resource Revenue Transparency,* which focuses on the problems of countries that derive a significant share of their revenues from hydrocarbon and mineral resources. The revised Code also extends the coverage of good practice to address more explicitly some key fiscal transparency issues, such as fiscal risk management, the openness of budgets and policy decisions, external audit processes, and the publication of a citizens' guide to the budget. Extensive revisions have also been made to the *Manual on Fiscal Transparency,* which provides detailed guidance on good fiscal transparency practices, with examples from a range of developing, emerging, and advanced economies.[22]

19 The Global Economy Model (GEM), which the IMF has been developing since 2002, is a large, multicountry macroeconomic model based on an explicit micro-economic framework in which consumers maximize utility and producers maximize profits. The integration of domestic supply, demand, trade, and international asset markets in a single theoretical structure allows transmission mechanisms to be fully articulated, providing new insights not obtainable from earlier models. A range of GEM simulations have been used in IMF work to assess issues such as the domestic and international consequences of policies to increase competition in markets, the impact of oil price increases, the effects on emerging market countries of exchange rate volatility across industrial countries, and appropriate monetary policy rules for emerging market countries. A detailed description of the model can be found at www.imf.org/external/np/res/gem/2004/eng/index.htm.

20 The Core Principles for Effective Banking Supervision, *which the Basel Committee on Banking Supervision originally published in September 1997, were updated in 2006 to keep pace with changes in banking regulation. The Core Principles and the* Core Principles Methodology *are used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying future work that needs to be done to overcome regulatory and supervisory shortcomings. The IMF and the World Bank also use the Core Principles in the context of the Financial Sector Assessment Program to assess countries' banking supervision systems and practices.*

21 The Code can be found at www.imf.org/external/np/fad/trans/code.htm.

22 Available at www.imf.org/external/np/fad/trans/manual/index.htm.

In addition, in September 2006 the IMF began publishing *International Financial Statistics, Supplement on Monetary and Financial Statistics, Supplement Series No.17,* a quarterly compilation of monetary and financial statistics for 65 countries. These data are an important input for compiling the matrices of the IMF's balance sheet approach to assessing debt vulnerabilities. Since the Asian crisis, the analysis of balance sheet vulnerabilities has become an increasingly important part of country risk assessment at the IMF. Information about balance sheets in a country's key economic sectors (public, private financial and nonfinancial, and household and nonresident) facilitates assessments of maturity, currency, and capital structure mismatches as well as intersectoral linkages.

In view of the evolving economic environment and changing needs for economic analysis, the IMF is updating macroeconomic statistical standards in close collaboration with member countries and other international organizations. The IMF is contributing to the update of the System of National Accounts 1993, and it has drafted and posted on its Web site for worldwide consultation the sixth edition of the *Balance of Payments and International Investment Position Manual* and the *Export and Import Price Index Manual.* The update of the various statistical standards is being coordinated to ensure maximum harmonization of statistical methodologies. The methodological standards in statistics underpin the IMF's work on data ROSCs, technical assistance, and training, and promote the comparability of data and best practices in statistical methodology.

Modernizing the Surveillance Framework and Integrating Financial Sector Analysis

Over the past 30 years, the Executive Board has reviewed the IMF's surveillance work at regular intervals. From 1988 to 2004, reviews were conducted biennially. A decision was made in 2006 to move to triennial reviews in accordance with the MTS's call for streamlining IMF procedures. The most recent

Currency exchange board, Bangkok, Thailand

review, conducted in 2004, called for deeper treatment of exchange rate issues, including (1) clear identification of the de facto exchange rate regime in staff reports, (2) more systematic use of a broad set of indicators and analytical tools to assess external competitiveness, and (3) a thorough and balanced presentation of the policy dialogue between the staff and the authorities on exchange rate issues.[23] Following up on these recommendations, in August 2006, the Executive Board discussed a paper by IMF staff assessing the quality of recent work by the IMF on exchange rate issues in 30 large economies accounting for more than 90 percent of world GDP.[24] Executive Directors generally agreed that exchange rate surveillance had improved appreciably since the 2004 review and that the quality of the analysis was mostly adequate in three of the four dimensions reviewed—the description of the exchange rate regime, the assessment of the regime, and the consistency of exchange rate policies with external stability—

23 *The Biennial Surveillance Review can be found on the IMF's Web site, at* www.imf.org/external/np/sec/pn/2004/pn0495.htm.

24 *The paper, "Treatment of Exchange Rate Issues in Bilateral Fund Surveillance—A Stocktaking," can be found on the IMF's Web site, at* www.imf.org/external/pp/longres.aspx?id=3951. *The summing up of the Board discussion can be found on the CD-ROM and on the IMF's Web site: PIN 06/131, "IMF Executive Board Discusses Treatment of Exchange Rate Issues in Bilateral Surveillance—A Stocktaking,"* www.imf.org/external/np/sec/pn/2006/pn06131.htm.

The IMF Executive Board has strengthened surveillance over exchange rate policies and called for greater scrutiny of the linkages between the financial sector and the macroeconomy.

but that there was room for better analysis in the fourth, the assessment of exchange rate levels and external competitiveness. The Board also called for a greater focus on the spillover effects of countries' exchange rate policies.

As part of the effort to strengthen the IMF's framework for assessing exchange rate issues, at an informal seminar in November 2006, the Executive Board discussed a staff report on revised and extended methodologies for exchange rate assessments by the IMF's Consultative Group on Exchange Rate Issues (CGER). The CGER, which has provided exchange rate assessments for a number of advanced economies since the mid-1990s, has extended its methodologies to cover about 20 emerging market countries. These methodologies can help gauge the consistency of current account balances and real effective exchange rates with their underlying fundamentals. Staff organized outreach events with officials, academics, and market participants in Europe, Asia, and Africa to discuss this extension and approaches to exchange rate modeling.[25]

Complementing the periodic efforts of the Executive Board and the Fund's management and staff to take stock of the effectiveness of surveillance, the IMF's Independent Evaluation Office (IEO; see Box 5.3) completed an evaluation in FY2007 of the IMF's exchange rate policy advice, for discussion by the Executive Board in early FY2008.[26] The IEO set out to answer three main questions: Is the role of the IMF clearly defined and understood? How good is the quality of the IMF's advice and its underlying analysis? And how effective is the IMF in its policy dialogue with country authorities? Its report acknowledges that the quality of the IMF's advice to its member countries had improved in some ways from 1999 to 2005, citing many examples of good analysis and dedicated staff teams. At the same time, it identifies a need to revalidate the fundamental purpose of IMF exchange rate surveillance and thus clarify the expected roles of the IMF and member countries, offering detailed recommendations for improving the management and conduct of the IMF's exchange rate policy advice and interactions with member countries.

The principles and procedures governing the scope and operational modalities of surveillance over exchange rate policies were adopted by the Executive Board in 1977, after the collapse of the Bretton Woods system of fixed exchange rate parities.[27] In FY2007, the Board held discussions on the possibility of revising the Decision to broaden it to cover surveillance more comprehensively, and to align it more closely with Article IV and current best practice.[28] A revised decision would not only demonstrate the Fund's resolve to strengthen the effectiveness of surveillance, including over exchange rates, but also serve as a basis for the practice of surveillance, unifying guidance, clarifying issues and procedures, and providing a better foundation for surveillance to address priority issues. In their discussion, Executive Directors found important areas of broad agreement and subsequently worked to build common ground on other areas. At the Spring Meetings of the IMF and the World Bank, the IMFC agreed that the following principles should guide further work: (1) there should be no new obligations, and dialogue and persuasion should remain key pillars of effective surveillance; (2) surveillance should pay due regard to country circumstances and emphasize the need for evenhandedness; and (3) a revised decision should be flexible enough to allow surveillance to evolve as circumstances warrant.[29]

25 *See Press Release 06/266, "IMF Strengthening Framework for Exchange Rate Surveillance," on the CD-ROM or at* www.imf.org/external/np/sec/pr/2006/pr06266.htm.

26 *The IEO's report can be found at* www.ieo-imf.org/eval/complete/eval_05172007.html.

27 *The 1977 Decision on Surveillance over Exchange Rate Policies can be found on the IMF's Web site, at* www.imf.org/external/pubs/ft/sd/index.asp?decision=5392-(77/63).

28 *See "Article IV of the Fund's Articles of Agreement: An Overview of the Legal Framework," a paper prepared by IMF staff, at* www.imf.org/external/np/pp/eng/2006/062806.pdf.

29 *On June 15, 2007, after the end of the financial year, the Board adopted the 2007 Decision on Bilateral Surveillance over Members' Policies, which replaces the 1977 Decision. The summing up of the Board discussion can be found at* www.imf.org/external/np/sec/pn/2007/pn0769.htm.

During FY2007, the Board also exchanged views on the possibility of introducing a clear statement of surveillance priorities to guide implementation and facilitate ex post monitoring of effectiveness (a "remit"), against the background of the existing accountability and independence framework. In doing so, it examined methods for assessing the effectiveness of IMF surveillance and agreed that a strengthened methodology should be introduced in the context of the next review of surveillance, scheduled to take place in FY2008.

Integrating financial sector and capital markets analysis into surveillance

A task force was established in FY2006 to study the issue of how to better integrate the IMF's financial sector work into its surveillance. The task force delivered its recommendations in FY2007, emphasizing the need for a broader multilateral perspective, more focus on the financial sector's impact on growth and the macroeconomy, and a thorough assessment of risks. Following up on these recommendations, the IMF has increased interdepartmental cooperation and prioritized its financial sector work, with heightened monitoring of both systemically important countries and countries vulnerable to crisis.

The IMF also contributes to international efforts to combat money laundering and the financing of terrorism, in collaboration with the Financial Action Task Force on Money Laundering (FATF), the World Bank, the United Nations, and FATF-style regional bodies (FSRBs). As a collaborative institution with near universal membership, the IMF is a natural forum for sharing information, developing common approaches to issues, and promoting desirable policies and standards. In addition, the IMF's broad experience in conducting financial sector assessments, providing technical assistance in the financial sector, and exercising surveillance over members' economic systems is particularly valuable in evaluating country compliance with international AML/CFT standards and in developing programs to help them address shortcomings. In 2004, the Executive Board agreed to make AML/CFT assessments and technical assistance a regular part of Fund work and to expand this work to cover the full scope of the FATF's 40 recommendations designed to guide national policymakers in implementing effective anti–money laundering programs and 9 additional recommendations on combating the financing of terrorism.

In its June 2006 discussion of a paper jointly prepared by IMF and World Bank staff on the quality and consistency of assessments of national AML/CFT regimes,[30] which are carried out by the IMF, the World Bank, the FATF, or the FSRBs, using an agreed common methodology, the Executive Board reiterated the importance of AML/CFT in strengthening the integrity of financial systems and deterring financial abuse and confirmed the IMF's collaborative arrangements with the FATF and FSRBs for assessing AML/CFT regimes. As part of its review, the Executive Board examined the findings of an expert panel that had analyzed a sample of AML/CFT assessments prepared by different bodies and concluded that there was a high degree of variability in the quality and consistency of the reports. The Executive Board noted that a number of initiatives had been taken or were under way to improve the assessments and called on IMF staff to provide technical assistance to, and cooperate more closely with, the FSRBs.

The Board also agreed that every assessment or update under the FSAP or Offshore Financial Center (OFC) assessment program[31] should include a full AML/CFT assessment using the most recent methodology and that full AML/CFT assessments should be conducted approximately every five years. The Fund is expected to continue monitoring significant financial sector problems arising from money laundering or terrorism-financing activities through other vehicles, such as assessments of other financial sector standards, Article IV consultations, and participation in FATF and regional forums.

The Executive Board has consistently underscored the importance of financial soundness indicators (FSIs) in facilitating financial sector surveillance, increasing the transparency and stability of the international financial

30 *The staff paper is available at* www.imf.org/external/np/pp/eng/2006/041806r.pdf. *The summing up of the Board's discussion can be found on the CD-ROM and on the IMF's Web site, at* www.imf.org/external/np/sec/pn/2006/pn0672.htm.

31 *The OFC assessment program was initiated in 2000. The monitoring of OFCs, to ensure their compliance with supervisory and integrity standards, has become a standard component of the IMF's financial sector work.*

system, and strengthening market discipline. After developing a core set and an encouraged set of FSIs in consultation with the international community, the IMF launched the three-year pilot Coordinated Compilation Exercise (CCE), which was endorsed by the Board, in March 2004 to (1) build the capacity of the 62 participating countries to compile FSIs; (2) promote cross-country comparability of FSIs; (3) coordinate efforts by national authorities to compile FSIs; and (4) disseminate the FSI data compiled in the CCE, along with metadata, to increase transparency and strengthen market discipline. The methodology recommended by the IMF to ensure cross-country comparability is presented in the *Financial Soundness Indicators: Compilation Guide*.[32] By the end of FY2007, FSI data and metadata for 52 of the 62 countries participating in the CCE were posted on the IMF's Web site.[33] Many countries also regularly compile and disseminate FSIs on their own, and these indicators are included in FSAP documents.

32 *The Guide can be found at* www.imf.org/external/pubs/ft/fsi/guide/2006/index.htm. *The list of core and encouraged FSIs can be found at* www.imf.org/external/np/sta/fsi/eng/fsi.htm.

33 *Another five countries posted their data and metadata in the first month of FY2008; see* www.imf.org/external/np/sta/fsi/eng/cce/index.htm.