CHAPTER • 3

Surveillance in action during FY2006

In accordance with Article IV of its Articles of Agreement, the IMF oversees the international monetary system to ensure its effective operation. The Fund also oversees that each member country complies with its obligations under Article IV "to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." The Fund discharges these responsibilities partly by monitoring economic developments and policies in its 184 member countries and the economic policies pursued under regional arrangements or currency unions. The Fund also monitors economic and financial developments at the global level. The Fund's oversight of policies and economic developments at the global, country, and regional levels is known as surveillance.

In FY2006, IMF global surveillance focused particularly on the risks to world growth posed by global payments imbalances, higher oil prices, and rising interest rates in industrial countries and their potential impact on growing household debt. Other questions examined included the economic consequences of a possible avian flu pandemic, innovation in financial markets, growing protectionist sentiment, and the fiscal and macroeconomic effects of population aging. These issues were covered in depth in the IMF's main global surveillance products, the semiannual *World Economic Outlook* (WEO), discussed by the Executive Board in August and September 2005 and March 2006, and *Global Financial Stability Report* (GFSR), discussed by the Board in August 2005 and March 2006.

In April 2006, on the eve of the Spring Meetings of the IMF and the World Bank, the IMF hosted a conference on global imbalances, which was attended by policymakers, senior officials, and a few distinguished academics. The closed-door, informal discussion focused on policy strategies for addressing global imbalances. The International Monetary and Financial Committee (IMFC) communiqué of April 22, 2006, noted that the conference discussion confirmed the validity of the agreed cooperative policy strategy to address imbalances and that—given economic interlinkages—all countries and regions would have a role to play. (For the full text of the communiqué, see Appendix IV.)

The Fund continued efforts to strengthen its surveillance of macroeconomic policies and financial markets, as called for in its Medium-Term Strategy (see Chapter 2). The role of the management-staff Surveillance Committee, chaired by the Managing Director, has been enhanced. The Independent Evaluation Office (IEO) completed detailed assessments of the IMF's multilateral surveillance (see page 34) and the Financial Sector Assessment Program (financial sector surveillance is covered in Chapter 4).[1]

The IMF also continued to give prominence to exchange rate issues, including by broadening and improving its tools for exchange rate analysis. As required by its Articles of Agreement, the Fund publishes the *Annual Report on Exchange Arrangements and Exchange Restrictions,* which is prepared in consultation with national authorities and contains a comprehensive data set on countries' exchange arrangements and exchange and trade restrictions.

At the country level, the IMF's Executive Board conducted 131 Article IV consultations during FY2006 (Table 3.1). At the regional level, it discussed the policies of four currency unions—the Eastern Caribbean Currency Union, the euro area, the Central African Economic and Monetary Community, and the West African Economic and Monetary Union.

Global surveillance

The Fund's Executive Board conducts global surveillance through its reviews of world economic and financial market developments and prospects. Twice a year in each case, these reviews are based on the staff's WEO reports and issues of the GFSR, which are published, together with a summing up of the Executive Board's discussion, ahead of the semiannual IMFC meetings. The WEO reports provide analysis of global, regional, and national economic prospects and policies, and the GFSR analyzes developments and risks in international capital markets. Between WEO reports and GFSR issues, the Board also holds more frequent informal discussions of world economic and market developments, and IMF staff continuously monitor economic and financial developments in the Fund's 184 member countries as well as globally. In addition,

[1]The IEO's mandate and activities are described in Chapter 9.

Table 3.1 Article IV consultations completed during FY2006

Country	Board date	PIN issued	Staff Report published
Afghanistan, Islamic Republic of	March 6, 2006	March 8, 2006	March 16, 2006
Algeria	February 13, 2006	March 9, 2006	March 9, 2006
Antigua and Barbuda	December 21, 2005	February 1, 2006	April 22, 2006
Argentina	June 20, 2005	June 30, 2005	July 18, 2005
Aruba	May 25, 2005	June 1, 2005	June 15, 2005
Australia	August 29, 2005	September 12, 2005	September 12, 2005
Austria	July 20, 2005	July 25, 2005	July 25, 2005
Azerbaijan	March 27, 2006	April 25, 2006	
Bahamas, The	June 24, 2005	July 7, 2005	July 7, 2005
Bahrain	February 17, 2006		
Bangladesh	June 29, 2005	July 18, 2005	July 22, 2005
Barbados	August 5, 2005	August 15, 2005	August 15, 2005
Belarus	June 17, 2005	June 28, 2005	June 28, 2005
Belgium	February 27, 2006	March 1, 2006	March 1, 2006
Belize	September 19, 2005	September 30, 2005	September 30, 2005
Bhutan	July 11, 2005	July 18, 2005	
Bosnia and Herzegovina	May 27, 2005	June 15, 2005	June 15, 2005
Botswana	June 22, 2005	February 23, 2006	February 23, 2006
Brunei Darussalam	July 13, 2005	September 30, 2005	
Burkina Faso	September 7, 2005	September 29, 2005	September 30, 2005
Cape Verde	May 25, 2005	August 11, 2005	September 6, 2005
Central African Republic	October 24, 2005	November 29, 2005	December 2, 2005
Chile	July 29, 2005	August 5, 2005	September 1, 2005
China	August 3, 2005	September 12, 2005	November 17, 2005
Comoros	July 18, 2005	August 12, 2005	August 16, 2005
Congo, Democratic Republic of the	August 29, 2005	September 29, 2005	October 20, 2005
Czech Republic	August 1, 2005	August 9, 2005	August 9, 2005
Djibouti	September 28, 2005		
Dominica	October 14, 2005	October 25, 2005	October 26, 2005
Dominican Republic	October 17, 2005	December 7, 2005	
Ecuador	January 25, 2006	February 9, 2006	March 10, 2006
Egypt	May 18, 2005	June 7, 2005	June 7, 2005
Eritrea	March 27, 2006		
Estonia	October 26, 2005	November 4, 2005	November 4, 2005
Ethiopia	March 17, 2006	May 2, 2006	
Finland	January 30, 2006	February 1, 2006	February 3, 2006
France	November 2, 2005	November 7, 2005	November 7, 2005
Gambia, The	July 18, 2005	September 8, 2005	January 10, 2006
Georgia	March 31, 2006	April 19, 2006	May 16, 2006
Germany	January 11, 2006	January 18, 2006	January 18, 2006
Ghana	June 20, 2005	August 9, 2005	August 15, 2005
Greece	December 14, 2005	January 6, 2006	January 6, 2006
Grenada	July 13, 2005	July 29, 2005	August 12, 2005
Guatemala	May 16, 2005	July 27, 2005	October 6, 2005
Guinea	December 23, 2005	January 27, 2006	February 3, 2006
Haiti	May 16, 2005	June 17, 2005	June 17, 2005
Hong Kong SAR	January 23, 2006	February 13, 2006	February 13, 2006
Hungary	June 15, 2005	June 29, 2005	June 29, 2005
Iceland	October 3, 2005	October 14, 2005	October 14, 2005
India	February 6, 2006	February 21, 2006	February 21, 2006
Indonesia	July 18, 2005	July 27, 2005	September 9, 2005
Iran, Islamic Republic of	March 10, 2006	March 27, 2006	April 28, 2006
Iraq	August 1, 2005	August 16, 2005	August 16, 2005
Ireland	October 5, 2005	October 17, 2005	October 17, 2005
Israel	March 22, 2006	March 23, 2006	March 23, 2006
Italy	February 6, 2006	February 7, 2006	February 16, 2006
Jamaica	March 24, 2006	April 25, 2006	May 1, 2006
Japan	July 29, 2005	August 8, 2005	August 8, 2005
Jordan	November 21, 2005	January 5, 2006	
Kazakhstan	July 1, 2005	July 13, 2005	July 21, 2005
Kiribati	May 4, 2005		
Kuwait	March 10, 2006	March 29, 2006	April 7, 2006
Lao People's Democratic Republic	March 8, 2006	March 21, 2006	
Latvia	July 27, 2005	August 10, 2005	August 10, 2005
Lesotho	September 19, 2005	September 29, 2005	December 28, 2005

Table 3.1 *(concluded)*

Country	Board date	PIN issued	Staff Report published
Liberia	April 26, 2006	May 2, 2006	
Libya	March 17, 2006	April 10, 2006	April 10, 2006
Luxembourg	April 26, 2006	May 8, 2006	May 8, 2006
Madagascar	June 1, 2005	September 27, 2005	September 27, 2005
Malaysia	March 13, 2006	March 20, 2006	
Maldives	February 22, 2006	February 28, 2006	
Mali	December 19, 2005	March 6, 2006	
Malta	October 14, 2005	October 24, 2005	October 24, 2005
Marshall Islands	February 15, 2006	March 8, 2006	March 8, 2006
Mauritania	May 27, 2005	June 2, 2005	
Mauritius	December 2, 2005	January 3, 2006	
Mexico	November 9, 2005	December 1, 2005	December 9, 2005
Mongolia	September 21, 2005	October 6, 2005	November 15, 2005
Morocco	August 29, 2005	September 15, 2005	November 23, 2005
Mozambique	June 22, 2005	September 6, 2005	September 6, 2005
Namibia	March 24, 2006	April 28, 2006	April 28, 2006
Nepal	January 18, 2006	February 2, 2006	February 7, 2006
Netherlands	June 29, 2005	July 14, 2005	July 14, 2005
Netherlands Antilles	March 10, 2006	March 30, 2006	March 31, 2006
New Zealand	May 2, 2005	May 5, 2005	May 5, 2005
New Zealand	April 28, 2006	May 4, 2006	May 4, 2006
Nicaragua	January 18, 2006		
Nigeria	July 18, 2005	August 10, 2005	August 26, 2005
Norway	June 3, 2005	June 13, 2005	June 14, 2005
Oman	November 11, 2005	December 9, 2005	
Pakistan	November 2, 2005	November 17, 2005	November 17, 2005
Palau	February 15, 2006	March 2, 2006	March 13, 2006
Panama	February 15, 2006	March 14, 2006	April 6, 2006
Papua New Guinea	February 13, 2006	February 24, 2006	March 13, 2006
Philippines	February 13, 2006	March 6, 2006	March 6, 2006
Poland	July 22, 2005	July 22, 2005	August 2, 2005
Portugal	October 14, 2005	October 19, 2005	October 20, 2005
Romania	April 26, 2006	May 4, 2006	May 9, 2006
Russian Federation	September 7, 2005	September 21, 2005	October 20, 2005
St. Kitts and Nevis	December 21, 2005	February 1, 2006	
St. Lucia	December 21, 2005	February 9, 2006	
St. Vincent and the Grenadines	July 13, 2005		
Samoa	June 17, 2005	June 27, 2005	June 29, 2005
São Tomé and Príncipe	March 6, 2006	March 29, 2006	
Saudi Arabia	October 7, 2005	December 5, 2005	
Serbia and Montenegro	June 29, 2005	July 5, 2005	July 14, 2005
Seychelles	March 10, 2006		
Singapore	March 17, 2006	May 5, 2006	May 4, 2006
Slovak Republic	March 20, 2006	March 22, 2006	March 21, 2006
Slovenia	July 20, 2005	July 28, 2005	July 28, 2005
Solomon Islands	September 28, 2005	October 13, 2005	October 13, 2005
South Africa	September 2, 2005	September 15, 2005	September 19, 2005
Sri Lanka	July 15, 2005	August 2, 2005	September 13, 2005
Suriname	February 24, 2006	April 10, 2006	April 10, 2006
Swaziland	February 8, 2006	February 24, 2006	March 13, 2006
Sweden	September 7, 2005	September 15, 2005	September 15, 2005
Switzerland	June 6, 2005	June 10, 2005	June 10, 2005
Syrian Arab Republic	August 31, 2005	October 3, 2005	October 3, 2005
Thailand	September 7, 2005	October 27, 2005	
Timor-Leste	June 15, 2005	July 20, 2005	July 25, 2005
Tonga	July 15, 2005	August 31, 2005	
Trinidad and Tobago	November 11, 2005	November 30, 2005	February 1, 2006
Turkmenistan	January 18, 2006		
Ukraine	November 9, 2005	November 11, 2005	November 28, 2005
United Arab Emirates	July 1, 2005	July 15, 2005	August 5, 2005
United Kingdom	March 1, 2006	March 3, 2006	March 3, 2006
United States	July 22, 2005	July 29, 2005	July 29, 2005
Uzbekistan	May 16, 2005	June 10, 2005	
Vietnam	October 7, 2005	January 24, 2006	January 24, 2006
Zambia	January 11, 2006	February 1, 2006	February 3, 2006
Zimbabwe	September 9, 2005	October 4, 2005	October 4, 2005

IMF management and staff take part in economic policy discussions with finance ministers, central bank governors, and other officials in a variety of groups, such as the Group of Seven major industrial countries (G-7), the Group of 24 developing countries (G-24), and the Group of 20 (G-20).

World Economic Outlook

World Economic Outlook, September 2005

At their August and September 2005 discussions of the WEO,[2] Executive Directors welcomed the continued strong expansion of the global economy. Following the strongest performance seen in three decades in 2004, global economic growth moderated to a more sustainable pace during 2005, while inflationary pressures remained subdued. However, growth divergences remained wide—with the United States and China leading global growth, Japan regaining momentum, and the expansion in the euro area remaining subdued. Global payments imbalances increased yet again.

Notwithstanding the impact of higher oil prices and global imbalances, Directors expected global economic conditions to remain favorable, but they cautioned that the balance of risks to the outlook was slanted to the downside, with projected growth still unbalanced and heavily dependent on China and the United States. Other short-term risks included the possibility of significant tightening in financial markets, which could contribute to a global weakening of housing markets, and rising protectionist sentiment in some countries.

Directors acknowledged that the limited impact of oil price increases on the global economy was attributable, in part, to the decreasing energy intensity of economic activity as well as to well-anchored inflationary expectations. A number of Directors were nevertheless concerned about the impact of high and volatile oil prices going forward.

Rising global imbalances and their changing distribution remained a central risk to the economic outlook over the medium term. Unusually low investment rates for this stage of the economic cycle have resulted in excess saving at the global level, contributing to low real interest rates and the observed distribution of imbalances across major regions. Directors noted that the continued willingness of foreign investors to hold U.S. dollar assets had enabled the large U.S. current account deficit to be financed without difficulty but emphasized that this situation would not continue indefinitely. They welcomed the progress made in implementing the cooperative policy strategy to address global imbalances agreed at the October 2004 meeting of the IMFC, noting, in particular, the improved fiscal position in the United States, the steps taken toward greater exchange rate flexibility by China and Malaysia, and signs of stronger domestic demand in Japan.

Nevertheless, they emphasized that considerable further efforts would be required and reiterated their concerns about long-standing vulnerabilities in the global economy, such as unsustainable medium-term fiscal positions and rising debt in major industrial countries. They stressed the need for policies that could boost long-term growth, such as product and labor market reforms in the euro area, financial and corporate reforms in Japan and much of emerging Asia, strengthened bank supervision in central and eastern Europe, and improvements in the investment climate in many emerging market countries. Successful completion of the Doha Round, actions by low-income countries to reduce poverty, and the establishment of sound institutions by emerging market and developing countries will be crucial. Directors emphasized that the oil-exporting countries, with their rapidly rising current account surpluses, need to take advantage of higher revenues to boost expenditures in areas where social returns are high or to allow some real exchange rate appreciation over the medium term.

The Board also welcomed the staff analysis of inflation targeting, which has become an increasingly favored monetary policy strategy in emerging markets (Box 3.1). Many Directors considered that inflation targeting could bring important benefits for emerging market countries by lowering inflation and better anchoring inflation expectations.

World Economic Outlook, April 2006

At their March 2006 discussion of the WEO,[3] Executive Directors welcomed the continued strong expansion of the global economy, which had exceeded expectations at their August 2005 discussion. Despite higher oil prices and a number of natural disasters, economic activity in the second half of 2005 and early 2006 was strong, and inflationary pressures remained subdued. The economic expansion had also become more broadly based. While the United States was still the main engine of growth among industrial countries, it was increasingly supported by the ongoing expansion in Japan and signs of a sustained recovery in the euro area. Growth remained strong in emerging markets and developing countries, with particularly buoyant activity in China, India, and Russia. Directors emphasized that, despite these broadly favorable developments, key vulnerabilities—most

[2] Available at *www.imf.org/external/pubs/ft/weo/2005/02/index.htm*; the summary of the Board's discussion can be found at *www.imf.org/external/pubs/ft/weo/2005/02/pdf/annex.pdf.*

[3] Available at *www.imf.org/external/pubs/ft/weo/2006/01/index.htm;* the summary of the Board discussion can be found at *www.imf.org/external/pubs/ft/weo/2006/01/pdf/annex.pdf.*

notably global current account imbalances—still had not been addressed.

Looking ahead, Board members expected that global economic conditions would remain favorable, with a gradual pickup in investment helping countries weather high oil prices. On the upside, they acknowledged that the growth outlook could be more positive if growth in some emerging market countries continued to exceed expectations or if the corporate sector in the advanced economies ran down its financial surpluses more rapidly than expected. On the downside, with the oil market remaining vulnerable to shocks, given limited excess production capacity, and with prices increasingly driven by supply-side concerns, many Directors felt that the adverse impact of high oil prices on global growth could well increase. Other risks include an abrupt tightening in financial market conditions and a possible avian flu pandemic.

Of most concern to Directors was the further widening of global imbalances. The U.S. current account deficit had widened to record levels, matched by large surpluses in oil exporters, a number of small industrialized countries, Japan, China, and a number of other emerging Asian countries. Board members generally believed that the probability of a disorderly unwinding of imbalances remained low. However, such an outcome could have sizable negative effects for the global economy and the international financial system, and Directors called for actions aimed at reducing these vulnerabilities. A progressive narrowing of imbalances would need to be based both on a significant rebalancing of demand across countries and on adjustments in exchange rates.

Directors emphasized that, while the private sector would play a key role in the resolution of global imbalances, a purely market-driven adjustment carried significant risks, underscoring the importance of more rapid implementation of the agreed policy strategy. They also noted the importance of achieving a better balance between externally and domestically led growth and reforming domestic financial systems to boost domestic demand. Given economic interlinkages, all countries and regions would play a role in the adjustment of imbalances, and countries should therefore increase the flexibility of their domestic economies to adapt better to changing global patterns of domestic and external demand.

The IMF continues to have a central role to play in promoting a coordinated multilateral medium-term solution for reducing global imbalances, Directors agreed. With consensus on the broad strategy, the challenge was to work out the precise modalities and accelerate implementation. Directors also underscored the importance of the IMF's advice in urging countries to resist protectionist pressures and helping them exploit comparative advantages through deeper integration.

Directors reiterated their concerns regarding two other long-standing policy challenges facing the global economy.

- Unsustainable medium-term fiscal positions remain a key risk. In the major industrial countries, with the exception of Japan, underlying fiscal positions had improved only modestly since 2003, and little improvement is projected over the next two years.
- More ambitious efforts are needed to put in place the preconditions for taking advantage of the opportunities

Box 3.1 Inflation targeting

Inflation targeting is being adopted in a growing number of emerging market and developing countries as an alternative nominal anchor to a fixed exchange rate or monetary targeting. It has generally been associated with positive macroeconomic performance, even in countries whose institutional and operational arrangements are not well developed until after the introduction of inflation targeting.

However, there are some important caveats related to the potential benefits of inflation targeting relative to other regimes. At a seminar in February 2006, the Executive Board pointed to the short experience with inflation targeting and the relatively small sample of countries studied.[1] A number of Directors also pointed to possible self-selection in the sample and considered that success with inflation targeting might reflect a broader shift in country preferences toward price stability.

The positive experience in emerging market countries suggests that the technical and institutional preconditions for inflation targeting may be less stringent than previously believed and less important than developing capabilities following adoption of inflation targeting. Nevertheless, a number of preconditions remain important for success—in particular, an autonomous central bank, fiscal consolidation, and adequate financial market development. Directors also highlighted the importance of a clear ex ante commitment to the inflation targeting framework on the part of both the monetary and the fiscal authorities, firm political support, a consistent fiscal policy, and effective communication of policy intentions.

At the same time, adoption of inflation targeting should not be seen as a panacea, and substantial operational and capacity constraints need to be overcome in many countries contemplating adoption of inflation targeting, a point noted by many Directors. Moreover, capacity constraints in some countries and other structural features of their economies might make inflation targeting unsuitable for the foreseeable future. While inflation targeting can offer significant benefits, it may not be appropriate for all countries.

[1]The discussion was based on a staff paper, "Inflation Targeting and the IMF," which can be found at *www.imf.org/external/np/pp/eng/2006/031606.pdf.* A summary of the Board's discussion is available at *www.imf.org/external/np/sec/pn/2006/pn0640.htm.*

Philippines

Since 2001, when the Philippines' last financing arrangement with the IMF ended, the IMF has been undertaking Post-Program Monitoring (PPM) in the country. The Fund's policy dialogue with the Philippine authorities has focused on the need for reducing vulnerabilities and laying the foundations for higher investment and growth. With heavy public debt, a large fiscal deficit, and major losses at the national power company, the Philippines has often been subject to major swings in investor sentiment in recent years.

Economic reforms have advanced significantly since late 2004, however. Power tariffs have been raised, substantially reducing the national power company's losses, and a landmark value-added-tax (VAT) reform has been fully implemented, including an extension of VAT to energy products and an increase in the VAT rate. In the financial sector, the Special Purpose Vehicle framework set up to facilitate the sale of nonperforming assets has gained traction. These developments have been received favorably by financial markets: the peso has appreciated and bond spreads have narrowed. This progress has been achieved despite political turbulence blowing the reform process temporarily off course in mid-2005. Several key members of the cabinet resigned, and the Supreme Court issued a temporary restraining order on the VAT package. In early 2006, the president declared a state of emergency in response to a failed coup attempt. Going forward, the challenge is to maintain the reform momentum to increase the low rate of domestic investment.

Throughout this reform process, the Philippine authorities and the IMF have maintained a close policy dialogue. The authorities value this relationship, as evidenced by their choice to continue PPM even though outstanding borrowing has fallen well below the 100 percent of quota threshold at which PPM usually ends. The Philippines has also received technical assistance from the IMF to improve tax and customs administration and strengthen the statistical base.

Philippines-IMF activities in FY2006

May 2005	Authorities and IMF jointly host Domestic Capital Market Development seminar in Manila
September 2005	Completion of the Philippines' Post-Program Monitoring discussions by the Fund's Executive Board
February 2006	Conclusion of the Philippines' Article IV consultation by the Fund's Executive Board

from globalization and for supporting growth. Directors reiterated the need to resist rising protectionist pressures and ensure an ambitious outcome for the Doha Round. They agreed that advancing the structural reform agenda at the national level remained key to removing impediments to long-term growth.

While emphasizing that the impact of globalization on inflation would be temporary unless it changed the objectives of monetary policy, Directors observed that import price declines had had sizable effects on inflation in industrial countries over one- to two-year periods and noted that globalization had had a significant impact on relative prices. They agreed, however, that globalization could not be relied upon to prevent a pickup in inflation and that central banks must remain vigilant for signs of inflationary pressures.

Conditions in global financial markets remained very favorable, with unusually low risk premiums and volatility. Directors noted that high corporate saving was one factor contributing to low global interest rates, but most believed that it would decline over the next few years as investment increased, probably putting upward pressure on long-term interest rates.

Industrial countries

Directors welcomed the continued strong expansion in the *United States* despite the temporary slowdown in the fourth quarter of 2005. With corporate profits expanding robustly, business investment and employment could be stronger than expected. On the downside, the large current account deficit made the United States vulnerable to a swing in investor sentiment, and a sharp weakening of the housing market and higher energy prices could slow consumption. With core inflation well contained, financial markets indicated their belief that the tightening cycle in the United States was nearly complete, although Directors emphasized the need for vigilance for signs of inflationary pressures. While welcoming the marked improvement in the federal budget deficit in FY2005, most Directors believed that a much more ambitious fiscal adjustment was needed in FY2006 and beyond, with the aim of achieving broad budget balance (excluding Social Security) by 2010, based on further spending discipline and consideration of revenue enhancements. In this context, a few Directors noted that a rapid decline in the U.S. fiscal deficit could slow U.S. and global growth in the absence of increased domestic demand elsewhere.

There were signs of a stronger recovery in the *euro area*, but Board members cautioned that it remained unduly vulnerable to external factors, particularly oil prices and world demand. Against the background of limited underlying inflationary pressures and still fragile domestic demand, most Directors observed that monetary policy needed to remain appropriately supportive of the recovery. Directors noted with concern the lack of progress in reducing budget deficits and believed that most countries should aim for a broadly balanced fiscal position by the end of the decade. With rising fiscal pressures from an aging population, Directors attached particular importance to the need to reform Europe's social systems and reiterated the importance of continued structural reforms for enhancing the region's low potential growth rate.

Welcoming the economic recovery in *Japan*, Directors noted that it was being driven by domestic demand and was underpinned by rising employment, buoyant corporate profits, and a turnaround in bank credit growth. They expected the positive growth momentum to continue, with potential risks from stronger-than-anticipated private consumption in response to rising employment and labor income. Although they welcomed the fact that core CPI inflation had turned slightly positive and that the Bank of Japan had been able to move away from its quantitative easing framework, they emphasized that interest rates should be kept at zero until deflation was decisively beaten. Directors acknowledged the reduction in the general government budget deficit but called for faster progress in improving the fiscal position to stabilize public debt and accommodate the budgetary pressures from an aging population. Directors underscored the need to complete structural reforms to boost productivity and to complete financial and corporate restructuring.

Emerging market and developing countries

Directors welcomed the continued rapid growth in *emerging Asia* and expected it to maintain momentum in 2006, once again led by China and India. Directors emphasized the need for more balanced growth in the region and encouraged policymakers to accelerate structural reforms. Most Directors also considered that exchange rates would need to be allowed to appreciate in surplus countries.

The robust economic expansion in *Latin America* was expected to continue in 2006, with external demand continuing to remain an important driver of growth. While welcoming the disciplined fiscal policies in much of the region, many Directors called for further progress in debt reduction in a number of countries, which will require a continuation of tight fiscal policies and structural reforms, including steps to improve the business climate.

Board members expected growth in *emerging Europe* to remain firm, although this will depend on the recovery of demand in the euro area. They saw downside risks to the outlook arising mainly from the region's large current account deficits and the rapid expansion of credit growth in a number of countries and urged increased fiscal consolidation in central Europe to reduce external deficits.

Real GDP growth slowed noticeably in the *Commonwealth of Independent States*. Directors emphasized that monetary policy would need to play a more active role in containing inflation, including by allowing greater nominal exchange rate appreciation where necessary. While countries benefiting from higher oil revenues have scope to raise productive spending, Directors cautioned that such spending should be consistent with broader macroeconomic objectives and cyclical considerations. They stressed the need for structural reforms to strengthen the role of the private sector and deepen market institutions.

Directors welcomed the robust economic expansion in *sub-Saharan Africa* and expected that the growth rate in the region in 2006 would be the highest in three decades, underpinned by high commodity prices, improved macroeconomic policies, and structural reforms. They stressed that maintaining high long-term growth rates will be crucial to reducing the incidence of poverty and making progress toward the Millennium Development Goals. The Board underscored the importance of continued reforms to improve the institutional environment, along with structural reforms to encourage greater private investment and to make economies less dependent on global commodity cycles. Directors also called on the international community to support Africa's reform efforts, including by following through on commitments for greater resource flows and improved market access.

In the *Middle East*, growth remained robust, led by substantially higher export earnings in oil-exporting countries. Despite stronger domestic demand, inflation remained subdued as countries saved a larger proportion of the increase in oil revenues compared with previous oil cycles. Directors emphasized that, with a significant proportion of higher oil revenues expected to be permanent, consideration should be given to carefully planned expenditures to raise growth in both the oil and the non-oil economy and increase employment opportunities for the growing working-age population.

Global Financial Stability Report

Global Financial Stability Report, September 2005

At its August 2005 GFSR discussion,[4] the Executive Board observed that the configuration of solid growth, low inflation, low bond yields, flat yield curves, and tight credit spreads was contributing to the resilience of the global financial system. Furthermore, the much-improved balance sheets of the sovereign, corporate, and household

[4]The Report is available at *www.imf.org/external/pubs/ft/GFSR/2005/02/index.htm;* the summary of the Board discussion can be found at *www.imf.org/external/pubs/ft/GFSR/2005/02/pdf/annex.pdf.*

sectors, together with structural changes such as the growing importance and diversity of institutional investors, were providing an important cushion to financial markets. However, although near-term risk had been reduced, potential vulnerabilities—mainly in the form of larger global imbalances and higher debt levels, particularly in the household sector—had been stored up for the medium term.

Long-term interest rates in mature markets remained low for a number of reasons, including low levels of investment resulting in excess global saving, a reduction in inflation risk premiums because of greater central bank credibility, reserve accumulation by Asian central banks, and an ongoing shift in institutional investor portfolio preferences from equities to bonds. The search for yield remained a dominant theme in financial markets.

Directors noted that the dollar rebounded against major international currencies despite the widening U.S. current account deficit, as investors focused on interest rate and growth differentials in favor of the United States. The global appetite for U.S. assets thus remained strong. However, the risk of increased exchange rate volatility and the possibility of a related spike in U.S. bond yields caused by a reduction of capital flows to the United States, although unlikely, could not be dismissed. The Board welcomed moves by China and Malaysia to make their currencies more flexible.

Many Directors expressed concern that low mortgage-financing costs had induced substantial increases in household debt, particularly in the United States. Relaxation of credit standards and products such as interest-only and negative amortization mortgages might add to risks in mortgage markets, allowing households to take on larger levels of debt and giving increased access to marginal borrowers. However, increases in asset prices, particularly in the housing sector, had also raised household net worth.

Emerging financial markets had become increasingly resilient, Directors said, but they cautioned that the positive global economic environment might be masking underlying vulnerabilities in some countries. The Board took note of the ongoing broadening of the investor base for emerging markets and the extension of investor interest into local instruments. They also welcomed improvements in the balance sheets of key sectors in mature market economies. Indicators of market and credit risk and financial strength underscored the resilience of the banking and insurance sectors in both mature and emerging markets. A number of Directors, however, stressed the need to guard against the potentially destabilizing effects of hedge fund operations and the growing use of structured products.

While considering policy measures to mitigate risks, Directors stressed that ongoing risk management by individual financial institutions and supervisory scrutiny by regulators were the most important lines of defense. In particular, given the risk of corrections in credit-derivative and CDO (collateralized debt obligations) markets, regulators must ensure that financial institutions maintain robust counterparty-risk-management practices. The Board also stressed the importance of disclosure and transparency, of work on standards and codes, and—especially for individual investors—of financial education. For the medium term, the risk of growing global imbalances must be addressed by a cooperative effort by the major countries.

Aspects of global asset allocation

Directors noted that a better understanding of the investment patterns of pension funds, insurance companies, mutual funds, and hedge funds would help anticipate the potential for abrupt changes in capital flows across borders and asset classes. Most Directors agreed that the increasing dominance of strategic asset allocations driven more by long-term economic fundamentals was a positive development.

Directors noted the sustained decline in "home bias" on the part of institutional investors in mature economies over the past 15 years. By raising average returns while reducing portfolio volatility, the shift toward internationalized portfolios has bolstered financial stability, but it has also increased cross-border capital flows and probably led to greater cross-border correlations among asset markets.

Directors also discussed the implications for financial stability of proposals and potential changes in accounting policy. In particular, they recognized the importance of international efforts to improve accounting principles to enhance the comparability and transparency of accounts and to strengthen market discipline.

Corporate bond markets in emerging market countries

Since a number of emerging market countries had achieved macroeconomic stability, the time might be right for the development of corporate bond markets. The Board called for continued efforts by emerging markets to facilitate the growth of institutional investors and noted that small and medium-sized corporations should adopt high standards of transparency and corporate governance. Directors stressed that, for the effective functioning of securities markets, the authorities should adopt a regulatory framework ensuring investor protection and market integrity and containing systemic risks. Emerging market countries should also reduce the approval time for, and cost of, issuance.

Directors stressed the importance of a well-developed secondary market in improving price discovery and liquidity while acknowledging that only a few industrial countries were able to achieve this goal. They also noted the complementary role of the development of a government bond market. Regional cooperation could help promote development of bond markets for countries lacking the minimum efficient scale for a deep and liquid bond market.

Global Financial Stability Report, April 2006

Meeting in March 2006 to discuss the GFSR,[5] Directors welcomed the continued resilience of the international financial system. They considered that financial conditions would likely remain benign, with continued growth, contained inflation, and stable inflationary expectations. Although the global system faced a number of challenges—in particular, rising interest rates and a turn in the credit cycle for both the corporate and the household sectors—most Directors considered that financial markets should be able to deal well with the expected cyclical risks. A number of Directors, however, cautioned that medium-term risks to financial stability might have increased somewhat in the face of growing global imbalances, higher household debt, and possible underpricing of risk in certain asset classes. Directors urged national authorities to pursue macroeconomic policies aiming for solid and well-balanced growth while strengthening supervisory and regulatory oversight.

Although the turn in the corporate credit cycle increased the chances that idiosyncratic risks could lead to a widening of credit spreads for specific firms, overall corporate sector balance sheets remained healthy. Moderate changes in the broad corporate spreads should enable self-correcting forces to operate.

Directors commented that housing and mortgage markets also pointed to a turn in the credit cycle, especially in the United States, where housing activity had moderated. In particular, higher interest rates could raise the already large debt-servicing burdens of households, worsening the credit quality of mortgage markets and causing losses to lending institutions. Since the majority of U.S. mortgages are at long-term fixed rates, however, these risks are mitigated. The main area of concern may lie in the sub-prime segment of the housing and mortgage market, where marginal borrowers are exposed to the risks of rising interest rates and a stagnation or decline in house prices.

Despite the rise in U.S. policy rates, spreads for emerging market external bonds were at record low levels, underpinned by fundamental improvements such as current account surpluses, strong capital inflows, strengthened debt structures, and large reserve cushions, in addition to strong macroeconomic policies and performance. Although emerging markets will likely be tested by less favorable

[5]Available at *www.imf.org/external/pubs/ft/GFSR/2006/01/index.htm;* the summary of the Board discussion can be found at *www.imf.org/external/pubs/ft/GFSR/2006/01/pdf/annex.pdf.*

Slovak Republic

The Slovak Republic's economic performance has strengthened progressively since 2000, in response to sound macroeconomic management, fundamental structural reforms, and large inflows of foreign direct investment. Real GDP growth has been rising, reaching 6.1 percent in 2005, underpinned by buoyant investment and exports. The country's export market share in the EU–15 countries has increased rapidly. However, the Slovak Republic's external current account deficit averaged 5¾ percent of GDP during 2000-05, reflecting high levels of investment-related imports. Average inflation declined to 2¾ percent in 2005 from 14 percent in 2000. The fiscal deficit fell to 2.9 percent of GDP in 2005 from 12¼ percent of GDP in 2000, largely because of expenditure restraint and strong revenue performance, the result of brisk economic growth. A wide array of reforms have been implemented to reduce economic distortions, stimulate investment and job creation, improve labor market flexibility, and increase incentives to seek work.

The Slovak Republic joined the European Union on May 1, 2004, entered the ERM II on November 28, 2005, and is well positioned for euro adoption. However, an important challenge ahead is to bring down inflation, which has risen above 4 percent in 2006 owing, in part, to regulated price hikes and high oil prices, in a manner that does not undermine exchange rate stability and competitiveness.

The country received technical assistance from the Fund in various areas prior to EU accession, and its financial sector has been assessed under the Financial Sector Assessment Program (FSAP). The assessment will be updated during FY2007.

Slovak Republic-IMF activities during FY2006

May 2005	Publication of the data ROSC (Report on Observance of Standards and Codes)
July 2005	Staff visit
November–December 2005	Discussions on 2005 Article IV consultation
March 2006	Completion of 2005 Article IV consultation

external conditions as liquidity conditions tighten, they will probably continue to be resilient.

Directors noted that a disorderly unwinding of global imbalances posed a risk for financial stability. So far, structural and cyclical factors have allowed financial markets to intermediate smoothly between surplus and deficit countries. Looking ahead, Directors remarked that the prospect of a smooth adjustment in the pattern of accumulation of U.S. dollar assets will be facilitated by the willingness of key countries to take cooperative policy measures aimed at reducing global imbalances over the medium term.

While cyclical changes could well expose weaker segments and pockets of financial markets, the Board considered that these were unlikely to pose systemic risks. Many Directors urged regulators to pursue a firm "no-bail-out" policy to contain risks of investor complacency. Broadly, regulators should place greater reliance on the self-correcting forces of financial markets, while focusing attention on ensuring robust market infrastructures, particularly for credit derivative markets. In particular, Directors emphasized that financial regulators should require rigorous risk-management practices. They also urged regulators to provide guidance on the content of business continuity plans to address possible vulnerabilities related to event risks, such as an avian flu pandemic.

Credit derivative and structured credit markets

Directors noted that the rapid growth in recent years of credit derivative and structured credit markets had facilitated the dispersion of credit risk by banks to a broader, more diverse group of investors, making the financial system more resilient and stable. However, Directors observed that these markets had grown rapidly in a relatively benign environment and had not been fully tested and that a paucity of information to monitor effectively the destination of risks posed a major challenge for policymakers and supervisors. They noted that credit derivative and structured credit markets presented new vulnerabilities that needed to be understood and carefully monitored, particularly with regard to market liquidity, and that policymakers should strengthen the institutional, legal, and regulatory infrastructures needed to attract a diverse and dedicated investor base as a key element of more liquid and robust markets. Industry representatives, regulators, and supervisors should push ahead with efforts to mitigate operational risks in credit derivative markets and continue to seek resolution on a generalized settlement protocol. Supervisors should also require that financial institutions have in place the risk-management systems and skills needed to manage their exposure in credit derivative markets, and enhanced monitoring of counterparty risk should become a higher priority for market participants and supervisors in all jurisdictions.

Directors noted that credit derivative markets provide useful information for supervisors to monitor credit quality across sectors and credit risks within institutions, and they encouraged supervisors to use this information to enhance financial sector surveillance. Directors encouraged national authorities and relevant international agencies to improve and coordinate their collection of credit derivative data—focusing on obtaining and reporting better, rather than simply more, information. Finally, Directors encouraged further research on how financial innovations may influence credit cycles and the provision of credit, as well as the transmission of monetary policy.

Emerging sovereign debt

Directors discussed the implications of recent improvements in debt management, debt structure, and diversification of the investor base in key emerging market countries. They noted the significant improvement in the macroeconomic performance of many emerging market countries since the Asian crisis.

Board members generally expected continued positive developments in emerging market countries' economic performance and debt management. The large current account surpluses and reserves buildup of emerging market countries as a group, including most of the systemically important countries, should reduce the need for external borrowing and provide a cushion against an expected moderate deterioration in external financing conditions. At the same time, Directors cautioned that a sharp rise in global interest rates could have a negative impact on emerging market countries and that several of these remained vulnerable, especially those with weaker fiscal positions, high debt and debt-service burdens, large current account deficits, or heavy dependence on a few key commodities. They also noted that many countries whose external positions had improved because of increases in commodity prices had postponed needed structural reforms and stressed that emerging market countries must continue to build on recent successes and the generally positive external scenario to mitigate remaining vulnerabilities.

IEO evaluation of the IMF's multilateral surveillance

This report by the IEO, discussed by the Board in March 2006,[6] was broadly positive, finding that the IMF's surveillance products had been largely successful in identifying relevant issues and related risks in a timely manner.

[6]Available at *www.imf.org/external/np/ieo/2006/ms/eng/index.htm;* the summary of the Board discussion can be found at *www.imf.org/external/np/ieo/2006/ms/eng/pdf/sumup.pdf.*

However, the IEO report identified scope for improvement. In particular, Directors took note of the IEO's recommendation that less weight should be given to descriptive information on developments and prospects and more to analysis of economic policy linkages and the modalities of collective action. Directors also concurred with the report's finding that it remained a significant challenge to effectively integrate macroeconomic analyses with financial sector and capital markets work and effectively integrate multilateral analysis with country surveillance. Complementary to these efforts, the scope of regional surveillance should be clarified.

Directors discussed ways to improve the effectiveness of multilateral surveillance, based on the IEO's four recommendations.

- Most Directors concurred that, while the Executive Board and the IMFC remain the most appropriate forums for discussions of policy spillovers and possible responses, the IMF should also enhance the effectiveness of its participation in other forums, including the G-7 and the G-20. The IMF should provide leadership to the global economic community in promoting cooperative solutions, drawing on its unique strengths of near-universal membership and access to policymakers of all systemically and regionally important countries, in a transparent manner and without departing from its core mandate.
- Most Directors welcomed the report's recommendation to enhance the roles of the Executive Board and the IMFC in multilateral surveillance but considered that the IEO's characterization of formal WEO and GFSR sessions failed to do justice to the usefulness of these exchanges. Many Directors saw merit in having the Board identify and agree on key issues for ministers to discuss during the IMFC meetings, focusing on matters related to policy spillovers and scenarios for collective action.
- Directors observed that, to heighten the impact of multilateral surveillance outputs on the global policy debate, they could be better targeted to their core audiences, streamlined, and focused on key issues. They saw merit in focusing regional surveillance efforts on regional economic interlinkages and policy spillovers and in better integrating them with multilateral surveillance.
- Directors took note of the report's recommendations on strengthening the structure of multilateral surveillance by defining organizational strategies and accountabilities within the IMF. They agreed that it would be beneficial to clarify the operational goals of multilateral surveillance but were not persuaded about the need for broad organizational changes. Directors agreed that priority should be given to strengthening the integration between multilateral and bilateral surveillance, particularly of systemically important countries.

Country surveillance

Under Article IV of the IMF's Articles of Agreement, each member country makes commitments to endeavor to pursue economic and financial policies that are conducive to orderly economic growth with reasonable price stability, to seek to promote stability by fostering orderly underlying economic and financial conditions, to avoid manipulating exchange rates to prevent balance of payments adjustment or to gain unfair competitive advantage, and to provide the IMF with the information necessary for surveillance. To ensure that members are fulfilling these obligations, the IMF conducts regular "Article IV" consultations, usually once a year but less often in some countries. (Informal staff visits often take place between formal consultations.) Through these consultations, the IMF seeks to identify policy strengths and weaknesses, indicate potential vulnerabilities, and advise countries on appropriate corrective actions if needed. Article IV consultations also examine the cross-border effects of countries' economic conditions and policies, particularly for systemically or regionally important member countries.

During an Article IV consultation, a staff team visits the member country to collect economic and financial data and discuss 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. The team may also meet with nonofficial groups such as legislators, trade unions, academics, and financial market participants to solicit their views on the economic situation. Toward the end of the visit, the team 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 team prepares a report describing the economic situation and the talks with the authorities and evaluating the country's policies. The report is discussed by the Executive Board and a summary of the discussion produced. If the member country agrees, a Public Information Notice (PIN), which provides background and a summary of the Board discussion, is published, with or without the full Article IV consultation report. All PINs are posted on the IMF's Web site, as are Article IV reports approved for release.

Supplementing these systematic and regular Board reviews of individual member countries are Executive Board assessments of economic developments and policies of member countries borrowing from the IMF, as well as frequent and informal sessions to discuss developments in individual countries. The IMF's country surveillance is also informed by voluntary assessments under the Financial Sector Assessment Program (see Chapter 4).

Regional surveillance

The IMF has recently been putting more emphasis on the regional context of surveillance to draw common policy lessons and capture cross-country spillovers. During FY2006, in addition to Executive Board discussions of the policies of four currency unions—the Eastern Caribbean Currency Union, the euro area, the Central African Economic and Monetary Community, and the West African Economic and Monetary Union—the IMF area departments produced *Regional Economic Outlook* reports for sub-Saharan Africa, Asia and the Pacific, Europe, the Middle East and Central Asia, and Latin America and the Caribbean. The Executive Board also held a seminar on the common challenges facing the central and eastern European countries that are members of the European Union (Box 3.2), and the IMF, the National Bank of Poland, and the Joint Vienna Institute organized a high-level conference in January 2006 on labor and capital flows in Europe following EU enlargement.[7] In September 2005, the Monetary Authority of Singapore and the IMF jointly hosted a high-level seminar on Asian regional financial integration (Box 3.3). In October, the IMF, the Chinese Academy of Social Sciences, and the Stanford University Center for International Development organized a high-level conference in Beijing on the domestic and regional implications of China's and India's changing economic structures.

The IMF also increased its outreach efforts and dialogue with civil society in Central America and the Eastern Caribbean Currency Union. For example, in December 2005, IMF Deputy Managing Director Agustín Carstens held a press conference in Basseterre, St. Kitts and Nevis, to discuss the economic challenges facing the region.[8] In February 2006, the IMF participated in the first regional meeting of the Caribbean Congress of Labor, the World Bank, and the Inter-American Development Bank. The meeting, which was held in Trinidad and Tobago, provided participants with the opportunity to discuss strategies for achieving poverty reduction, equitable growth, employment creation, and regional integration, among other things. The IMF and the World Bank jointly carried out a study of financial sectors in six countries in Central America, as cross-border financial intermediation in the region has increased (Box 3.4). The Fund also provided technical assistance to the countries of the Cen-

[7]Press Release No. 06/28, "IMF, National Bank of Poland, and Joint Vienna Institute High-Level Conference on Labor and Capital Flows in Europe Following EU Enlargement," *www.imf.org/external/np/sec/pr/2006/pr0628.htm.* The conference papers are available at *www.jvi.org/index.php?id=4447.*

[8]Press Release No. 05/268, "IMF Presents Regional Outlook at a Press Conference at the Eastern Caribbean Central Bank," *www.imf.org/external/np/sec/pr/2005/pr05268.htm.*

Box 3.2 Growth in central and eastern Europe

At a seminar in February 2006, the IMF's Executive Board discussed the challenges facing the central and eastern European countries (CEECs) of the EU as they raise living standards to western European levels.

Directors recognized the difficulty of disentangling the unique forces that shaped the CEECs' growth over the past 15 years, including the steep post-transition drop in output, the macroeconomic and institutional reforms related to EU accession, and, more recently, benign global conditions. While the CEECs' per capita output growth in the past five years had put them in the upper half of the emerging market comparator group—with the Baltics among the top five performers—Directors cautioned that the continuation of these rapid growth rates cannot be taken for granted.

Directors noted important differences in the pattern of growth in the CEECs vis-à-vis other emerging markets, particularly the lack of employment growth and the heavy contribution of total factor productivity (TFP) gains. They acknowledged that the convergence experience of other EU members, such as Greece, Ireland, Portugal, and Spain, demonstrated the viability of sustained periods of high productivity growth. Nevertheless, they pointed out that the CEECs' recent TFP growth might have been heavily influenced by the elimination of the inefficiencies of central planning—implying the possibility of some trailing off in the absence of strong efforts to improve the business environment.

Prospects for the CEECs will depend on how well they do in establishing macroeconomic and structural conditions conducive to sustained growth, which is expected to be based on greater labor use and higher investment rates. Directors noted that certain environmental features and conditions more subject to policy influence played important roles in supporting growth. The former include initial income gaps, population growth and aging, and historical trade relationships; the latter, the quality of legal and economic institutions, government size, real cost of investment, educational attainment and labor market performance, openness to trade, and inflation.

Directors agreed that European integration would play a critical role in supporting a rapid catch-up in the CEECs. Substantial transfers from the EU to the new member states were one obvious benefit, but potentially more important would be the benefits from closer institutional, trade, and financial integration with western Europe. In this regard, Directors were encouraged by indications that foreign savings had contributed significantly to growth in most CEECs and that even the large current account deficits of some countries had been in line with their growth rates. Directors observed, however, that increased reliance on foreign savings would generate significant vulnerabilities in the CEECs and that this trend therefore needed to be watched. Large current account deficits were a potential source of increased indebtedness, and their composition deserved careful assessment.

Directors identified a number of policy priorities for CEEC governments, including establishing cushions against shocks, using fiscal surpluses to build up domestic savings, avoiding disincentives to private saving, strengthening financial supervision and corporate governance, improving the efficiency of bankruptcy procedures, and making all economic activities more transparent. Directors also encouraged authorities to enact policies that would enable early euro adoption.

tral American–Dominican Republic–United States Free Trade Agreement (CAFTA-DR) on coordinating their tax systems (see Chapter 7).

Currency unions

In December 2005, IMF staff issued a paper on surveillance over members of currency unions, and the Executive Board discussions of the common policies of three monetary unions—the Eastern Caribbean Currency Union, the Central African Economic and Monetary Community, and the West African Economic and Monetary Union—were formalized within the process for Article IV consultations with individual countries of those monetary unions.[9]

Eastern Caribbean Currency Union (ECCU)

The challenges confronting the ECCU's members[10] since the early 1990s contributed to a sharp decline in economic growth—including the erosion of trade preferences for bananas and sugar, a decline in official development assistance, natural disasters, and a drop in tourism after the September 11, 2001, attacks. This decline, combined with a relaxation of fiscal stances, has considerably weakened economic conditions and led to a rapid buildup of public debt. In their July 2005 discussion,[11] Directors noted that, while growth and fiscal outcomes have improved since 2004, economic policies have not strengthened sufficiently to place debt on a clearly downward path and ensure sustainable growth, and many structural rigidities and vulnerabilities remain.

Directors noted the authorities' increasing determination to tackle the region's difficult economic situation and welcomed their outreach efforts. However, the easing of fiscal policies in some countries in anticipation of elections and the 2007 Cricket World Cup was a setback. Directors stressed that the authorities should take advantage of the favorable global growth outlook to step up the pace of fiscal reform.

The importance of ensuring consistency between national fiscal policies and the regional quasi-currency-board arrangement was underscored by Directors. They noted that protracted fiscal weaknesses could adversely affect confidence in the currency board arrangement and macroeconomic stability. In this regard, Directors urged that

Box 3.3 Seminar on regional financial integration in Asia

The Monetary Authority of Singapore and the IMF jointly hosted a high-level seminar in Singapore on Asian regional financial integration in September 2005, which was attended by delegates from 14 Asian economies. The seminar brought together ministers, central bank governors, and other senior officials from Asia, as well as officials from the IMF and the Asian Development Bank, to discuss the opportunities and challenges of Asian financial integration and potential avenues for enhancing regional surveillance and monetary cooperation.

Participants agreed that deep, efficient, and well-regulated capital markets are essential for effective allocation of the region's savings and for strengthening the region's resilience to external shocks in a more open and globalized environment. They recognized the steps taken since the Asian financial crisis to enhance regional financial cooperation and integration. These include the Chiang Mai Initiative[1] and measures to diversify, broaden, and deepen regional bond markets and link regional capital markets.

In this regard, delegates noted the importance of keeping up the momentum of strengthening these linkages. They discussed putting in place the necessary financial market infrastructure, such as clearing and settlement systems and credit-rating systems. They also noted that, in enhancing intra-Asia integration, their economies had to remain outward-looking and connected to the multilateral global system.

The key building blocks for Asian financial integration include continuing economic and financial sector reforms, the building of institutional capacity, and maintaining outward-oriented policies. Delegates exchanged views on ways for Asian countries to further promote financial integration while taking into account the diverse states of development of the Asian economies. They also explored the scope for greater cooperation in capital market development and agreed on the importance of pursuing a multipronged approach. This includes the harmonization of financial regulatory and supervisory standards in Asia, consistent with international standards.

Delegates noted that the Chiang Mai Initiative had helped provide a useful additional safety net to complement international financing arrangements. Participants also discussed the links between trade integration, financial integration, and monetary and exchange rate collaboration. On monetary and exchange rate cooperation, there was a broad consensus that developments would be evolutionary. Participants noted that there would be greater potential for collaboration as they forged common perspectives on fiscal and monetary issues and further integrated the real economy.

Delegates also agreed to further their efforts in regional financial sector surveillance to monitor potential vulnerabilities in the financial system, thereby complementing the surveillance work of international financial institutions such as the IMF and the Asian Development Bank.

[1]The Chiang Mai Initiative, announced in 2000, expanded swap arrangements among the Association of Southeast Asian Nations (ASEAN) and called for a network of bilateral swap and repurchase agreement facilities among the ASEAN countries and China, Japan, and Korea. The goal was to strengthen existing regional frameworks for economic cooperation by establishing a regional financing agreement that would supplement existing international facilities.

[9]See "Fund Surveillance over Members of Currency Unions," a staff paper issued in December 2005, at *www.imf.org/external/np/pp/eng/2005/122105.pdf*

[10]The ECCU is composed of six Fund members—Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines—and two dependent territories of the United Kingdom—Anguilla and Montserrat.

[11]The Board's discussion is summarized in Public Information Notice No. 05/118, available at *www.imf.org/external/np/sec/pn/2005/pn05118.htm.*

Box 3.4 Regional financial integration in Central America

A distinctive feature of the financial landscape in Central America is its high level of integration. Cross-border flows are significant, and regional financial groups—local conglomerates operating in more than one country in the region—account for an important share of regional intermediation. Financial integration holds promise for supporting economic development in Central America but presents increased vulnerabilities and risks. Central American countries also share key challenges in terms of modernizing their financial infrastructure and developing nonbank financial intermediaries.

The IMF, with input from the World Bank, carried out a regional financial sector study in 2005 covering the six Spanish-speaking countries of Central America—Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.[1] The study, which was discussed in an informal Executive Board Seminar in June 2005, explores the countries' achievements in the path toward regional financial integration and development and makes recommendations on ways to address the remaining challenges:

- On cross-border banking, governments in the region need to increase the independence of financial oversight agencies and provide adequate legal protection for their staff, along with full accountability. A regional approach is needed to consolidate supervision of regional banking groups, including adequate reporting and exchange of information among relevant regulators.
- A stronger legal and regulatory framework and greater harmonization of regulations in the insurance sector would help unleash the sector's potential, in terms of both financial deepening and greater access by consumers.
- National payments and securities settlement systems, in which Central American central banks have played a very active role, need to be brought into line with international standards and best practices to create the basis for further regional harmonization and integration.
- There is a need to reduce the costs associated with workers' remittances—a large and stable source of external financing in the region and an important component of cross-border payments—notably through increased transparency and competition among providers and steps to upgrade the remittance payments infrastructure.

In carrying out this project, IMF staff liaised with the regional financial bodies that are members of the Central American Monetary Council and the Central American Council of Superintendents of Banks, Insurance, and Other Financial Institutions. The project was formally launched following discussions with the Council of Superintendents in Tegucigalpa in November 2004. Subsequent work was carried out at IMF headquarters and during visits to the countries. The IMF is undertaking outreach to disseminate the study's findings to policymakers, relevant nongovernmental organizations, and financial institutions and markets.

[1]The study, by a staff team led by Patricia Brenner, was published by the IMF in 2006 as *Central America: Structural Foundations for Regional Financial Integration* and can be ordered from IMF Publication Services.

efforts be made by regional governments to achieve the fiscal benchmarks approved by the Eastern Caribbean Central Bank's (ECCB) Monetary Council.

The Board noted that financial contagion risks were likely to rise as regional financial markets deepened, pointing to a need for continued efforts to strengthen financial sector supervision. It urged the implementation of key measures identified by the regional Financial Sector Assessment Program, including an increase in the frequency of on-site bank inspections and the approval of amendments to the Uniform Banking Act at the national level. The regulatory and supervisory frameworks for the nonbank and insurance sectors should also be strengthened. Further, Directors underscored the importance of developing contingency plans, in coordination with the ECCB, to prepare for unanticipated shocks and crises.

The region's high public debt levels limit the ability of ECCU governments to use fiscal policy to respond to external shocks, underscoring the need for measures to reduce the region's vulnerabilities. Directors urged the authorities to further enhance disaster mitigation and preparedness activities and to undertake greater investment in insurance of public assets and infrastructure, possibly through participation in regional insurance pooling arrangements.

Directors stressed the importance of boosting the competitiveness and growth potential of the region. They urged the public sector to shift from serving as the employer of last resort and main engine of growth to providing a supportive business environment. Directors recommended that the investment climate be improved by deepening regional integration, removing labor market rigidities, revamping the regulatory framework, and attaining greater efficiencies through consolidation and provision of collective government services. Directors also emphasized that the region's distortionary, nontransparent, and costly tax concessions should be reformed, and that a coordinated regional approach should be adopted to avoid costly tax competition between islands. Also, in light of the high emigration rates of skilled labor from the region, Directors saw scope for tapping the Caribbean diaspora to support domestic private investment. They also recommended that distortions in financial markets be gradually phased out to stimulate private sector credit and investment.

The emphasis placed by the ECCB on strengthening the availability and quality of statistics in the region was welcomed by Directors. They stressed that improvements in the coverage, quality, and timeliness of statistical data in all areas would facilitate better assessment of economic, social, and financial conditions and would enhance the quality of policymaking and public debate at all levels.

Euro area

At their July 2005 discussion of policies in the euro area,[12] Directors expressed disappointment with the struggling recovery and continuing high unemployment but noted that the economic fundamentals in the euro area have continued to strengthen, reflecting significant structural reforms in several member states. At the same time, Directors observed that the burden of accumulated rigidities and aging continued to weigh heavily on the euro area, and that fiscal policies fell well short of the area's fiscal consolidation requirements. Furthermore, business and consumer confidence remained low. Against this background, Directors called for a more decisive and consistent pursuit of forward-looking policies aimed at strengthening fiscal adjustment and structural reform.

Directors considered that the fundamentals remained in place for the modest recovery to resume in the second half of 2005, but the outlook was uncertain and the risks lay mainly on the downside. They included further sharp increases in oil prices, multilateral euro appreciation in the context of unwinding global imbalances, a reversal in the benign global financial conditions, and a potentially sluggish investment recovery in the face of weak business confidence.

Directors agreed that the monetary policy stance of the European Central Bank (ECB) remained broadly appropriate. While headline inflation was still hovering around 2 percent, underlying inflation pressures remained subdued. However, many Directors stressed that, absent new information on prices or wages, a cut in interest rates would be appropriate if evidence of a fading recovery continued to accumulate over the coming months. These Directors felt that a rate cut would also be warranted if the euro appreciated significantly on a multilateral basis. Some Directors, however, questioned the case for a rate cut. Given the considerable uncertainty surrounding the economic outlook, Directors encouraged the ECB's authorities to remain vigilant and to stand ready to respond flexibly, as warranted.

The need to prepare the euro area's public finances for the looming demographic shock was underscored by Directors. It would require steady progress toward achieving underlying fiscal balance by 2010, when population aging was set to accelerate. Many Directors advocated policies that consistently correct current and intertemporal fiscal deficits to anchor consumer confidence. Fiscal adjustment was also needed to achieve adequate safety margins below the 3 percent Maastricht deficit ceiling and restore the credibility of the Stability and Growth Pact.

Actions to boost potential growth and employment were deemed crucial. Directors called for particular attention to the appropriate sequencing of product, service, labor, and financial market reforms. Key actions included reforming entitlement systems, boosting labor utilization, deregulating and strengthening competition, completing the internal market, and integrating national financial systems. In this regard, the new integrated guidelines under the revamped Lisbon Strategy were welcomed, as they should aid in the formulation of consistent National Action Plans. Directors observed, however, that with the agenda-setting shifting away from the center, the prospects for reform would hinge on the leadership and determination of national governments. Many Directors considered that growth-enhancing structural reforms would be helpful in underpinning an orderly unwinding of global current account imbalances.

Directors welcomed the progress that had been made through the Financial Services Action Plan and the so-called Lamfalussy process in laying the foundation for further integration of financial markets and convergence of supervisory practices in Europe. The onus now was on all member states to take a pan-European view to make this process work effectively and on the European Commission to enforce existing rules. Directors agreed that the growing cross-border activities of major, complex financial groups were placing an increasing burden on national supervisors. Many Directors also thought that a more integrated approach to supervision deserved consideration.

On trade policy, Directors welcomed the continued commitment of the EU to play a leading role in forging agreement on the Doha Development Agenda. They underscored the importance of and the multilateral benefits from greater access to the EU's agricultural markets. Many Directors regretted the recent moves to limit imports of textiles, clothing, and footwear.

Directors stressed that effective area-wide surveillance called for improvements in the quality, availability, and timeliness of statistics, and strengthened statistical institutes. While the availability of statistics was broadly adequate, better fiscal data should remain a key priority for a number of countries.

Central African Economic and Monetary Community (CEMAC)

At their June 2005 discussion, Directors welcomed the positive macroeconomic developments in 2004 in the Central African Economic and Monetary Community, while noting that the situation varied across the six member countries,

[12]Members of the euro area are Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. The summary of the Board's discussion can be found at *www.imf.org/external/np/sec/pn/2005/pn05103.htm.*

five of which are oil producers that benefited from the effects of oil windfalls.[13] The strong growth performance of the region was due mainly to sharp increases in oil output in Chad and Equatorial Guinea. Oil accounts for nearly 80 percent of the region's exports, and oil prices increased by over 30 percent during the year. Higher oil output and prices led to a growth rate for the region of 8.3 percent, the highest in 10 years. There was a marked improvement in the balance of payments and fiscal accounts and an accumulation of international reserves. In addition, inflation remained low as a result of the peg of the CFA franc to the euro, improved fiscal performance, and positive agricultural developments in most member countries.

However, non-oil growth in the region slowed from 3.6 percent in 2003 to 3.2 percent in 2004. Directors observed that, while CEMAC shares many of the growth challenges facing other sub-Saharan African countries, its task is more complex given the exchange rate regime, the volatility of oil receipts, and the expected depletion of oil reserves in several member countries over the medium term. They therefore stressed the importance of steady progress on structural reforms to strengthen non-oil growth, diversify exports, and advance toward the Millennium Development Goals. In this regard, they welcomed the broad-based structural measures proposed under ongoing trade initiatives, such as the Economic Partnership Agreement with the European Union.

The importance of fiscal discipline in CEMAC countries was underscored by Directors. They welcomed the prudent management of the increased oil revenue, most of which had been saved in the form of higher foreign exchange reserves. However, as oil prices were expected to remain high in the medium term, and given the overall favorable fiscal and external positions, Directors acknowledged that there could now be scope for additional spending on infrastructure and poverty reduction programs provided that such spending was consistent with the medium-term fiscal and debt sustainability of individual members and their absorptive capacity.

The Board noted that international reserves might need to increase further in view of CEMAC's fixed exchange rate regime and the underlying economic vulnerabilities. They supported the creation of country-owned oil stabilization funds and "funds for future generations" under the management of the regional central bank, provided that this did not weaken the external position of the Bank of Central African States (BEAC) and that the funds were managed efficiently and with full transparency. They stressed that changes in the institutional arrangements for managing oil receipts must take into account the need to maintain adequate levels of reserves. Since oil was by far the predominant export, Directors recommended that part of the oil export receipts continue to be placed in the common pool of reserves.

Monetary policy had been broadly successful in keeping liquidity and inflationary pressures under control. Directors commended the recent measures by the regional central bank to strengthen its monetary policy framework and the progress made toward the establishment of a regional payments platform. They stressed the importance of gradually shifting toward the use of market-based instruments in the conduct of monetary policy but noted the lack of such instruments given the region's shallow and segmented money markets. Directors therefore urged faster progress in finalizing the abolition of statutory advances to member countries and their replacement with treasury bills.

The region's banking sector continued to show weakness, including a high level of nonperforming loans and the failure of some banks to comply with capital adequacy standards. Directors stressed the importance of strengthening the regional supervisory agency and also noted the very low level of bank credit to the private sector. They encouraged the authorities to step up their efforts to develop a sound and competitive financial sector and supported the use of a regional Financial Sector Assessment Program to help guide a comprehensive reform.

Directors expressed concern that continued obstacles to trade and financial market integration had resulted in low levels of intraregional trade and capital flows and prevented CEMAC from reaping the full benefits of regional integration. They regretted, in particular, the persistent lack of implementation of agreed regional policies. They stressed that commitment to, and compliance with, the convergence criteria were crucial to the integration process and to strengthening investor confidence and the business environment.

Authorities should increase the effectiveness of existing regional institutions and agreements before pursuing additional regional integration efforts, Directors said. They cautioned that prematurely integrating CEMAC with a broader group of countries could hamper the necessary deepening of common policies and stressed that changes to the regional integration pattern would need to be consistent with efforts to further trade liberalization.

Directors commended the regional authorities for improvements in the regional surveillance process, in particular the more nuanced review of member countries'

[13]The five oil-producing members are Cameroon, Chad, the Republic of Congo, Equatorial Guinea, and Gabon; the sixth member is the Central African Republic. The summary of the Board's discussion can be found at *www.imf.org/external/np/sec/pn/2005/pn05151.htm*.

fiscal stance. Further changes should aim at strengthening the effectiveness of the regional surveillance framework, including the introduction of appropriate incentives and sanctions and the strengthening and harmonization of the legal and institutional framework. Directors supported the formalization of the IMF's regional surveillance of CEMAC and its integration with the Article IV consultations with individual countries. Directors emphasized, however, that the lack of resources in CEMAC for continuous regional surveillance and adequate follow-up on findings needed to be addressed.

West African Economic and Monetary Union (WAEMU)

In March 2006, the Executive Board discussed the staff appraisal of economic developments and policy issues in WAEMU.[14] Economic performance in 2004–05 had been affected by difficult external and, in some cases, internal environments in WAEMU members. Economic growth was moderate, inflation rose, and the pace of structural reform and regional integration was slow. Directors noted that prospects for strengthened economic performance depend on developments in the external environment, the strength of macroeconomic and structural policy implementation, and the resolution of sociopolitical difficulties in Côte d'Ivoire. They called on member authorities to make progress on agreed regional policies, particularly in the area of trade.

The fixed exchange rate regime has provided a useful anchor for regional policy, and the regional central bank's ability to maintain adequate international reserves has added to the arrangement's credibility. The real effective exchange rate has appreciated, but it remained broadly in line with fundamentals. Directors stressed that future exchange rate and terms of trade developments should be monitored carefully and called for increased domestic price and wage flexibility to help alleviate past losses in price competitiveness. They also underscored the importance of prudent fiscal policies.

Directors observed that structural and regulatory impediments to private sector activity might be more damaging to export growth than price factors and called for a broad-based liberalization of WAEMU members' business environments.

Rapid credit and monetary expansion was a source of concern. Directors considered that, with increasing regional financial integration, the use of differentiated reserve requirements would become less effective. They called on the Central Bank of West African States (BCEAO) to reactivate its market-based instruments.

The failure of the region to reach macroeconomic convergence within the agreed time frame reflects both underlying economic policies and shortcomings in the design of the convergence criteria, and Directors welcomed efforts to redefine the latter. They urged a renewed commitment of members to adhere to common macroeconomic targets and to promote more integrated regional markets.

Directors also urged the authorities to step up efforts to improve financial sector soundness and enforce prudential regulations. In particular, they underscored the importance of preserving confidence in the regional banking system and welcomed the actions already taken to address systemic banking problems in Togo. Directors also welcomed the development of the microfinance sector.

WAEMU should place a renewed focus on trade issues. Directors pointed to the need to abolish nontariff barriers and the desirability of a pre-announced, phased reduction of external tariffs over the medium term. They stressed the importance of strengthening domestic revenue mobilization to offset any adverse impact on fiscal revenue of further trade liberalization. They also recommended that the regional authorities focus on growth-supporting policies relating to infrastructure, trade facilitation, and improvements in energy supply.

[14]WAEMU has eight members: Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo. The summary of the Board's discussion can be found at *www.imf.org/external/np/sec/pn/2006/pn0653.htm*.