Strengthening surveillance and crisis prevention

CHAPTER • 4

During the financial year, the IMF made progress with a range of reforms that followed up on the 2004 Biennial Surveillance Review.[1] It sharpened the focus of surveillance, deepened its coverage of exchange rate and financial sector issues, improved its analysis of debt sustainability and balance sheet vulnerabilities, paid greater attention to the possibility of regional and global spillovers (see Chapter 3), and enhanced surveillance in low-income countries (Chapter 6). Many of these steps were given added impetus by the Fund's Medium-Term Strategy (Chapter 2), which was discussed by the International Monetary and Financial Committee (IMFC) at its April 2006 meeting. In its communiqué of April 22, 2006, the IMFC reiterated the importance of making IMF surveillance more effective (see Appendix IV for the full text of the communiqué).

The Fund took steps to improve the effectiveness and organizational structure of its financial sector work:

- An external working group reviewed the Fund's financial and capital markets work. Based on the working group's report, the Managing Director initiated a major operational reorganization aimed at putting financial issues at the center of the Fund's work and at ensuring that such financial expertise better serves its 184 members (Box 4.1).
- Additional resources were devoted to monitoring financial systems, especially in supporting the compilation of financial soundness indicators (Box 4.2).
- The Board considered a report by the Independent Evaluation Office on the Financial Sector Assessment Program (FSAP).
- All of the Fund's anti-money-laundering and combating-the-financing-of-terrorism (AML/CFT) work was unified in its Legal Department. This is expected to strengthen work in this area.

With many countries facing important fiscal challenges, the Fund continued to advance its analysis of, and policy advice on, public investment and fiscal policy and related issues. In a pilot project, a new framework for looking at public investment issues was applied in eight countries; experience with the pilot has helped define directions for further work, which will be coordinated with the World Bank. Another staff study focused on the contingent liabilities created by government guarantees and reviewed related disclosure and fiscal accounting issues. The Board discussed several of these issues in May and November 2005.

As oil prices rose during the year, Fund advice focused partly on the need for improved data quality and transparency in the oil sector. The Fund encouraged Special Data Dissemination Standard (SDDS) and General Data Dissemination System (GDDS) participants to provide more information on oil and gas activities and to improve the quality and transparency of oil market data. In this connection, the Fund's *Guide to Resource Revenue Transparency* was finalized. In addition, the Board carried out major reviews of the Fund's work on standards and codes, including data standards.

The IMF continued to work closely with standard-setting bodies such as the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, the International Organization of Securities Commissions, the Committee on Payments and Settlement Systems, the International Accounting Standards Board, and the Financial Action Task Force on Money Laundering. IMF staff participated in public commentary on proposals for a new capital adequacy framework for banks issued by the Basel Committee in 2004, and the Board discussed the implications of the framework for the Fund's work in October 2005.

In the area of crisis prevention, the Fund participates in the Financial Stability Forum (FSF), reporting regularly on various issues related to financial stability. In FY2006, the IMF contributed to the FSF agenda on a range of issues related to risk transfer and global asset allocation in financial systems, as well as on strategies (such as business continuity planning) to mitigate risks from a possible avian flu pandemic, the robustness of international standard-setting processes, and financial institutions' funding liquidity risk management practices. The IMF's Board also discussed a report by the IEO on the Fund's approach to capital account liberalization, and Fund staff applied balance sheet analysis in their surveillance work.

[1]The review and the Public Information Notice summarizing the Board's discussion of the review can be found at *www.imf.org/external/np/pdr/surv/2004/082404.htm.*

Box 4.1 Reorganizing the Fund's financial sector work

In a globalized world where capital moves almost instantaneously across borders, the distinction between domestic and international financial markets is increasingly blurred. In recognition of this, the IMF is shifting the emphasis in its surveillance from real to financial developments and their interactions, with a greater focus on balance sheet linkages and the sources of financing.

To improve its financial sector surveillance, in June 2005, the IMF commissioned a study by an external working group chaired by William J. McDonough, U.S. Public Company Accounting Oversight Board Chairman.[1] Based on the group's recommendations, the IMF decided to strengthen the Fund's financial and capital markets work by creating a new department in early FY2007 to serve as the center of all aspects of financial, capital markets, and monetary work in the IMF.[2] The new department merges the functions and staff of the former International Capital Markets Department (ICM) and the Monetary and Financial Systems Department (MFD).

A new Financial Sector Steering Committee chaired by the Managing Director is overseeing the merger and will be responsible for coordinating financial sector work and ensuring the close involvement of Fund management in financial sector issues. A task force assisted by outside experts and policymakers has been set up to upgrade the analytical framework for covering financial sector issues in the IMF's surveillance over individual member countries' policies ("Article IV consultations").

[1]See Press Release No. 05/132, at *www.imf.org/external/np/sec/pr/2005/pr05132.htm.*

[2]See Press Release No. 06/21, at *www.imf.org/external/np/sec/pr/2006/pr0621.htm.*

Financial sector surveillance

During the year, the IMF completed 16 assessments[2] under the FSAP, of which 4 were updates (another 43, of which 16 are updates, are either under way or agreed and being planned). Work continued on the Offshore Financial Centers and AML/CFT programs (Boxes 4.3 and 4.4).

Implications of Basel II for the Fund

In June 2004, the Basel Committee on Banking Supervision issued a new capital adequacy framework for banks, *International Convergence of Capital Measurement and Capital Standards—A Revised Framework* ("Basel II"), for implementation in the Group of Ten countries[3] beginning in January 2007. This new framework, which is far more complex than the 1988 Accord ("Basel I"), consists of three pillars. Pillar 1 introduces a menu of options for assessing the capital adequacy of banks; Pillar 2 requires an upgrading of supervisory practices to review banks' international capital adequacy assessments; and Pillar 3 requires public disclosure of more information on banks' risk profile and risk-management systems.

In October 2005, the IMF's Executive Board met to discuss the implications for the IMF of the new framework,[4] which Directors considered an important step toward addressing weaknesses in the existing Basel I framework, especially in improving risk management in financial institutions. For many countries, however, the new framework—in particular, Pillar 1—might be too complex and resource-intensive to become an immediate priority. Some countries have not yet fully implemented Basel I. The Board emphasized that premature adoption of Basel II in countries with limited capacity could divert resources from more urgent needs.

Under these circumstances, Directors generally considered that many countries might benefit more in the short term from a strengthening of supervisory practices as set out under Pillar 2 and from an enhancement of banks' disclosure practices under Pillar 3 to facilitate the exercise of market discipline. Countries should give priority to developing their financial sector infrastructure and, over time, move toward Basel II implementation. Directors stressed that road maps for Basel II implementation should be comprehensive and realistic and give appropriate attention to necessary preconditions, such as adequate credit data systems. In countries where banks implement the advanced approaches under Basel II, financial sector surveillance should include an assessment of the adequacy of Basel II implementation.

Directors cautioned that Fund staff should avoid conveying the impression that countries would be criticized for not moving to adopt the Basel II framework. They urged staff to be completely candid when asked to assess countries' readiness to move to Basel II and to indicate clearly the risks of moving too quickly and too ambitiously.

Directors voiced concerns that increased risk sensitivity would result in higher capital requirements for loans to emerging market and developing countries as well as higher risk-related capital charges, resulting in reduced capital flows

[2]These numbers refer to financial sector assessments discussed by the Board during FY2006.

[3]The Group of Ten (G-10) refers to the group of countries that have agreed to participate in the IMF's General Arrangements to Borrow, a supplementary borrowing arrangement established in 1962 that can be invoked if the IMF's resources are estimated to be below members' needs.

[4]See Public Information Notice No. 05/154, "IMF Executive Board Discusses Implications of the New Basel Capital Adequacy Framework for Banks," *www.imf.org/external/np/sec/pn/2005/pn05154.htm.*

to these countries. Also, bank lending to these countries during an economic downturn would become more costly, resulting in reduced bank lending and increased procyclicality. On the other hand, it was noted that bank lending rates to emerging market and developing countries may already incorporate the risk premium, and that the greater risk sensitivity under Basel II could mitigate "herd behavior" by banks, which makes this outcome less likely.

Many Directors considered it appropriate for Fund staff, together with other relevant institutions, to develop guidance materials to support assessments of countries choosing to adopt Basel II, taking into account each country's specific circumstances. Technical assistance should focus on putting in place the prerequisites for countries seeking to adopt the Basel II framework—namely, strengthening financial sector infrastructure, core supervisory functions, and the conditions allowing for the exercise of market discipline. Directors called for a clear division of labor between the IMF and the World Bank, with the Fund bearing primary responsibility for financial stability issues and the supervisory framework and practices, and the Bank for financial sector infrastructure and institutional development.

To conduct financial sector surveillance effectively in the Basel II environment, the Fund will need to build its expertise, although resources will be scarce in the coming years. The Fund will need to use external funding where possible and to recruit outside experts for both the short and the long terms.

Box 4.2 Financial soundness indicators

The IMF, in consultation with the international community, has developed indicators to monitor the soundness of the financial sector. Financial soundness indicators (FSIs) have also been developed for the markets in which the financial institutions operate, for the corporate and household sectors, and for real estate markets. The new methodology is contained in the IMF's *Compilation Guide on Financial Soundness Indicators*.[1]

As part of its efforts to enhance financial system surveillance, in 2004 the IMF launched a coordinated compilation exercise for FSIs. The terms of reference required that the 62 participating countries compile and submit to the IMF end-2005 data for at least the core set of 12 indicators, along with detailed metadata. Countries were also encouraged to compile and submit data and metadata for any of 28 encouraged FSIs (see Table 2.1 in the IMF's *2004 Annual Report)*. These data and metadata will be made public by the IMF by end-2006. Participating countries are encouraged to follow the IMF *Compilation Guide's* recommendations to the extent possible to foster comparability of data across countries.

To support the compilation of FSIs, the IMF conducted four regional meetings during May–July 2005 (in Brasilia, Frankfurt, Singapore, and Vienna), which were attended both by representatives from the participating countries and by observers from international and regional agencies. The meetings provided an opportunity to discuss the methodology of the *Compilation Guide* and the implications of evolving supervisory and accounting standards, and to consult with countries on their FSI compilation issues, as well as on their first draft FSI metadata.

Later in the year, participating countries provided a second draft of FSI metadata to IMF staff. In December 2005, representatives from eight international and regional agencies that are members of a reference group for the exercise met in Washington, D.C., to receive updates on the progress made on the exercise and to discuss remaining issues.[2]

[1]Available at *www.imf.org/external/np/sta/fsi/eng/2004/guide/index.htm*.

[2]"Progress on the Financial Soundness Indicators Work Program" is available at *www.imf.org/external/np/sta/fsi/eng/2005/061405.htm.*

IEO report on the Financial Sector Assessment Program

The Financial Sector Assessment Program (FSAP) was introduced in May 1999 by the IMF and the World Bank to strengthen the monitoring of member countries' financial systems. It is designed to help countries prevent and increase their resilience to crises and cross-border contagion and to foster sustainable growth by promoting financial system soundness and financial sector diversity. Assessments of financial systems undertaken under the FSAP

- identify the strengths, risks, and vulnerabilities in the financial system and the two-way linkages between financial sector performance and the macroeconomy;
- ascertain the financial sector's development needs; and
- help country authorities design appropriate policy responses.

The comprehensive nature of financial sector assessments requires a wide range of analytical tools and techniques. These include financial stability analysis, stress testing and scenario analysis, and assessments of countries' observance of relevant international financial sector standards, codes, and good practices. In implementing the FSAP, the IMF and the World Bank draw on feedback received from the Executive Boards of both institutions, from countries that have participated in the program, and from various international groups. They also draw on the knowledge of experts from a range of cooperating central banks, supervisory agencies, standard-setting bodies, and other international institutions, and outside experts augment the expertise in the IMF and the World Bank. In September 2005, the institutions jointly published a *Financial Sector Assessment Handbook*.[5]

Executive Directors met in January 2006 to discuss the IEO's evaluation of the FSAP.[6] They agreed with the key IEO conclusion that the FSAP represented a distinct improvement in the Fund's ability to conduct financial sector surveillance and to understand linkages between financial sector vulnerabilities and macroeconomic stability. Directors were encouraged by the IEO's assessment that FSAPs and FSAP updates contributed to the articulation of policy recommendations, prompted better discussions with authorities, and supported policy and institutional changes.

At the same time, Directors considered that the IEO report provided a balanced and candid assessment of areas for improvement—in particular, making financial stability assessments an integral part of the Fund's bilateral and multilateral surveillance and ensuring participation by countries most in need of stronger financial sector surveillance. Directors recognized that any adjustments and improvements would need to take into account possible resource implications for the Fund.

Most Directors agreed that incentives to participate in FSAP assessments and updates were critical for maintaining the program's effectiveness. They were concerned that some countries that are systemically important or that might have vulnerable financial systems had not yet volunteered for initial assessments and that some countries had been reluctant to volunteer for updates, but most Directors considered that the voluntary nature of the FSAP should be maintained.

Directors welcomed the discussion in the IEO report on whether the criteria for prioritizing FSAPs and FSAP updates were adequate (Recommendation 1). While a few Directors considered that the IEO report did not provide sufficient evidence that current mechanisms are inadequate, many Directors agreed on the need for clearer guidance.

To align FSAP coverage better with the needs of surveillance, most Directors agreed with the IEO proposal that management should indicate to the Board which countries it considered the highest priorities for FSAP assessments and updates (Recommendation 2). Most Directors considered that Article IV staff reports should explicitly recommend an initial FSAP or FSAP update in priority cases but should be mindful of potential market sensitivities. A number of Directors also pointed to the report's finding that the burden of FSAPs on the authorities is high and stressed that reducing this burden through better planning and focus is critical for achieving increased participation.

Many Directors saw merit in the IEO proposal that staff develop country-specific plans for financial sector surveillance. It was noted, however, that this proposal goes to fundamental questions as to how the Fund should conduct financial sector surveillance. Directors agreed that the proposal, as well as possible adjustments to resource allocation and other modalities (including the frequency of FSAPs), would be considered in the broader context of the ongoing discussion on enhancing the effectiveness of Fund financial sector surveillance.

Box 4.3 Monitoring offshore financial centers

The offshore financial center (OFC) assessment program was initiated in 2000 and reviewed by the Executive Board in 2003. At that time, the Executive Board agreed that the monitoring of OFCs, to ensure their compliance with supervisory and integrity standards, should become a standard component of the Fund's financial sector work. In February 2006, the staff issued a progress report to the Executive Board.[1] Forty-two assessments were completed under the first phase of the program. In the second phase, as of April 30, 2006, six jurisdictions had been assessed. Assessments are being conducted in accordance with the four– to five-year cycle envisaged by the Executive Board.

Progress has also been made on the information dissemination and monitoring initiative that was undertaken (1) to provide the IMF with information for its ongoing monitoring of financial developments in these centers and (2) to help improve the transparency of activities in international and offshore financial centers. As of end-April 2006, 18 jurisdictions had provided the IMF with data as part of this initiative. The IMF continues to provide technical assistance, generally to small, lower-income jurisdictions, mainly on banking supervision and anti-money-laundering and combating-the-financing-of-terrorism measures.

In November 2005, the IMF held the third roundtable for onshore and offshore supervisors and standard setters. The roundtable highlighted the need for continued attention to cooperation and information sharing, risk-based supervision, and appropriate sequencing of standards implementation as the means to address increasingly complex cross-border issues. Participants agreed that supervisors and standard setters should consider disseminating good practices on information sharing, providing Web site guides to jurisdictions' information-sharing arrangements, and assigning priority and resources to information exchange issues.

[1]The report is available at *www.imf.org/external/np/pp/eng/2006/020806.pdf*

[5]The Handbook is available online at *www.imf.org/external/pubs/ft/fsa/eng/index.htm.*

[6]The IEO's "Report on the Evaluation of the Financial Sector Assessment Program" is available at *www.imf.org/external/np/ieo/2006/fsap/eng/index.htm;* the summary of the Board's discussion can be found at *www.imf.org/external/np/ieo/2006/fsap/eng/pdf/sumup.pdf.*

Box 4.4 Update on AML/CFT

In September 2005, the IMF's Executive Board endorsed an adjustment of the IMF's anti-money-laundering/combating-the-financing-of-terrorism (AML/CFT) program to focus more on tackling the challenges faced by countries implementing standards and regimes. The IMF's Board also endorsed Special Recommendation IX of the Financial Action Task Force (FATF) concerning measures to deter cross-border movements of currency and monetary instruments related to the financing of terrorism and money laundering. These decisions were based on a review of the Fund's and the Bank's work programs following a call by their Boards in March 2004 to make AML/CFT a regular part of the work of both institutions.[1]

Although AML/CFT regimes have been strengthened in the member countries of the Fund and the Bank in recent years, the review indicated that the revision of the FATF standard in June 2003 significantly raised the bar for countries' legal, regulatory, and institutional frameworks. Comparing assessments carried out before and after the revision, the review showed that all countries faced difficulties in achieving compliance with the revised standard. Given the complexity of the revised standard, the higher costs of implementation, and the competing demands on national resources, the review advised focusing on practical considerations, vulnerabilities, priorities, and sequencing in putting AML/CFT regimes in place.

The IMF and the World Bank, in collaboration with other donors, have greatly intensified the delivery of technical assistance to respond to countries' needs. Nearly 1,000 officials from 111 countries have been trained in AML/CFT, including legal, financial intelligence unit, and supervisory issues, and 37 countries have adopted or are in the process of enacting AML/CFT legislation, while a number of others are at earlier stages in the process. However, in light of the Fund's and the Bank's limited resources, the review urged the donor community to commit additional resources to helping countries implement the revised standard.

Going forward, the Fund and the Bank will focus on conducting assessments of members' AML/CFT regimes, technical assistance delivery, and broader regulatory and economic policy issues; increasing outreach to raise awareness among parliamentarians and key decision makers on AML/CFT; and working with the donor community to commit additional resources in support of countries' needs for technical assistance.

[1]The review is available at *www.imf.org/external/np/pp/eng/2005/083105.htm.*

and clarity of stress-testing analysis, the reports needed to contain more informative and candid discussions on methodological and data limitations, and the staff should not refrain from carrying out analysis of politically sensitive shocks.

Directors discussed the implications of the publication policy of FSSAs for the effectiveness of FSAPs. While some Directors considered that a move to presumed publication of the FSSA would enhance the impact of FSAPs on country authorities, donors, and market participants, many other Directors argued that such a move would not be consistent with the voluntary nature of the program.

Many Directors welcomed the IEO's recommendation to introduce changes in the organization of IMF mission activities to utilize scarce financial sector expertise more effectively in the surveillance process (Recommendation 5).

While the view was expressed that the Fund should take the lead on all FSAPs, most Directors were in broad agreement with the report's recommendations regarding Bank-Fund collaboration (Recommendation 6).

Directors concurred with the IEO recommendation to strengthen links between FSAPs and surveillance (Recommendation 3). To facilitate this, Financial Sector Stability Assessments (FSSAs) should contain candid summaries of the main findings of FSAPs with relevance for the macroeconomy and potential macroeconomic implications of key financial sector risks. Directors stressed that financial stability issues judged to be of high importance—including those with potential global repercussions—should be a major focus of Article IV consultations and of the Board discussions of them.

Directors encouraged the staff to follow up on IEO recommendations to improve further the quality of FSAPs and strengthen their impact (Recommendation 4). Staff recommendations should be clearly prioritized and the potential consequences of not addressing key weaknesses candidly discussed. Directors emphasized the importance of treating financial sector and cross-border linkages more systematically in FSAP analysis in light of the growing importance of regional and global spillover effects. To improve the quality

They concurred that the current joint approach, including the central role for the Bank-Fund Financial Sector Liaison Committee, should be maintained. At the same time, further efforts should be made to take full advantage of the distinctive contributions that the two institutions can make—with the Fund focusing on stability issues and the Bank on financial sector development and institution building.

Directors concurred that there was room to improve the coordination of FSAP-related technical assistance activities, based on the country's own action plans (Recommendation 7). They noted that steps had been taken in this direction—such as follow-up meetings on technical assistance of the authorities with IMF staff and, sometimes, donors. At the same time, Directors cautioned against overburdening the FSAP with additional expectations regarding the assessment and planning of technical assistance needs and taking excessively formal approaches to follow-up that could overtax already stretched Fund resources and discourage ownership by the authorities.

Fiscal analysis and policy advice

Many countries with IMF-supported programs must undertake fiscal adjustment to stabilize their economies, address their balance of payments problems, and improve their longer-term growth performance.[7] How can countries undertake fiscal adjustment without neglecting their infrastructure needs? The Board first discussed this issue at an informal seminar in April 2004, based on two papers prepared by IMF staff.[8] Following up on that discussion, the IMF staff carried out a study in eight pilot countries in Africa, Asia, Latin America, and the Middle East. Another staff study focused on the contingent liabilities created by government guarantees and reviewed related disclosure and fiscal accounting issues. The findings were summarized in three papers discussed by the Board in May 2005.[9]

Public investment and fiscal policy

At their discussion, Directors generally supported the staff's conclusions. They reiterated the importance of public infrastructure investment for economic growth, while acknowledging the lack of hard evidence in the pilot countries on the precise relationship between the two, and emphasized the relative importance of complementary factors such as macroeconomic stability and the investment climate. Public infrastructure investment and rehabilitation needs remained sizable, especially in low-income countries. Directors noted the possible causes and consequences of the decline in public investment observed in several of the pilot countries. Among the possible causes are fiscal consolidation, including in the context of Fund-supported programs; a fall in public saving; completion of major public infrastructure projects; preference for a smaller public sector; and private sector development. Directors encouraged the staff to investigate further how the quality and composition of public expenditure affect growth and to improve debt sustainability analyses by taking account of robust estimates of the growth implications of public investment. However, they emphasized that the World Bank should take the lead in exploring the growth implications of specific public investment projects.

Directors supported the focus on the overall fiscal balance and on complementary indicators, such as the current fiscal balance, when assessing the scope for increasing public investment and the quality of a country's fiscal policy. The scope for increasing public investment by relaxing overall fiscal targets remained quite limited in most countries, particularly in those that had a high debt burden and were vulnerable to macroeconomic shocks. Directors stressed the overarching importance of ensuring that borrowing to finance public investment was consistent with macroeconomic stability and debt sustainability. Where this outcome was not assured, increases in public investment would need to be matched by increases in public saving through better prioritization of expenditure and, in many countries, sustained efforts to mobilize additional revenue. More policy options were available to countries with relatively low debt burdens and to countries with access to concessional financing on a sustained basis. Directors also emphasized the need to improve the quality of new investment by strengthening the institutional capacity for project appraisal, selection, and implementation, which remain the responsibility of the multilateral development banks; in this regard, they saw an important role for technical assistance from the latter.

A key conclusion that emerged from the studies was that additional room for public infrastructure spending could not be created by changes in fiscal accounting. Countries with different levels of economic and institutional development could well have different "optimal" ratios of public investment to GDP. An assessment of the scope for increasing public investment in any given country would require, in particular, careful analysis of macroeconomic conditions; debt sustainability; the quality of the proposed projects; and the trade-offs among taxes, public infrastructure spending, and other types of expenditure. Directors also emphasized the need to address noninfrastructure bottlenecks to economic development, in particular, the policy and institutional environment for private investment, including especially the tax and regulatory frameworks and governance.

Directors generally saw merit in the staff's call for comprehensive coverage of public enterprises in fiscal statistics, in line with the IMF's *Government Finance Statistics Manual 2001* (GFSM 2001) framework, but recognized that this would be a difficult task achievable only over time because of data problems. Most Directors endorsed the approach proposed by the staff for moving forward in this area by progressively integrating public enterprise operations into

[7] The IMF issued updated guidelines for fiscal adjustment in January 2006, reflecting not only the significant changes that have taken place in the world economy since the previous guidelines were published in 1995 but also changes in the IMF's approach to fiscal adjustment. The new guidelines can be found at *www.imf.org/external/np/pp/eng/2006/012706a.pdf.*

[8] See Public Information Notice No. 04/45, "IMF Executive Board Holds Informal Seminar on Public Investment and Fiscal Policy," *www.imf.org/external/np/sec/pn/2004/pn0445.htm;* "Public Investment and Fiscal Policy," *www.imf.org/external/np/fad/2004/pifp/eng/index.htm;* and "Public-Private Partnerships," *www.imf.org/external/np/fad/2004/pifp/eng/031204.htm.*

[9] See Public Information Notice No. 05/68, "IMF Executive Board Holds Follow Up Meeting on Public Investment and Fiscal Policy," *www.imf.org/external/np/sec/pn/2005/pn0568.htm;* "Public Investment and Fiscal Policy—Lessons from the Pilot Country Studies," *www.imf.org/external/np/pp/eng/2005/040105a.htm;* "Public Investment and Fiscal Policy—Summaries of the Pilot Country Studies," *www.imf.org/external/np/pp/eng/2005/040105b.htm;* and "Government Guarantees and Fiscal Risk," *www.imf.org/external/np/pp/eng/2005/040105c.htm.*

countries' fiscal accounts, thereby ensuring greater uniformity of reporting across the membership over time. With regard to the treatment of public enterprises in fiscal indicators, Directors noted that hardly any public enterprises met the criteria for commercial orientation proposed in the staff paper considered by the Board in April 2004. They broadly endorsed the proposed revised approach, which focused more on the fiscal risks posed by the operations of public enterprises. Most Directors also agreed that testing the revised criteria in a sample of upcoming Article IV consultations could inform the design of a strategy. A few Directors felt that it would not be appropriate to allow for greater case-by-case flexibility in making decisions on integrating public enterprises in fiscal indicators and targets in a Fund-supported program context and noted the difficulties of assessing fiscal risks posed by individual enterprises. These Directors called for the development of a more standardized approach.

Public-private partnerships (PPPs) offer a potential avenue to increase infrastructure investment, provided they are appropriately structured and the institutional framework is well developed. Directors agreed with the view that PPPs should be undertaken with the goal of increasing efficiency by attracting private capital. Directors strongly cautioned against pursuing PPPs because of a desire to move investment spending off budget. Furthermore, the government should ensure that the risk associated with PPPs was appropriately shared with the private sector, with the risk borne by the government reflected in the fiscal accounts. Directors endorsed the view that high priority should be given to strengthening the institutional framework for PPPs—including the establishment of a sound legal framework and the preparation of a public sector comparator—and called on the multilateral development banks to take the lead on these issues.

Directors saw the lack of an internationally accepted accounting and reporting standard for PPPs as a possible obstacle to the development of efficient PPPs and endorsed continued staff work with the relevant accounting bodies to promote the preparation of such a standard. In the meantime, they generally endorsed the proposed disclosure and reporting requirements for PPPs, noting the importance of valuing the contingent liabilities associated with guarantees. They saw merit in the staff's proposed approach to incorporating PPPs in debt sustainability analysis, which involves counting committed payments by the government under PPP contracts and expected payments arising from the calling of guarantees as future primary spending. A few Directors called for caution in factoring implicit contingent liabilities related to PPPs into debt sustainability analyses. Most Directors agreed that the issue of setting caps on expected costs arising from PPPs, including in Fund program design, should be determined on a case-by-case

Ireland

Ireland's economy has performed impressively over the past decade. Real GNP growth averaged about 7 percent a year during 1995–2004, bringing income per capita up to the average of the EU-15; the unemployment rate declined sharply and is now one of the lowest in the industrial countries; and inflation stabilized close to the euro area average. This remarkable performance owed much to sound economic policies, including prudent fiscal policy, low taxes on labor and business income, and social partnership agreements that contributed to wage moderation.

Economic performance continues to be strong. In 2005, real GNP growth reached $5^1/_2$ percent, driven by domestic demand; unemployment was close to the natural rate; and the general government recorded a surplus of 1 percent of GDP. Labor force growth, fueled by increased participation and immigration, has helped dampen wage pressures. House price appreciation, which had eased through mid-2005, has picked up again against the backdrop of rapid credit growth. In response to a reported relaxation of lending standards, the authorities have increased the risk weighting on residential mortgages.

In March 2006, an IMF team visited Dublin to update the 2000 Financial Sector Assessment Program (FSAP). The team found that Ireland's financial system remained robust but recommended some improvements to the supervisory framework, including upgrading stress testing, strengthening on-site supervision of insurers, and enhancing public disclosure requirements for insurers.

Ireland-IMF activities during FY2006

May 2005	Discussions on 2005 Article IV consultation
October 2005	Completion of 2005 Article IV consultation
March 2006	Mission to update the 2000 FSAP

basis, with a focus on cases where these costs contribute to, or limit the capacity to respond to, debt sustainability problems.

Directors noted the staff's assessment that further work along the lines being proposed may require significant additional staff resources, which will be quantifiable only over the longer term, depending on the pace at which national authorities can move to include public enterprises in the fiscal accounts, and on the results of the testing in a sample of Article IV consultations of the revised criteria for assessing the fiscal risks posed by public enterprises. The issue of resource cost, as well as the balance of costs and benefits that emerges moving forward, will therefore need to be kept under close review.

Statistical frameworks for strengthening fiscal analysis in the Fund

As a follow-up to the Executive Board May 20, 2005, meeting on public investment and fiscal policy, Directors held a seminar in November at which they discussed a staff paper on using the *Government Finance Statistics Manual 2001* (GFSM 2001)[10] statistical framework to strengthen fiscal analysis in the Fund. They considered that the GFSM 2001 provided a comprehensive analytical framework that would strengthen fiscal policy analysis and reporting in Fund surveillance and program work through three summary fiscal tables—the operating statement, the balance sheet, and the cash statement—and the core indicators that are derived from these tables.

Use of the GFSM 2001 framework, which enhances the ability to record noncash transactions in a coherent and consistent manner, leads to greater transparency and consistency in the presentation of country fiscal data in staff reports. Directors acknowledged that GFSM 2001 was an appropriate framework for handling new and complex fiscal operations that could pose challenges to fiscal reporting and analysis.

Directors were encouraged that the actions recommended by the staff could be accomplished in three phases: data presentation (short term), country reporting (medium term), and full implementation of accrual reporting and the associated underlying systems (long term). Noting that the GFSM 2001 framework had not been tested across the Fund's membership, most Directors supported the staff's proposal to conduct pilot studies for volunteer countries over two years and within the Fund's existing budgetary envelope to map out more fully the process involved in shifting to the GFSM 2001 framework. The staff will report back to the Board on the pilot studies, together with proposals for full implementation of the GFSM 2001 methodology. Proposals would need to take account of countries' different capacities and legal constraints and of the costs to the Fund and to national authorities.

Directors were supportive of the technical assistance work being done by the Fund staff, including provision of guidance to country compilers in reporting operational data to the Fund using the GFSM 2001 framework. They emphasized the importance of this technical assistance work to strengthen the underlying accounting and classification systems.

Standards and codes, and data provision to the Fund

The Standards and Codes Initiative and Data Standards Initiatives have been important adjuncts to the Fund's surveillance and capacity-building activities. In FY2006, the IMF's Executive Board carried out its third review of the Standards and Codes Initiative and its sixth review of the Data Standards Initiatives, the Special Data Dissemination Standard (SDDS) and the General Data Dissemination System (GDDS). Of the Fund's 184 members, 146 subscribe to the SDDS or participate in the GDDS (Box 4.5).

Standards and Codes Initiative

In July 2005, the IMF's Executive Board considered a joint IMF–World Bank staff paper on the Standards and Codes Initiative, which was launched in 1999 as part of efforts to strengthen the international financial architecture.[11] The initiative was designed to promote greater financial stability at both the domestic and the international levels through the development, dissemination, adoption, and implementation of international standards and codes in 12 areas—data quality, monetary and financial policy transparency, fiscal transparency, banking supervision, securities, insurance, payments systems, anti-money-laundering provisions, corporate governance, accounting, auditing, and insolvency and creditor rights. The IMF and the Bank evaluate member countries' policies against international standards and codes that serve as benchmarks of good practice in these areas and

[10]The staff paper, "Using the GFSM 2001 Statistical Framework to Strengthen Fiscal Analysis in the Fund," can be found at *www.imf.org/external/np/pp/eng/2005/102505.pdf.* The manual is available at *www.imf.org/external/pubs/ft/gfs/manual/index.htm.* For a summary of the Board discussion, see Public Information Notice No. 05/167, *www.imf.org/external/np/sec/pn/2005/pn05167.htm.*

[11]For a summary of the Board discussion, see Public Information Notice No. 05/106, at *www.imf.org/external/np/sec/pn/2005/pn05106.htm.* The paper discussed by the Board, "The Standards and Codes Initiative—Is It Effective? And How Can It Be Improved?" is available at *www.imf.org/external/np/pp/eng/2005/070105a.htm.*

Box 4.5 ROSCs and Data Standards Initiatives

Reports on the Observance of Standards and Codes (ROSCs). A ROSC is an assessment of a country's observance of standards in one of 12 areas useful for the operational work of the Fund and the World Bank. The reports—about 74 percent of which have subsequently been published—examine three broad areas: (1) transparent government operations and policymaking (data dissemination, fiscal transparency, monetary and financial policy transparency); (2) financial sector standards (banking supervision, payments systems, securities regulation, insurance supervision, and efforts to combat money laundering and the financing of terrorism (AML/CFT)); and (3) market integrity standards for the corporate sector (corporate governance, accounting, auditing, insolvency, and creditor rights). Participation in the Standards and Codes Initiative continues to grow. As of end-April 2006, 725 ROSC modules had been completed for 130 countries, or 71 percent of the Fund's membership, and most systemically important countries had volunteered for assessments. More than 340 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, the SDDS is a voluntary standard whose subscribers—countries with access to international financial markets or seeking it—commit to meeting internationally accepted norms of data coverage, frequency, and timeliness. Subscribers also agree to issue calendars on data releases and follow good practice with respect to the integrity and quality of the data and access by the public. SDDS subscribers provide information about their data compilation and dissemination practices (metadata) for posting on the IMF's Dissemination Standards Bulletin Board (DSBB).[1] Subscribers are also required to maintain a Web site electronically linked to the DSBB that contains the actual data. SDDS subscribers began disseminating prescribed data on external debt in September 2003; data for 54 countries are published in the World Bank's *Quarterly External Debt Statistics* (QEDS). Romania and Morocco became subscribers in FY2006, raising the number of SDDS subscribers to 62 as of April 30, 2006.

General Data Dissemination System (GDDS). The GDDS framework was established in 1997 to help Fund member countries improve their statistical systems. Voluntary participation allows countries to set their own pace but provides a detailed framework that promotes the use of internationally accepted methodological principles, the adoption of rigorous compilation practices, and ways in which the professionalism of national statistical agencies can be enhanced.

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

The 83 participants in the GDDS at end-April 2006 provide metadata describing their data compilation and dissemination practices as well as detailed plans for improvement for posting on the IMF's Dissemination Standards Bulletin Board. Between the fifth review of the Data Standards Initiatives in July 2003 and April 30, 2006, 30 countries and territories began participating in the GDDS. Of the 89 countries and territories participating in the GDDS since it was introduced, 6 have graduated to the SDDS, 5 since the fifth review.

In addition, the Fund staff has been developing the **Statistical Data and Metadata Exchange (SDMX)** standard, in collaboration with other international organizations. The SDMX aims to facilitate efficient electronic exchange and management of statistical information among national and international entities by providing standard practices, coherent protocols, and other infrastructural blueprints for reporting, exchanging, and posting data on Web sites.

Data Quality Assessment Framework (DQAF). The DQAF is an assessment methodology that was integrated into the structure of the data module of ROSCs following the fourth review of the Data Standards Initiatives in 2001. The DQAF's broader application in providing guidance for improving data quality has been integrated into the Data Quality Program as well as more prominently into Article IV consultations.

issue Reports on the Observance of Standards and Codes (ROSCs), which are intended to help countries strengthen their economic institutions, to inform the work of the Fund and the Bank, and to inform market participants.[12]

The Fund and the Bank Boards previously reviewed the implementation of the initiative in 2001 and 2003. A key focus of the second review[13] was on how to handle growing demand for assessments. Directors saw greater prioritization as key to focusing scarce resources on areas where reforms were most needed. The 2005 review sought to assess the initiative's effectiveness, including by surveying the views of stakeholders, such as country authorities and market participants.

At their discussion, Directors noted that the number of completed assessments had grown substantially in the past two years, although at a somewhat slower pace than earlier, reflecting a reduction of the number of financial sector standards assessed under the streamlined FSAP and the completion of initial assessments for a substantial portion of the IMF's membership. Most systemically important countries had participated in the initiative. There had been some important exceptions, however, and regional participation had remained uneven.

Directors were broadly satisfied with the initiative's effectiveness to date, although some objectives had been met more successfully than others—for example, the identification of vulnerabilities and establishment of priorities for

[12]The Board has not yet endorsed a standard for insolvency and creditor rights.
[13]See Public Information Notice No. 03/43 at *www.imf.org/external/np/sec/pn/2003/pn0343.htm.*

strengthening domestic institutions. Although the initiative had not yet had a large impact on the implementation of reforms, it was still relatively new, considering the long time frame of institutional reforms, and more of its benefits should materialize as time passes. The initiative had helped the Fund prioritize technical assistance needs and increasingly led to follow-up technical assistance. In part of the membership—including many emerging market economies—the initiative had contributed significantly to surveillance, even though, overall, its contribution to surveillance across the membership had been modest. Directors expressed disappointment that the use of ROSCs by market participants remained low.

The Board saw merit in maintaining the initiative, stressing that it had already delivered substantial results in some dimensions and that it was expected to yield further benefits, particularly in helping members implement institutional reforms. Directors generally concurred with stakeholders that the scope of the initiative and its key governance features should be left unchanged but recommended a number of other changes. Although they continued to support the voluntary nature of the initiative, Directors called for stronger efforts to encourage country participation and, in particular, to ensure that countries that chose to participate in the initiative were those most likely to benefit from it. To encourage further participation, many Directors supported the proposal to include consistently in Article IV consultations staff's views on priority areas for standards assessments.

Directors noted that frequent updating of ROSCs would be too costly. They supported a more flexible approach similar to that agreed for the FSAP, which featured an average update frequency of five years, to allow for country-specific circumstances. Priority would be given to updates for countries in which significant gaps had been identified in previous assessments and that would contribute the most to national or systemic stability.

Directors supported measures to strengthen the integration of the initiative with Fund surveillance and technical assistance through greater coordination between and within departments. In line with the conclusions of the 2004 Biennial Review of Surveillance, Directors stressed the need to reflect ROSCs' macro-relevant findings in Article IV reports, while cautioning against the mechanistic inclusion of detailed ROSC recommendations.

Directors favored steps to enhance the clarity of ROSC findings. Each ROSC should include (1) an executive summary providing a clear assessment, while avoiding a rating or "pass or fail" report; (2) a principle-by-principle summary of the observance of the standard; and (3) a prioritized list of key recommendations. These changes, while falling short of meeting market participants' suggestions, would promote greater use of ROSCs, although the objective of informing market participants would likely remain challenging. Directors agreed that the practice of sharing draft ROSCs with the authorities, the current policy of voluntary publication of ROSCs, and outreach activities should continue.

Directors noted that, after extensive consultations, the Organization for Economic Cooperation and Development (OECD) had revised the *Principles of Corporate Governance*. The main revisions related to governance, shareholder rights, disclosure and transparency, and insolvency and creditor rights. Directors agreed to recognize the revised principles for use in the initiative.

Sixth review of Data Standards Initiatives

The Fund's Data Standards Initiatives, the SDDS and GDDS, aim to increase the comprehensiveness and timeliness of statistical information available to markets and the public, thus contributing to member countries' pursuit of sound macroeconomic policies and the improved functioning of financial markets.

In November 2005, Executive Directors concluded discussions on the sixth review of the Data Standards Initiatives.[14] They commended the member country authorities for their efforts to promote adherence to the initiatives. Since the last review, which was concluded in July 2003, the number of SDDS subscribers and GDDS participants had increased. Further progress in these initiatives continued to be important for the efficient operation of markets, and for effective surveillance and crisis prevention. Directors broadly agreed that adherence to international transparency standards—and to the SDDS in particular—could be an important factor in improving a country's access to international capital markets. In this vein, Directors recommended moving forward with the Fund's voluntary and cooperative strategy for assisting members to participate in the initiatives.

Directors welcomed the graduation of a number of countries from the GDDS to the SDDS since the last review and supported continuing the Fund staff's integrated outreach and technical assistance efforts in building countries' statistical capacities to levels that meet SDDS requirements.

Directors also supported continued efforts to promote the dissemination and exchange of statistical information on the Internet among international organizations and their member countries using a common data transmission and dissemination standard. Among these efforts was the

[14]For a summary of the Board discussion, see Public Information Notice No. 05/155, *www.imf.org/external/np/sec/pn/2005/pn05155.htm*. The review can be found at *www.imf.org/external/np/pp/eng/2005/070105s.pdf*.

Box 4.6 External debt Web site

In March 2006, the IMF, the Bank for International Settlements (BIS), the Organization for Economic Cooperation and Development (OECD), and the World Bank launched a new Web site—the Joint External Debt Hub (JEDH)—to provide a one-stop source of comprehensive external debt statistics compiled from national and creditor/market sources.[1]

The JEDH brings together national external debt data provided by 54 subscribers to the IMF's Special Data Dissemination Standard (SDDS), creditor/market–sourced data on external debt and data on selected foreign assets for 175 countries, and associated metadata for the two sets of statistics. The national external debt data are sourced from the World Bank's *Quarterly External Debt Statistics* (QEDS) database, and the creditor/market data are sourced from the four agencies. The JEDH replaces the tables currently at *www.oecd.org/statistics/jointdebt* and expands the available range of information.

The new Web site provides timely access to quarterly external debt statistics, thereby greatly facilitating macroeconomic analysis and cross-country and data source comparisons. For each of the 54 SDDS subscribers, data are provided on loans and deposits, debt securities, and trade credits, and the national and the creditor/market viewpoints, when available, are compared.

The Web site builds on initiatives started in the late 1990s by the Inter-Agency Task Force on Finance Statistics[2] to improve the availability of comprehensive and consistent external debt statistics. Major milestones include the quarterly publication of market/creditor data from 1999; the publication of the *External Debt Statistics: Guide for Compilers and Users*[3] in 2003; the dissemination since September 2003 of national data on the quarterly external debt position with a one-quarter lag by SDDS subscribers, with redissemination of these data for most subscribers on the World Bank's QEDS Web site[4] from 2004; and the recent development by the IMF of the data quality assessment framework for external debt statistics.

The JEDH uses Statistical Data and Metadata Exchange (SDMX) standards established by the BIS, the European Central Bank, Eurostat, the IMF, the OECD, the United Nations, and the World Bank.

[1]The new Web site is located at *www.jedh.org*.

[2]The agency's members are the IMF, the Commonwealth Secretariat, the European Central Bank, Eurostat, the Paris Club Secretariat, and the United Nations Conference on Trade and Development.

[3]The Guide is available at *www.imf.org/external/pubs/ft/eds/Eng/Guide/index.htm.*

[4]At *www.worldbank.org/data/working/QEDS/sdds_main.html.*

development of data and metadata transmission standards under the Statistical Data and Metadata Exchange Initiative (SDMX) of seven international organizations, including the IMF.[15]

Directors welcomed the generally positive experience with implementing new data categories. In particular, nearly all SDDS subscribers now met the data dissemination requirements for external debt data, and a majority of GDDS participants disseminated metadata on their external debt (Box 4.6). No member had availed itself of the opportunity to report inflation-targeting indicators, however, and incorporation of Millennium Development Goals indicators into the metadata of the GDDS had also been slow. Looking ahead, Directors agreed to consider at the next review of the Fund's Data Standards Initiatives whether a core set of Financial Soundness Indicators (FSIs) should be incorporated into the SDDS.

Directors broadly supported requiring subscribers to use standardized electronic reporting procedures to allow more effective monitoring of their observance of the SDDS. They encouraged the staff to work with subscribing countries in designing the system so as to minimize the reporting burden and cost of observance while maximizing the efficiency of monitoring.

Directors noted the staff's intention of posting annual assessments of subscribing countries' observance of their SDDS undertakings on the Dissemination Standards Bulletin Board (DSBB), beginning in early 2007, stressing that these reports should distinguish between major and minor deviations from SDDS requirements. They encouraged the staff to continue to raise SDDS observance issues with country authorities.

Many Directors considered that countries' commitment to improving data transparency and their statistical systems should be a factor in allocating technical assistance. However, they observed that a country's decision not to participate could be a function of limited resources and capacity constraints and thus felt that the criteria for access to Fund technical assistance should remain flexible. Directors recognized the central role played by Fund area departments in developing a technical assistance strategic framework and supported further collaboration with the World Bank and other institutions and donors in helping GDDS participants become SDDS subscribers. In addition, they supported the integration of the GDDS in Poverty Reduction Strategy Papers (PRSPs).

Most Directors endorsed the suggestion that SDDS subscribers and GDDS participants be encouraged to provide

[15]The SDMX consortium comprises, in addition to the IMF, the Bank for International Settlements, the European Central Bank, Eurostat, the Organization for Economic Cooperation and Development, the United Nations, and the World Bank.

Uruguay

In June 2005, the IMF's Executive Board approved a three-year Stand-By Arrangement for Uruguay. Since then, the economy has continued to perform strongly, with sound macroeconomic policies and a supportive external environment contributing to strong growth and low inflation, enabling the government to make progress on its social agenda.

Real GDP growth in 2005 reached 6.6 percent, driven by strong exports and private consumption. The public sector primary surplus moved close to the government's medium-term target of 4 percent of GDP, and in December 2005 the government adopted a five-year budget consistent with its key objective of ensuring debt sustainability. This was accompanied by prudent monetary policy, and annual inflation was 6.5 percent in March 2006, well within the central bank's target range.

The government has made significant progress on an ambitious structural agenda and expects to complete important reforms in 2006, including tax reform, financial sector restructuring, central bank independence, and improvement of debt management and the investment climate. The implementation of these reforms should further reduce vulnerabilities and help sustain high growth over the medium term.

Market confidence in Uruguay's policies and favorable external conditions have also contributed to a significant reduction in the country's sovereign spreads and improved market access. Moreover, strong exports and private capital inflows have allowed Uruguay to strengthen its reserve position significantly. In March 2006, Uruguay advanced its planned issuance of global bonds, enabling it to repay, ahead of schedule, $625 million in obligations coming due to the IMF in 2006.

Uruguay-IMF activities in FY2006

June 2005	IMF Executive Board approves a new three-year Stand-By Arrangement for Uruguay
September 2005	Completion of first review of Uruguay's performance under Stand-By Arrangement
January 2006	Completion of second review of performance under Stand-By Arrangement
March 2006	Completion of third review of performance under Stand-By Arrangement
March 2006	Visit of Deputy Managing Director Agustín Carstens

additional metadata on oil and gas activities and products. They noted that this would promote public knowledge and understanding of how countries incorporate oil market information when compiling macroeconomic indicators.

Directors generally endorsed the further integration of the SDDS and the GDDS into the Fund's Data Quality Program by reformatting countries' SDDS/GDDS metadata according to the Data Quality Assessment Framework (DQAF). Using a common metadata structure would increase both the effectiveness and the efficiency of the staff's work on the SDDS, the GDDS, the data ROSC, and statistical technical assistance, without imposing an additional burden on participating countries.

Guide on Resource Revenue Transparency

In December 2004, the IMF disseminated for public comment a draft *Guide on Resource Revenue Transparency.* The Guide[16] was finalized in June 2005, following a period of comment by the Executive Board and the general public. Given the potentially substantial costs of nontransparent practices in the management of natural resource revenues, institutional strengthening to improve transparency in resource-rich countries can provide ample payoff for a relatively modest investment.

The Guide applies the principles of the *Code of Good Practices on Fiscal Transparency*[17] to the unique set of problems faced by countries that derive a significant share of revenues from natural resources (the focus of the Guide is on hydrocarbon and mineral resources). It complements the *Manual on Fiscal Transparency*[18] by providing a framework that covers the resource-specific issues to be considered in assessing fiscal transparency—for example, as part of a fiscal ROSC. It also includes a summary overview of generally recognized good or best practices for transparency of resource-revenue management that can be used by member countries, the IMF, the World Bank, and others providing technical support.

Crisis prevention

Surveillance is one of the IMF's main tools in the prevention of financial crises. Although the crises of the 1990s have been followed by several years of relative calm, the IMF continues to refine its tools for identifying vulnerabilities and weaknesses in its member countries and in the international financial system so that they can be addressed before a crisis erupts.

---

[16]Available at *www.imf.org/external/pubs/ft/grrt/eng/060705.pdf.*
[17]The Code can be found at *www.imf.org/external/np/fad/trans/code.htm.*
[18]Available at *www.imf.org/external/np/fad/trans/manual/index.htm.*

In September 2005, the IMF sponsored a high-level conference at its Washington, D.C., headquarters that addressed key financial stability issues. Participants in the conference—central bank and supervisory officials from 40 of the IMF's member countries—examined the risks stemming from rapid credit growth and asset price bubbles in financial and housing markets, possible monetary and prudential policy responses for addressing these risks, the institutional aspects of implementing the financial stability mandate, and issues related to supervisory gaps and preconditions.

Another key issue for financial stability is the dramatic increase in capital mobility. Despite its considerable potential benefits, capital mobility can put countries at risk of a crisis if investors suddenly lose confidence and withdraw their capital. The Fund has therefore sought to build up its expertise on the issues surrounding capital account liberalization and to strengthen its policy advice in this area. The importance of this issue was highlighted in both the Medium-Term Strategy and the IEO's "Report on the IMF's Approach to Capital Account Liberalization."[19]

IEO report on IMF's approach to capital account liberalization

At their May 2005 discussion of the IEO's report on the IMF's approach to capital account liberalization, Executive Directors noted that financial integration can confer benefits to the global economy by promoting an efficient allocation of savings and a diversification of risks. Stressing the increasing significance of capital account issues in IMF surveillance and of fully addressing the difficulties and complexities the Fund faces in providing advice in this area, they welcomed the opportunity to explore how the Fund's effectiveness could be further advanced.

Directors appreciated the IEO's efforts in evaluating the IMF's experience since the early 1990s with a large sample of representative countries. They noted that the report offered a broadly accurate account of the evolution of Fund thinking and practice on the issues surrounding capital account liberalization and capital flow management. Directors welcomed the IEO's confirmation that the Fund did not apply an inappropriate "one-size-fits-all" approach to capital account liberalization in individual countries and concurred with the report's finding that the IMF did not pressure members to liberalize their capital accounts sooner than desired by the authorities and generally did not challenge the use of temporary capital controls. The Fund's approach to capital account liberalization should continue to be flexible and take account of countries' specific circumstances and preferences. At the same time, Directors recognized that the risks of an open capital account had not always been sufficiently highlighted in the Fund's past operational policy advice and that little policy advice had been offered in the context of multilateral surveillance. Substantial strides have been made in recent years, however, based on experience and supported by the Fund staff's extensive analytical work on capital account issues and financial system stability.

Directors expressed a variety of views on the importance of factors motivating capital account liberalization, such as free trade agreements and bilateral investment treaties. It was acknowledged that such agreements are negotiated voluntarily by country authorities when considered to be in the national interest. At the same time, many Directors saw a key role for Fund involvement in policy advice on capital account issues as a means of promoting orderly and nondiscriminatory capital account liberalization.

Directors also commented on the two main recommendations of the IEO report. With respect to the first recommendation—the need for more clarity on the IMF's approach to capital account issues—Directors stressed that the Fund had long attached importance to capital account issues and vulnerabilities. The Fund had provided country-specific guidance to member countries on strengthening domestic policies and practices to manage risks related to capital account liberalization. Furthermore, regional and global surveillance had increasingly focused on global financial market linkages, demand and supply factors, and the implied costs and benefits of capital account liberalization. Directors agreed that the IMF had a responsibility to its members to analyze the benefits and risks in a world of open capital markets and to provide them with practical, sound, and appropriate policy advice on those issues. On the broader aspects of the Fund's role in capital account liberalization, most Directors did not wish to explore further at that time the possibility of giving the Fund jurisdiction over capital movements. However, a number of Directors felt that the Fund should be prepared to return to this issue at an appropriate time. Directors also noted that additional work on capital account issues was contemplated in the context of the Fund's Medium-Term Strategy.

Directors saw scope for sharpening the IMF's advice on capital account issues. They emphasized that Fund staff should continue to draw upon all available research in its policy advice to members, and that further research and study were needed to fully understand how best to obtain the benefits and manage the risks of capital account liberalization, including sequencing issues. Directors urged the staff to base policy advice on solid analysis of individual country situations. Directors also encouraged the staff to

[19]The report and the summary of the Board's discussion are available at *www.imf.org/external/np/ieo/2005/cal/eng/index.htm.*

further strengthen its technical expertise on capital account issues.

With respect to the second recommendation—that the IMF's analysis and surveillance should give greater attention to the supply-side factors of international capital flows and to what can be done to minimize the volatility of capital movements—Directors welcomed the various initiatives under way in the Fund to strengthen research, analysis, and surveillance of the supply of capital flows. They agreed with the IEO's view that considerable progress had already been made in this area. A number of recent staff studies had examined the supply-side features of capital flows, and Directors noted that recent issues of the *Global Financial Stability Report* had examined the determinants and volatility of capital flows to emerging market countries. Directors further pointed to the Capital Markets Consultative Group, which served as an informal forum for dialogue between participants in international capital markets and Fund management,[20] as well as to the visibility given to supply-side issues by staff at the Financial Stability Forum (FSF) and the Basel Committee on Banking Supervision.

Directors encouraged the staff to continue to deepen its understanding of supply-side factors and their operational and policy implications. In particular, they suggested that more attention be devoted to the spillover effects from regional developments and from policies in systemically important advanced and developing countries. Directors cautioned that any expanded work on supply-side issues should not entail Fund involvement in the regulation of the sources of capital, noting that the Fund should instead coordinate with the FSF and other forums that have the necessary expertise and mandate in the setting of standards.

Directors agreed that the IMF's future work on capital account issues should seek to buttress efforts to promote financial stability, while helping to ensure that controls are not used as a substitute for adjustment. The aim would be to build on existing Fund expertise in this area and to ensure that policy advice on capital account issues was fully incorporated in bilateral and multilateral surveillance. As a follow-up to the findings of the IEO report, Directors looked forward to capital account issues being addressed in the context of the Fund's Medium-Term Strategy.

[20]The Capital Markets Consultative Group (CMCG) was established in July 2000 by Horst Köhler, the IMF's Managing Director at that time, to provide a forum for informal dialogue between participants in international capital markets and the IMF. The CMCG is chaired by the IMF's Managing Director. In March 2006, Rodrigo de Rato, the IMF's current Managing Director, participated in a meeting of the Capital Markets Consultative Group in Mexico City.

Balance sheet analysis

In line with the increased emphasis on key balance sheet risks and financial vulnerabilities, the *World Economic Outlook* reports and two issues of the *Global Financial Stability Report* published in FY2006 applied balance sheet analysis to their coverage of mortgage markets and the U.S. household sector, respectively, as did Germany's Article IV consultation with respect to long-term public sector issues (see Chapter 3). A staff paper on debt-related vulnerabilities and financial crises examined developments in Argentina, Brazil, Lebanon, Peru, Turkey, and Uruguay.[21] The IMF staff refined its modeling tools and developed its databases to support the analysis of global imbalances and other multilateral policy issues. In addition, the analytical framework for the balance sheet approach was extended by use of a contingent claims approach.

Global economic and financial impact of an avian flu pandemic

In its present form, the virus that causes avian flu cannot transmit efficiently from human to human, but a mutation allowing such transmission could cause a pandemic. To help raise awareness about the potential economic and financial risks of an avian flu pandemic, the Fund has published a paper, "The Global Economic and Financial Impact of an Avian Flu Pandemic and the Role of the IMF," with an attachment outlining the elements emerging as good practices in business continuity planning in the financial sector in the event of a pandemic.[22]

Although predictions are subject to a high degree of uncertainty, a severe pandemic would likely have a significant economic impact. A high level of illness and absenteeism could lead to a sharp, albeit temporary, decline in global economic activity because it would pose a negative shock to both supply and demand. Demand could contract sharply, with consumer spending falling and investment being put on hold, while trade and tourism flows could be interrupted in some countries. The fiscal challenges associated with an avian flu pandemic, as fiscal deficits widen, could be significant, especially for low-income countries, and some countries could face overall balance of payments pressures.[23]

[21]Published as Christoph B. Rosenberg and others, 2005, *Debt-Related Vulnerabilities and Financial Crises*, IMF Occasional Paper No. 240; see *www.imf.org/external/Pubs/NFT/Op/240/op240.pdf.*

[22]Available at *www.imf.org/external/pubs/ft/afp/2006/eng/022806.htm;* see also "Progress Report to the International Monetary and Financial Committee on Fund Initiatives to Promote Avian Flu Preparedness," *www.imf.org/external/np/pp/eng/2006/041806.pdf.*

[23]The economic and financial impact of a pandemic are discussed in the *World Economic Outlook, April 2006,* and the *Global Financial Stability Report, April 2006.*

High absenteeism could also disrupt critical functions and services of the financial system, including payments, clearing and settlement, and trading. Such disruptions could spill over into other jurisdictions. As regards financial markets, some increase in risk aversion is highly likely, leading to a greater demand for liquidity and for low-risk assets. While the "flight to quality" should be temporary, asset price declines could put the balance sheets of some financial institutions under stress. There could be a period in which net capital flows to some emerging markets decline or are even reversed.

Preparations to limit the impact of the avian flu outbreak are rapidly moving to the forefront of policy priorities in many countries and international organizations. At the International Pledging Conference on Avian and Human Influenza, held in Beijing in January 2006, $1.9 billion was pledged to support efforts at all levels to help fight avian flu and prepare for a possible pandemic. The World Bank, the World Health Organization (WHO), the Food and Agriculture Organization (FAO), and the Organization for Animal Health (OIE) are taking the lead in preparing a global coordinated response strategy to the possibility of an avian flu crisis and helping members improve surveillance and control capacity and develop national action plans.

The Fund is encouraging countries to prepare for a possible pandemic and facilitating cooperation across countries in preparing contingency plans, particularly in the financial sector. It would be willing to help organize technical assistance for members preparing to deal with a pandemic, if requested to do so.

The level of preparedness in the financial sector for a pandemic varies significantly across the Fund's membership. Some countries, particularly those affected by the 2003 SARS (Severe Acute Respiratory Syndrome) outbreak, are well advanced, while others appear to be only starting to develop a comprehensive approach. Cross-country coordination is being supported by efforts of the Financial Stability Forum, the Fund, and the Joint Forum.[24]

To facilitate sharing of knowledge and experience in business continuity planning in the financial sector, the Fund is organizing regional seminars bringing central banks and supervisory authorities together with health experts and business continuity planners from private financial institutions to share their knowledge on key issues related to avian flu pandemic preparedness. Five such seminars were conducted by early May 2006, including four hosted at the Fund's facilities in Singapore, Tunis, Vienna, and Washington, D.C., and one hosted by the Reserve Bank of South Africa in Pretoria. Additional seminars will be offered in 2006 to ensure that all members have an opportunity to participate.

Should a pandemic occur, the Fund will advise members on appropriate macroeconomic policies and help support them with balance of payments financing if needed.

[24] The Joint Forum consists of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors. The Joint Forum organized a meeting in Hong Kong SAR on February 22, 2006, to discuss business continuity planning. The Financial Stability Forum met on March 16–17, 2006, in Australia and discussed, among other things, pandemic avian flu preparedness.