CHAPTER 1

# The Setting: World Economic Developments in FY2001

The global economy in 2000 grew at its fastest pace in over a decade and a half, bolstered by the continuing strong performance of most advanced countries and a substantial pickup in growth in other regions of the world, particularly in the Western Hemisphere, Middle East, and countries in transition (Table 1.1 and Figure 1.1).[1] The pace of global economic growth moderated in late 2000 and early 2001, however, led by a slowdown in the advanced economies—especially the United States—and moderating growth in a number of emerging market countries.

"Headline" inflation (including energy and food) edged up in the advanced economies, reflecting higher energy prices and strong economic activity, but fell in the developing countries and countries in transition. Fiscal imbalances were reduced in the major regions of the world but external imbalances remained a source of concern in some countries. Financial flows to emerging market economies continued to recover in 2000, although the cost of financing increased in the final quarter of the year as international market conditions tightened. Buoyant world demand supported strong growth in the volume of trade, both in advanced economies and, especially, in developing and transition economies.

Other key developments during 2000 and early 2001 included the sharp fall in the major equity markets, particularly in the United States; problems with two important emerging market borrowers, Argentina and Turkey; and a retreat of oil prices from their late-2000 high. U.S. equity markets fell during most of 2000 and early 2001, reflecting weak corporate earnings reports, a downward revision of technology valuations, tightening credit conditions, and increased expectations of a U.S. slowdown. This fall was mirrored in other mature equity markets and spilled into emerging markets. Spreads on emerging market bonds widened in the last quarter of 2000, driven by tighter external liquidity conditions worsened by concerns about the economic and financial situation in Argentina and Turkey. Global liquidity conditions improved in early 2001, partly as a response to cuts in U.S. interest rates that began in January. Conditions tightened once again in March, however, largely reflecting the growing financing problems in Argentina. Oil prices increased from the second quarter of 2000 through to November but then eased, partly because of the global slowdown. The outlook for oil prices and production, however, remained highly uncertain.

Output growth strengthened in the developing countries as a group in 2000, fueled by buoyant exports as well as recoveries in domestic demand. Economic growth picked up strongly in Latin America, the Middle East, and, to a lesser extent, in Africa and in developing Asia. The buoyancy of the Latin American economies was aided by strong U.S. demand and recoveries in domestic demand from the depressed levels of 1999. In 2000, sharp terms-of-trade improvements and increases in oil production quotas of the Organization of Petroleum Exporting Countries (OPEC) boosted output growth in the Middle East to rates not seen since the early 1990s. Continued strong growth in China and India supported the economic improvement in Asia as a whole.

Following a period of economic growth at or above potential, activity in the advanced economies weakened late in 2000, led by a sharp slowdown in the United States, stalling recovery in Japan, and moderating growth in Europe. After annualized growth of 5½ percent in the second quarter of 2000, economic expansion in the United States slowed sharply during the rest of the year—with GDP growing by only 1 percent (annualized) in the fourth quarter. This slowdown was a result, in part, of the tightening of monetary policy during the year, and also of higher oil prices and the decline in equity markets, including a sharp fall in the NASDAQ. Weighed down by low consumer confidence, slowing business investment, and weakening external demand, economic growth in Japan failed to sustain the strong performance of the first quarter of

[1]This chapter generally covers developments in the IMF's financial year 2001 (May 2000 through April 2001), although references to calendar years are necessary in many instances, including in Table 1.1.

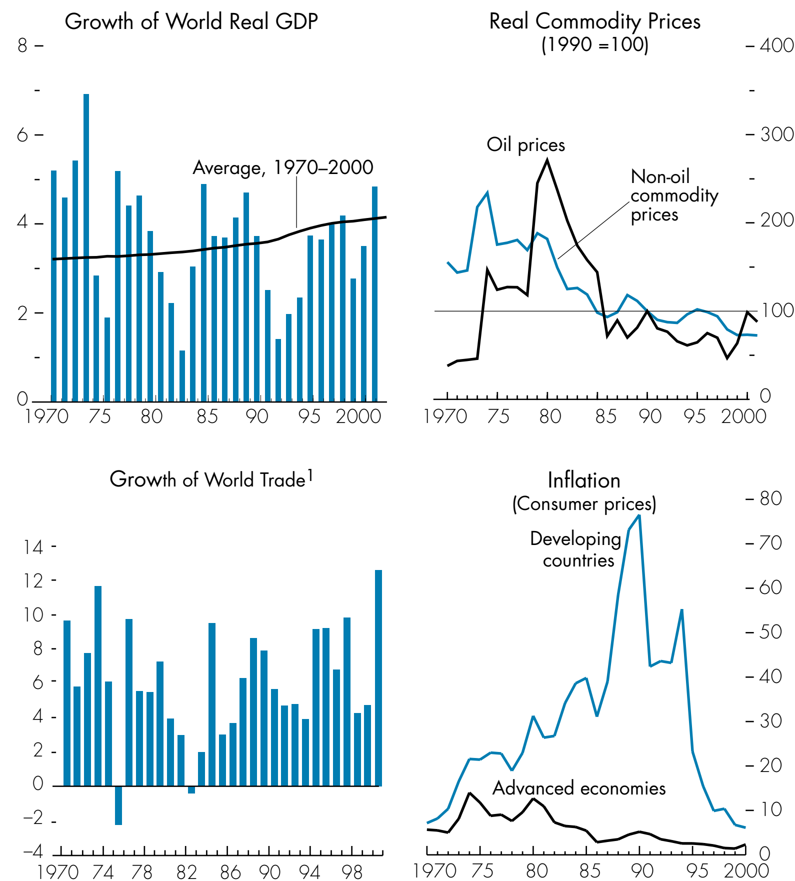
Table 1.1
## Overview of the World Economy
*(Annual percent change unless otherwise noted)*

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|
| **World Output** | **2.3** | **3.7** | **3.6** | **4.0** | **4.2** | **2.8** | **3.5** | **4.8** |
| Advanced economies | 1.4 | 3.4 | 2.7 | 2.9 | 3.5 | 2.7 | 3.4 | 4.1 |
| Major advanced economies | 1.3 | 3.1 | 2.3 | 2.7 | 3.3 | 2.8 | 3.0 | 3.8 |
| United States | 2.7 | 4.0 | 2.7 | 3.6 | 4.4 | 4.4 | 4.2 | 5.0 |
| Japan | 0.5 | 1.0 | 1.6 | 3.3 | 1.9 | –1.1 | 0.8 | 1.7 |
| Germany | –1.1 | 2.3 | 1.7 | 0.8 | 1.4 | 2.1 | 1.6 | 3.0 |
| France | –0.9 | 1.8 | 1.9 | 1.0 | 1.9 | 3.3 | 3.2 | 3.2 |
| Italy | –0.9 | 2.2 | 2.9 | 1.1 | 2.0 | 1.8 | 1.6 | 2.9 |
| United Kingdom | 2.3 | 4.4 | 2.8 | 2.6 | 3.5 | 2.6 | 2.3 | 3.0 |
| Canada | 2.3 | 4.7 | 2.8 | 1.5 | 4.4 | 3.3 | 4.5 | 4.7 |
| Other advanced economies | 1.9 | 4.6 | 4.3 | 3.8 | 4.2 | 2.2 | 4.8 | 5.2 |
| *Memorandum* | | | | | | | | |
| European Union | –0.4 | 2.8 | 2.4 | 1.6 | 2.6 | 2.9 | 2.6 | 3.4 |
| Euro area | –0.8 | 2.3 | 2.3 | 1.5 | 2.4 | 2.9 | 2.6 | 3.4 |
| Newly industrialized Asian economies | 6.4 | 7.9 | 7.5 | 6.3 | 5.7 | –2.4 | 7.9 | 8.2 |
| Developing countries | 6.3 | 6.7 | 6.1 | 6.5 | 5.8 | 3.5 | 3.8 | 5.8 |
| Africa | 0.2 | 2.4 | 2.9 | 5.7 | 2.9 | 3.3 | 2.3 | 3.0 |
| Developing Asia | 9.4 | 9.6 | 9.0 | 8.2 | 6.6 | 4.0 | 6.1 | 6.9 |
| China | 13.5 | 12.6 | 10.5 | 9.6 | 8.8 | 7.8 | 7.1 | 8.0 |
| India | 5.0 | 6.7 | 7.6 | 7.1 | 4.9 | 6.0 | 6.6 | 6.4 |
| ASEAN-4[1] | 6.9 | 7.6 | 8.1 | 7.3 | 3.4 | –9.5 | 2.8 | 5.0 |
| Middle East, Malta, and Turkey | 3.3 | 0.3 | 4.3 | 4.8 | 5.4 | 3.6 | 0.8 | 5.4 |
| Western Hemisphere | 4.1 | 5.0 | 1.7 | 3.6 | 5.3 | 2.3 | 0.2 | 4.1 |
| Brazil | 4.9 | 5.9 | 4.2 | 2.7 | 3.3 | 0.2 | 0.8 | 4.2 |
| Countries in transition | –7.5 | –7.6 | –1.5 | –0.5 | 1.6 | –0.9 | 2.6 | 5.8 |
| Central and eastern Europe | 0.3 | 3.5 | 5.5 | 4.0 | 2.5 | 2.1 | 1.8 | 3.8 |
| Commonwealth of Independent States and Mongolia | –10.9 | –13.3 | –5.5 | –3.3 | 1.0 | –2.8 | 3.1 | 7.1 |
| Russia | –10.4 | –11.6 | –4.2 | –3.4 | 0.9 | –4.9 | 3.2 | 7.5 |
| Excluding Russia | –11.8 | –17.0 | –8.6 | –3.1 | 1.4 | 1.6 | 2.7 | 6.3 |
| **World trade volume (goods and services)** | **3.7** | **9.0** | **9.1** | **6.5** | **10.1** | **4.2** | **5.3** | **12.4** |
| Imports | | | | | | | | |
| Advanced economies | 1.4 | 9.6 | 9.2 | 6.2 | 9.3 | 5.7 | 7.9 | 11.4 |
| Developing countries | 11.2 | 7.4 | 10.2 | 8.1 | 10.6 | –0.6 | 1.6 | 16.9 |
| Countries in transition | 7.6 | 4.2 | 11.6 | 7.6 | 11.5 | 0.8 | –7.3 | 13.3 |
| Exports | | | | | | | | |
| Advanced economies | 3.1 | 8.8 | 8.9 | 6.0 | 10.6 | 3.8 | 5.0 | 11.4 |
| Developing countries | 9.4 | 11.8 | 7.4 | 9.2 | 12.0 | 5.3 | 4.1 | 15.7 |
| Countries in transition | 4.5 | 1.0 | 9.7 | 4.8 | 5.8 | 4.7 | 0.6 | 14.9 |
| **Commodity prices** | | | | | | | | |
| Oil[2] | | | | | | | | |
| In SDRs | –11.1 | –7.3 | 1.8 | 23.7 | –0.2 | –31.2 | 36.5 | 62.6 |
| In U.S. dollars | –11.8 | –5.0 | 7.9 | 18.4 | –5.4 | –32.1 | 37.5 | 56.9 |
| Nonfuel (average based on world commodity export weights) | | | | | | | | |
| In SDRs | 2.7 | 10.6 | 2.3 | 3.3 | 2.2 | –13.5 | –7.8 | 5.5 |
| In U.S. dollars | 1.8 | 13.4 | 8.4 | –1.2 | –3.2 | –14.7 | –7.1 | 1.8 |
| **Consumer prices** | | | | | | | | |
| Advanced economies | 3.1 | 2.6 | 2.6 | 2.4 | 2.1 | 1.5 | 1.4 | 2.3 |
| Developing countries | 43.2 | 55.3 | 23.2 | 15.4 | 9.9 | 10.4 | 6.7 | 6.1 |
| Countries in transition | 634.3 | 274.2 | 133.5 | 42.4 | 27.4 | 21.8 | 43.9 | 20.1 |
| **Six-month London interbank offered rate (LIBOR, percent)** | | | | | | | | |
| On U.S. dollar deposits | 3.4 | 5.1 | 6.1 | 5.6 | 5.9 | 5.6 | 5.5 | 6.7 |
| On Japanese yen deposits | 3.0 | 2.4 | 1.3 | 0.7 | 0.7 | 0.7 | 0.2 | 0.3 |
| On euro deposits | 7.4 | 5.7 | 5.7 | 3.7 | 3.5 | 3.7 | 3.0 | 4.6 |

Source: IMF, *World Economic Outlook* (May 2001).
[1]Indonesia, Malaysia, the Philippines, and Thailand.
[2]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil.

2000. Output growth in Europe increased further relative to the previous year, registering its strongest expansion since the late 1980s. Growth eased during the latter part of 2000 and in early 2001, however, apparently in response to the impact of higher oil prices on purchasing power, weaker business confidence, and spillover effects of the U.S. slowdown.

Figure 1.1
**World Indicators**
(Annual percent change unless otherwise noted)




Source: IMF, *World Economic Outlook* (May 2001). Weighted average. See Statistical Appendix to the *World Economic Outlook* for details.
[1]Goods and services, volume.

## Global Environment

In *commodity markets*, oil prices continued to increase during most of 2000, paced by strong energy demand and supply constraints, before easing in December and in early 2001. To contain oil prices within its $22–$28 reference range, OPEC announced plans to cut oil production. Spot prices stayed volatile, reflecting uncertainties about the extent and duration of the global economic slowdown, and also about oil production prospects and the political situation in some parts of the Middle East. Nonfuel commodity prices remained in a slump, rising little from their depressed level of 1999—especially when measured in U.S. dollar terms. The largest changes were in prices of metals and timber. Metals prices, after firming slightly in the third quarter of 2000, fell back. Food prices increased late in 2000 but also declined subsequently. In addition to a fall in coffee prices, the beef market was hurt by health concerns, particularly in Europe, and cereals stocks remained high relative to consumption. During early 2001, weakening global demand put further downward pressure on commodity prices.

*World trade* volumes rose sharply in 2000, particularly early in the year. Imports to the advanced economies grew at double-digit annual rates as demand growth picked up in North America and Europe. Imports to developing countries also grew strongly, especially in developing Asia, the Middle East, and the Western Hemisphere. Rapid consumption and investment growth in the largest countries of these regions fueled the increase in demand for imports.

*Capital flows* to emerging market economies surged in 2000, although remaining below the peak levels of 1997. The flows were mostly in the form of syndicated lending and equity investment. Syndicated lending in 2000 rose well above the volumes of the previous two years, buoyed by lending to sovereign or quasi-sovereign entities. Asian and Western Hemisphere countries received more than half of these loans, with Hong Kong SAR, Taiwan Province of China, Korea, Malaysia, Mexico, Chile, and Brazil receiving the largest shares. Although it faced financial crisis, Turkey also obtained much-needed private external financing. Sizable volumes of lending were channeled to the telecommunication and energy sectors, the latter reflecting continued high prices of oil and natural gas. Despite sharp drops in emerging equity markets, particularly in technology sectors, equity issuance placements set a new record in 2000. Asia was the dominant issuer—particularly China, which accounted for about half of total international equity issuance by emerging

markets and for 85 percent of all issues in the last quarter. China listed three large companies in the energy and telecommunications sectors in 2000, with the equity issue of China's mobile telecom being the largest-ever equity placement in Asia, excepting Japan.

In the last quarter of 2000, *financing conditions* for emerging market borrowers deteriorated, with spreads widening across the board, in tandem with developments in U.S. high-yield paper. Concerns over external financing problems in Argentina widened its spread to more than 1,000 basis points in the latter part of March 2001, and Turkey's spread also remained large.

While dollar- and euro-denominated *interest rates* rose for short-term maturities in 2000, partly because of a tightening of monetary policy in North America and Europe, long-term rates fell or remained constant. As long-term U.S. government bond yields fell, corporate credit spreads widened from mid-2000 and spreads between risk classes showed greater differentiation, notably the high-yield market. With mounting evidence that private investment and consumption were slowing, the Federal Reserve began to cut interest rates in early 2001 for the first time since late 1998. With headline inflation in Europe remaining above the target ceiling, the European Central Bank kept interest rates at their late 2000 levels through the first quarter of 2001. In an attempt to boost financial sector liquidity, in March 2001 the Bank of Japan in effect returned to a zero-interest-rate policy and adopted a framework for further monetary stimulus; as a result, both overnight interbank interest rates and longer-term bond yields edged down.

In *currency markets*, an apparent misalignment persisted among major currencies, particularly the euro and the U.S. dollar, associated with ongoing large external imbalances among the largest economies. The U.S. dollar strengthened against the euro in early 2001 and both the U.S. dollar and the euro firmed against the yen. While the dollar's strength may have reflected investors' perceptions of a relatively strong growth outlook for the United States over the longer term, the appreciation of the dollar appeared at odds with the need to reduce external imbalances to more sustainable levels. The strength of the U.S. dollar was also reflected in a fall in the dollar/sterling exchange rate in 2000, declines in the Australia and New Zealand dollars to record-low levels, and downward pressures on some emerging market currencies.

## Key Developments in Emerging Market and Advanced Economies

Output growth in *emerging Asia* picked up in 2000 as this region continued its recovery from the 1997–98 crisis. The pace of economic expansion, however, slowed from mid-2000, largely as a result of the U.S. slowdown, higher oil prices, a decline in regional equity markets, and, in some countries, concerns about delays of corporate and financial restructuring and a decline in electronics exports. The effects of these influences varied across the region. For example, in China and India—which account for three-quarters of regional output—economic activity remained well sustained (providing an important source of stability). At the same time economic activity slowed more markedly in countries where recovery from the earlier crisis was relatively advanced, such as in Korea, Singapore, and Malaysia.

In *Latin America and the Caribbean*, economic activity continued to recover in 2000 as a whole, spurred by strong U.S. growth in the first half of the year, increased domestic demand, and—for some countries—higher oil prices. Performance differed across the region, however, with strong growth in Mexico, Chile, and Brazil, a moderate pickup in the Andean region, and very weak activity in Argentina. Despite rapid export growth, the regional current account deficit improved only slightly, reflecting a strong rebound of imports. Toward the end of the financial year, Mexico and a number of countries in the Andean region and Central America were affected most by the U.S. slowdown; Brazil and Argentina, with weaker trade links to United States, were more moderately affected. The late-2000 crisis in Argentina overshadowed other developments in the hemisphere. The Argentine economy came under increasing pressure in 1999 and 2000 following large terms-of-trade losses, the floating of the Brazilian real, increases in international interest rates, and the firming of the U.S. dollar. Economic activity in Argentina stagnated as domestic demand weakened under the influence of deflation and a fall in international investor confidence leading to a deterioration in external financing conditions—including a widening of Argentina's bond spread. The authorities responded by introducing several measures to strengthen the fiscal position and make product and labor markets more flexible.

Economic growth in *Africa* strengthened somewhat in 2000 although in many countries it remained insufficient to raise average per capita incomes. And the pickup remained fragile and highly dependent on the evolution of commodity prices. Output growth in South Africa recovered from a series of adverse shocks, including higher oil prices, unfavorable weather conditions, and contagion from the crisis in Zimbabwe. Despite high oil prices, the oil-exporting countries experienced only a modest pickup in real activity, a result of structural weaknesses and, in some cases, political instability and armed conflict. In much of the rest of Africa, the deterioration of the terms of trade was absorbed through lower domestic demand and weaker growth, thereby preventing these countries from reaping the benefits of their reform efforts. Conflicts or domestic political turmoil in some cases contributed to

a weakening of macroeconomic policy and performance. For many countries in the region, HIV/AIDS has become the major threat to development. Although some countries increased their HIV/AIDS-prevention efforts, a more concerted effort at prevention and treatment, together with increased international support, will be needed to combat the pandemic. More generally, ongoing debt relief and increased official development assistance would help to spur growth in Africa.

Economic activity in the *Middle East* surged in 2000, boosted by strong oil prices and increases in OPEC oil production quotas. The volatility of oil prices, however, underscored the need to promote economic diversification to achieve sustained growth. Output growth in the Mashreq region (Egypt, Jordan, Lebanon, Syria, and the West Bank and Gaza Strip) picked up, particularly in Egypt. Growth in Israel also rebounded strongly in 2000, led by buoyant technology sector exports, but declined late in the year, affected by both the global high-technology slowdown and the deterioration in the security situation.

Growth also strengthened in *European emerging market economies*. Still, persistently high inflation and wide external imbalances remained problematic in a number of these countries. In Turkey, growing problems in the banking sector and a widening of the current account deficit led to a financial and currency crisis in late 2000. In response, the authorities strengthened their economic program in December, including by adopting tighter macroeconomic policies and accelerated structural reforms. However, political difficulties and delays in the privatization program contributed to an erosion of investor confidence and to a renewed crisis in February 2001, leading to the authorities' decision to allow the currency to float.

Economic growth in the *advanced economies* was strong for much of 2000 but weakened later in the year and in early 2001. Following a strong start, growth in the United States slowed during the year in response to the increase in oil prices, the drop in equity markets, tightening credit conditions, and the U.S. dollar appreciation. The downturn was most severe in manufacturing production. The external current account deficit widened in 2000, driven by the strength of private investment and the continued decline in household saving. In Japan, economic recovery stalled, reflecting persistent weaknesses in the financial sector and consumer confidence, together with the slowdown of the global economy. This setback, against the background of the prolonged economic stagnation in Japan, again highlighted the urgency of structural reforms to put Japan's financial and corporate sectors on a sounder footing. The European Union grew strongly in 2000, with the largest economies—Germany, France, Italy, and the United Kingdom—all growing by about 3 percent, with declining unemployment. Signs of weakness emerged late in the year, although these were not consistent across the region: for example, industrial production growth and business confidence declined in Germany, while activity and confidence in France appeared to be relatively well sustained. In Australia and New Zealand, economic activity continued to be supported by rapid export growth, underpinned by competitive exchange rates and relatively strong external demand.

CHAPTER 2

# IMF Surveillance in Action

The IMF's charter—or Articles of Agreement—directs it to oversee the exchange rate policies of its member countries in order to ensure the effective operation of the international monetary system. To this end, the IMF assesses whether members' economic developments and policies are consistent with the achievement of sustainable growth and macroeconomic stability. It does this by holding regular discussions with its member countries about their economic and financial policies, and by continuously monitoring and assessing economic and financial developments at the country, regional, and global levels. In these ways, the IMF can help signal dangers on the horizon and enable members to take early corrective policy actions.

IMF oversight, or surveillance, has evolved continuously to reflect changing global economic realities. In recent years, economic globalization and the increasing international integration of financial markets—and the 1994 Mexican and 1997–98 Asian and Russian financial crises—have underscored the importance of effective surveillance for crisis prevention. The IMF's surveillance now devotes more attention to factors that make countries vulnerable to financial crises, including financial systems, capital account developments, poor governance, and public and external debt management. The IMF has continued to develop better analytical tools, such as those for assessing reserve adequacy and vulnerability to crises, and has strengthened efforts to incorporate the views of and developments in international financial markets into its surveillance activities. It has also underscored the importance of reporting accurate, timely, and comprehensive statistics and has encouraged members to publish country reports with a view to facilitating more informed decisions in the public and private sectors. As a result of these efforts, surveillance has become more focused and candid.

The IMF conducts its surveillance in several ways:

- *Country surveillance.* As mandated in Article IV of its Articles of Agreement, the IMF holds "Article IV" consultations, normally every year, with each member country about its economic policies.
- *Global surveillance.* The IMF's Executive Board regularly reviews international economic and financial market developments. The reviews are based partly on the World Economic Outlook reports, prepared by IMF staff twice a year, and the annual International Capital Markets report. In addition, the Board holds frequent, informal discussions about world economic and financial market developments.
- *Regional surveillance.* To supplement country consultations, the IMF also examines policies pursued under regional arrangements. It holds regular discussions with such regional economic institutions as the European Union, the West African Economic and Monetary Union, the Central African Economic and Monetary Community, and the Eastern Caribbean Currency Union. IMF management and staff have increased their participation in regional initiatives of member countries—including the Southern African Development Community, the Common Market of Eastern and South Africa, the Manila Framework Group, the Association of South East Asian Nations, the Meetings of Western Hemisphere Finance Ministers, and the Gulf Cooperation Council.

IMF management and staff also take part in policy discussions of such country groups as the Group of Seven industrial countries and the Asia-Pacific Economic Cooperation forum.

Recent developments have made clear that effective IMF surveillance depends on the following:

*Provision of timely, reliable, and comprehensive data.* Each member country is required to provide the IMF with the information necessary for surveillance. The IMF also encourages countries to be transparent about their policies and about economic developments, for example, by publishing data on external reserves, related liabilities, and short-term external debt. IMF technical assistance is playing an important role in improving many countries'

data systems and institutional arrangements so that they meet the requirements of transparency.

*Continuous surveillance.* To ensure more continuous surveillance, the IMF supplements yearly consultations with member countries with, for example, interim staff visits and frequent informal Executive Board meetings to review major developments in selected member countries.

*A sharper focus for surveillance.* Particularly in view of the globalization of financial markets, surveillance now involves a closer examination of financial sector issues, capital account developments, and public and external debt management. It also includes evaluations of a country's financial health—including explicit attention to policy interdependence and the risks of "contagion" (that is, the spread of crises from one country to others).

*Observance of standards and codes.* The IMF and other international organizations and regulatory bodies have developed internationally recognized standards and codes of good practice, which can be used to help countries improve their economic and financial policies and systems and thereby strengthen the international financial system. Countries' adherence to such standards and codes is voluntary, but they can play an important role in helping prevent financial crises and in enhancing economic performance. Standards and codes in place include the IMF's Special Data Dissemination Standard, which covers key economic data, and codes for transparency in monetary, fiscal, and financial sector policy. The IMF and the World Bank are preparing Reports on the Observance of Standards and Codes (ROSCs) by member countries.

*Transparency.* The importance of credibility in maintaining and restoring market confidence underscores the value of transparency. The IMF has taken steps to encourage its members to increase the transparency of their policies, as well as to increase the transparency of its own policy advice. In FY2001, for example, it adopted a policy whereby Article IV staff reports are published when the country concerned agrees.

See Chapter 3 for more details on the IMF's work in the above areas.

## Country Surveillance

An IMF staff team meets with government and central bank officials of each member country, generally every year (with interim discussions held as needed), to review economic developments and policies. These consultations touch on major aspects of macroeconomic and financial sector policies, but they also cover other policies affecting a country's macroeconomic performance, including, where relevant, those relating to structural policies and governance.

To conduct country surveillance, an IMF staff team visits the country, collects economic and financial information, and discusses with the national authorities recent economic developments and the monetary, fiscal, and relevant structural policies the country is pursuing. The Executive Director for the member country usually participates. The IMF staff team normally prepares a concluding statement, or memorandum, summarizing the discussions with the member country and leaves this statement with the national authorities, who have the option of publishing it. On their return to headquarters, IMF staff members prepare a report describing the economic situation in the country and the nature of the policy discussions with the national authorities, and evaluating the country's policy stance. The Executive Board then discusses the report. The country is represented at the Board meeting by its Executive Director. The views expressed by Executive Directors during the meeting are summarized by the Chairman of the Board (the Managing Director), or the Acting Chairman, and a summing up is produced. If the Executive Director representing the member country agrees, the full Article IV consultation report is released to the public, together with the summary text of the Board discussion and background material in the form of a Public Information Notice (PIN), or only a PIN could be issued. In FY2001 the Board conducted 130 Article IV consultations with member countries (see Table 2.1). The PINs and Article IV reports are published on the IMF website.

In addition to Article IV consultations, the Board also carries out country surveillance through discussions of ongoing IMF lending in support of member countries' economic programs, including precautionary financing (see Chapter 4), and through monitoring.

*Staff-Monitored Programs.* The IMF staff monitors a country's economic program and meets regularly with the country's authorities to discuss economic developments and policies. Staff monitoring does not constitute formal IMF endorsement of the member's policies, nor is IMF financing provided.

*Post-Program Monitoring.* The IMF also now monitors countries' economic policies after the conclusion of IMF-supported programs, particularly where there is substantial credit outstanding to the IMF, to help safeguard IMF funds and preserve the achievements of IMF-supported programs (see also Chapter 4).

## Global Surveillance

### *World Economic Outlook*

The Executive Board carries out its surveillance of global economic conditions based on the staff's World Economic Outlook reports, which feature a comprehensive analysis of prospects for the world economy,

Table 2.1
## Article IV Consultations Concluded in FY2001

| Country Name | Board Date | PIN Issued | Staff Report Published |
|---|---|---|---|
| Albania | June 9, 2000 | June 23, 2000 | June 23, 2000 |
| Algeria | July 7, 2000 | August 4, 2000 | August 4, 2000 |
| Angola | July 19, 2000 | August 10, 2000 | |
| Antigua and Barbuda | March 7, 2001 | March 22, 2001 | |
| Argentina | September 15, 2000 | October 3, 2000 | December 19, 2000 |
| Australia | March 2, 2001 | March 21, 2001 | March 21, 2001 |
| Austria | August 3, 2000 | August 8, 2000 | August 8, 2000 |
| Azerbaijan | August 1, 2000 | | |
| Bahrain | June 21, 2000 | | |
| Barbados | November 1, 2000 | December 4, 2000 | December 4, 2000 |
| Belarus | October 13, 2000 | October 20, 2000 | |
| Belgium | February 21, 2001 | March 7, 2001 | March 7, 2001 |
| Belize | May 19, 2000 | May 25, 2000 | |
| Benin | January 8, 2001 | February 2, 2001 | |
| Botswana | March 12, 2001 | April 13, 2001 | |
| Brazil | November 27, 2000 | December 22, 2000 | |
| Brunei Darussalam | February 21, 2001 | | |
| Bulgaria | March 23, 2001 | April 3, 2001 | April 3, 2001 |
| Burkina Faso | July 10, 2000 | August 8, 2000 | August 8, 2000 |
| Central African Republic | July 12, 2000 | October 27, 2000 | |
| Cambodia | September 15, 2000 | October 13, 2000 | October 13, 2000 |
| Cameroon | June 7, 2000 | June 21, 2000 | |
| Canada | March 23, 2001 | April 23, 2001 | April 23, 2001 |
| Chad | July 25, 2000 | | |
| Chile | July 7, 2000 | August 9, 2000 | August 9, 2000 |
| China, P.R. of | July 26, 2000 | September 1, 2000 | |
| Colombia | March 28, 2001 | April 12, 2001 | April 23, 2001 |
| Comoros | July 12, 2000 | September 5, 2000 | |
| Congo, Rep. of | November 17, 2000 | December 7, 2000 | |
| Côte d'Ivoire | July 12, 2000 | September 8, 2000 | |
| Croatia | March 19, 2001 | March 23, 2001 | March 23, 2001 |
| Cyprus | August 3, 2000 | August 24, 2000 | August 24, 2000 |
| Czech Republic | July 26, 2000 | August 9, 2000 | August 9, 2000 |
| Dominican Republic | February 23, 2001 | March 14, 2001 | |
| Ecuador | August 28, 2000 | September 7, 2000 | |
| Egypt | July 27, 2000 | | |
| Estonia | June 30, 2000 | July 11, 2000 | July 11, 2000 |
| Ethiopia | March 19, 2001 | | |
| Finland | August 22, 2000 | August 31, 2000 | August 31, 2000 |
| France | October 27, 2000 | November 13, 2000 | November 13, 2000 |
| Gabon | October 23, 2000 | November 22, 2000 | |
| Gambia, The | July 19, 2000 | August 15, 2000 | |
| Germany | October 23, 2000 | November 2, 2000 | November 2, 2000 |
| Greece | February 23, 2001 | March 16, 2001 | March 28, 2001 |
| Grenada | July 5, 2000 | July 20, 2000 | July 20, 2000 |
| Guinea | December 20, 2000 | | |
| Guinea-Bissau | December 15, 2000 | | |
| Guyana | November 13, 2000 | November 30, 2000 | |
| Haiti | November 22, 2000 | January 5, 2001 | January 5, 2001 |
| Hong Kong SAR | February 16, 2001 | March 2, 2001 | March 2, 2001 |
| India | June 19, 2000 | June 30, 2000 | |
| Indonesia | September 14, 2000 | September 25, 2000 | |
| Iran, Islamic Republic of | August 3, 2000 | | |
| Ireland | August 2, 2000 | August 10, 2000 | August 10, 2000 |
| Italy | June 5, 2000 | June 13, 2000 | June 13, 2000 |
| Japan | August 4, 2000 | August 11, 2000 | August 11, 2000 |
| Jordan | July 25, 2000 | | |
| Kazakhstan | December 11, 2000 | December 18, 2000 | |
| Korea | January 31, 2001 | February 1, 2001 | |
| Kyrgyz Republic | September 13, 2000 | October 13, 2000 | |
| Lao People's Dem. Rep. | April 23, 2001 | April 26, 2001 | |
| Latvia | June 30, 2000 | July 11, 2000 | July 11, 2000 |
| Lesotho | March 9, 2001 | May 21, 2001 | June 12, 2001 |
| Libya | March 12, 2001 | | |
| Lithuania | January 10, 2001 | January 22, 2001 | January 22, 2001 |

| Country Name | Board Date | PIN Issued | Staff Report Published |
|---|---|---|---|
| Luxembourg | May 8, 2000 | May 16, 2000 | May 16, 2000 |
| Macedonia, FYR | May 10, 2000 | June 23, 2000 | June 23, 2000 |
| Madagascar | June 23, 2000 | August 30, 2000 | |
| Malawi | December 21, 2000 | January 23, 2001 | February 20, 2001 |
| Malaysia | July 25, 2000 | August 10, 2000 | |
| Maldives | November 3, 2000 | | |
| Mali | September 6, 2000 | October 10, 2000 | October 10, 2000 |
| Marshall Islands | January 5, 2001 | | |
| Mauritania | June 19, 2000 | June 27, 2000 | |
| Micronesia | January 5, 2001 | | |
| Moldova | December 15, 2000 | March 13, 2001 | |
| Morocco | June 7, 2000 | September 1, 2000 | |
| Mozambique | December 18, 2000 | January 17, 2001 | January 17, 2001 |
| Myanmar | December 4, 2000 | | |
| Namibia | October 18, 2000 | | |
| Netherlands | June 12, 2000 | June 16, 2000 | June 16, 2000 |
| New Zealand | October 13, 2000 | October 27, 2000 | October 27, 2000 |
| Niger | December 14, 2000 | January 12, 2001 | January 12, 2001 |
| Norway | January 26, 2001 | February 5, 2001 | February 5, 2001 |
| Oman | March 26, 2001 | April 11, 2001 | |
| Pakistan | November 29, 2000 | December 14, 2000 | January 26, 2001 |
| Panama | January 22, 2001 | February 16, 2001 | February 20, 2001 |
| Papua New Guinea | October 13, 2000 | October 26, 2000 | October 26, 2000 |
| Peru | March 12, 2001 | March 19, 2001 | March 19, 2001 |
| Philippines | March 1, 2001 | March 13, 2001 | |
| Poland | March 9, 2001 | April 10, 2001 | April 10, 2001 |
| Portugal | October 20, 2000 | November 20, 2000 | November 20, 2000 |
| Romania | November 29, 2000 | December 12, 2000 | December 12, 2000 |
| Russian Federation | September 15, 2000 | November 9, 2000 | November 9, 2000 |
| Rwanda | December 20, 2000 | March 27, 2001 | |
| Saudi Arabia | October 6, 2000 | | |
| Senegal | June 21, 2000 | August 16, 2000 | |
| Seychelles | November 1, 2000 | December 26, 2000 | |
| Sierra Leone | January 22, 2001 | February 12, 2001 | |
| Singapore | June 5, 2000 | June 30, 2000 | |
| Slovak Republic | July 21, 2000 | July 28, 2000 | |
| Solomon Islands | January 19, 2001 | | |
| South Africa | March 19, 2001 | May 9, 2001 | |
| Spain | October 20, 2000 | November 16, 2000 | November 16, 2000 |
| Sri Lanka | April 20, 2001 | May 14, 2001 | May 16, 2001 |
| St. Kitts and Nevis | October 23, 2000 | December 4, 2000 | January 8, 2001 |
| St. Lucia | March 7, 2001 | March 29, 2001 | |
| St. Vincent and the Grenadines | October 27, 2000 | November 13, 2000 | November 13, 2000 |
| Sudan | May 22, 2000 | June 9, 2000 | June 9, 2000 |
| Swaziland | July 19, 2000 | September 13, 2000 | |
| Sweden | August 22, 2000 | September 8, 2000 | September 8, 2000 |
| Syrian Arab Rep. | November 1, 2000 | | |
| Tajikistan | April 12, 2001 | April 24, 2001 | April 24, 2001 |
| Tanzania | August 1, 2000 | September 15, 2000 | |
| Togo | April 20, 2001 | May 3, 2001 | |
| Tonga | November 20, 2000 | | |
| Tunisia | February 7, 2001 | February 13, 2001 | February 14, 2001 |
| United Arab Emirates | June 9, 2000 | | |
| Uganda | March 26, 2001 | | |
| Ukraine | December 19, 2000 | January 19, 2001 | |
| United Kingdom | February 23, 2001 | February 28, 2001 | February 28, 2001 |
| United States | July 21, 2000 | July 28, 2000 | July 28, 2000 |
| Uruguay | February 26, 2001 | March 14, 2001 | March 15, 2001 |
| Uzbekistan | February 7, 2001 | | |
| Vanuatu | August 1, 2000 | September 5, 2000 | |
| Venezuela | February 26, 2001 | | |
| Vietnam | July 21, 2000 | August 4, 2000 | |
| Yemen | February 28, 2001 | March 8, 2001 | |
| Zambia | July 26, 2000 | | |
| Zimbabwe | December 6, 2000 | December 13, 2000 | January 8, 2001 |

individual countries, and regions, and examine topical issues. These reports are usually prepared and published twice a year, but they may be produced more frequently if rapid changes in world economic conditions warrant.

During FY2001, the Board discussed the World Economic Outlook in September 2000 and in April 2001. At its September 2000 meeting, the Board welcomed the strength of the world economy. The high global growth rate was attributable in large part to the remarkable strength of the U.S. economy, supported by a robust expansion in Europe and the countries in transition. Also contributing to world growth were a consolidation of the recovery in Asia, improved growth in Africa, and rebounds from year-earlier slowdowns in Latin America and the Middle East. While economic activity in Japan was also improving, the incipient recovery remained fragile.

Although the overall outlook as of September 2000 was encouraging, Directors cited continuing risks and uncertainties and saw no room for complacency. In particular, a number of serious economic and financial imbalances persisted in the world economy: the lopsided pattern of output and demand growth among industrial countries and the associated imbalances in the external current accounts, the misalignments among the major currencies, and the generous level of asset market valuations in the United States and several other countries. The possibility that these imbalances might unwind in a disorderly fashion remained a risk to the global expansion. The recent increase in oil prices, if sustained, would also hamper global growth and increase inflationary pressures in advanced economies and hurt oil-importing developing countries, including many poor countries in sub-Saharan Africa.

Against this background, Directors observed that policymakers continued to face important, if widely varying, challenges. The advanced economies had to continue efforts to facilitate an orderly rebalancing of growth and demand across the three main currency areas. In some advanced economies, a further tightening of macroeconomic policies might be needed to reduce the risks of overheating, particularly if higher energy prices fed through to underlying inflation; in others, where there were margins of slack, macroeconomic policies had to continue to support recovery. More broadly, Directors stressed that progress with structural reforms had to continue in most advanced, and in almost all developing, countries so as to strengthen prospects for sustained economic growth.

At the September 2000 meeting, Directors also expressed concern that, despite the strength of the global recovery, poverty remained unacceptably high, and many poor countries continued to face serious economic problems—compounded in some cases by natural disasters and adverse movements in non-oil commodity prices. Directors agreed that sustained efforts by the poorest countries were essential, notably in promoting macroeconomic and political stability, good governance, and domestic ownership of the reform agenda. Stronger support from the international community was also important, including through debt relief targeted at poverty reduction—which required funding in full the enhanced Initiative for Heavily Indebted Poor Countries (HIPC Initiative); a reversal of the declining trend in some advanced countries' official development aid; and reform of protectionist trade policies in advanced economies that particularly affected poor countries. More international assistance was also needed to help address the HIV/AIDS pandemic, which posed a severe human as well as economic threat, especially in sub-Saharan Africa and parts of Asia.

At their April 2001 discussion on the World Economic Outlook, Directors agreed that prospects for global growth had weakened significantly, led by a marked slowdown in the United States, a stalling of the recovery in Japan, and a slowing of growth in Europe and in a number of emerging market countries. Some slowdown from the rapid rates of global growth of late 1999 and early 2000 had been both desirable and expected—especially in those countries most advanced in the cycle—but the deceleration was proving to be steeper than previously thought. At the same time, while headline inflation in most advanced economies had begun to stabilize—with moderate wage increases and declining oil prices—underlying inflation remained generally subdued, except perhaps in a number of faster-growing European and emerging market economies.

Given the rapid policy response by several central banks in both advanced and emerging market economies, Directors thought that prospects were reasonable that the global slowdown would be relatively short lived, although the pace of recovery might be slowed by continuing declines in global equity markets. Declining short- and long-term interest rates were expected to support economic activity in the second half of 2001, and, with inflation risks receding, policymakers in most advanced economies—except for Japan—had substantial room for further easing. Moreover, given the remarkable strengthening in fiscal positions in recent years, most advanced economies also had room for fiscal easing as a second line of defense—which the United States in particular was expected to use. In addition, while a number of emerging market countries continued to face serious difficulties, external and financial vulnerabilities had generally been reduced since the 1997–98 crises as a result of wide-ranging structural reforms; moreover, the shift away from soft exchange rate pegs to flexible exchange rate systems had improved countries' ability to cope with external shocks.

Most Directors agreed, however, that the outlook remained subject to considerable uncertainty and that a deeper and more prolonged downturn was possible. The U.S. adjustment process could be complicated by the substantial imbalances that developed during the expansion—including the large current account deficit, the apparent overvaluation of the U.S. dollar, and the negative household savings rate—as well as by the risk of possible further declines in equity markets.

Directors emphasized that the extent of the slowdown would be affected by policy decisions by all countries. In the advanced economies, Directors agreed that a more proactive approach to macroeconomic policies—particularly on the monetary side—might well be required, and should be pursued consistently with these countries' respective cyclical positions and without compromising medium-term stabilization goals. Where needed, these policies should be complemented by the determined pursuit of structural reforms. In view of the prevailing fragility of external financing conditions, prospects in emerging markets depended critically on maintaining investor confidence. For these countries, Directors underscored the need to maintain prudent macroeconomic policies and to press ahead with corporate, financial, and—especially in the transition economies—institutional reforms.

Directors were concerned that the slowdown in global growth would hurt the low-income countries, both directly and through lower commodity prices. The need for such countries to sustain strong policies was even greater, both in those countries receiving debt relief under the enhanced HIPC Initiative and in others. To help the low-income countries, Directors stressed that the advanced economies had a special responsibility to increase aid flows, to support initiatives promoting peace and domestic stability, and to provide further assistance to fight the spread of the HIV/AIDS pandemic. They especially emphasized the importance of reducing further barriers to the exports of the developing countries, and of the poorest countries in particular. In this connection, the Board welcomed the European Union's recent initiative to eliminate tariffs on almost all exports of the least-developed countries.

Given the change in the global economic outlook, Directors felt it was particularly important for the IMF—in its dialogue with member countries, and through its multilateral surveillance—to continue to support actively the implementation of policies that promote economic stability and prosperity.

### *Major Currency Areas*

For the *United States,* the outlook was subject to more than the usual amount of uncertainty. While growth was likely to remain weak in the first half of 2001, reflecting rapid inventory adjustment, most Directors believed that it would pick up in the second half, supported by lower short- and long-term interest rates, although the rate of pickup might be slowed by the lagged effect of the fall in equity prices. Directors also acknowledged the significant risk that the imbalances built up during the long expansion could unwind in a less orderly fashion, accompanied by further declines in confidence and increases in risk aversion in financial markets. With the balance of risks shifting increasingly toward weaker aggregate demand, Directors strongly welcomed the timely and significant easing of U.S. monetary policy in the first quarter. If economic and financial conditions remained weak, they felt that some further easing would be appropriate. While monetary policy remained the preferred instrument for responding actively to cyclical developments, Directors believed that—given the sustained fiscal surpluses in prospect in coming years—moderate and front-loaded tax cuts would also be appropriate from a cyclical perspective. These tax cuts should preferably be enacted in phases, with each phase put in place only when it was clear that sufficient budgetary resources would be available to finance it. At the same time, they recommended that the surpluses of the Social Security and Medicare Health Insurance trust funds be preserved to help meet future pension and health care costs.

Board members expressed considerable concern about the renewed setback to recovery in *Japan,* which could worsen the global slowdown and have a particularly serious impact on a number of Asian countries. While this setback partly reflected economic slowdown elsewhere—especially the weakening of global demand for electronics equipment—it was also due to continued weak consumer confidence and underlying structural weaknesses, especially in the Japanese corporate and financial sectors. Given the deteriorating outlook and continued deflation, Directors welcomed Japan's introduction of a new monetary policy framework, which effectively returned to the zero-interest-rate policy and included a commitment to maintain the new framework until consumer prices had stopped declining, and (if needed) would step up outright purchases of long-term government bonds. Directors urged that the framework be forcefully implemented. Given the high level of public debt, Directors believed that the very gradual fiscal consolidation under way remained appropriate, and that further fiscal easing should be considered only as a last resort. Directors stressed, however, that the prospects for a return to sustained growth in the medium term depended most critically on determined action to address weaknesses in banks and life insurance companies—including through the vigorous application of the regulatory and supervisory framework—along with measures to further encourage corporate restructuring.

Turning to *the euro area,* Directors observed that while growth remained relatively well sustained, signs of slowing had intensified and confidence had weakened. While headline inflation remained above the target of the European Central Bank, underlying price pressures were muted, with little evidence of pass-through effects of higher energy prices and the weaker euro on wages. Against this background, many Directors believed that a moderate cut in interest rates was appropriate, with a further cut if the euro were to appreciate sharply or if indications of slowing growth were to mount. While recent tax cuts in some countries would provide a helpful stimulus, Directors saw no further need to use fiscal policy actively to support output, although fiscal execution should allow the full play of automatic stabilizers. While welcoming the important progress made in some areas of structural reform, Directors underscored that further deepening and acceleration of market-oriented reforms—especially of pension systems, labor markets, and product markets—was necessary both to raise potential output growth over the medium term and to address the challenges posed by aging populations. They also underscored the need, over the medium term, to further reduce tax burdens, which remained very high in a number of euro-area countries. Such reductions would need to be accompanied by spending restraint to help meet medium-term budget targets.

### Emerging Market Economies

Following a rapid recovery from the regional crisis, growth in the *Asian emerging market economies* had weakened as a result of higher oil prices, slowing growth in the United States and Japan, the downturn in the global electronics cycle, and—in some countries—the lagging pace of corporate and financial restructuring. Directors noted that growth was expected to slow most in the newly industrialized economies and in member countries of the Association of South East Asian Nations (ASEAN), particularly those more advanced in the recovery and where corporate and financial restructuring had lagged. In these countries, it was crucial to restore the momentum of structural reforms. For countries with low inflation and sustainable fiscal positions, Directors recommended moderate interest rate reductions, coupled in some cases with an easier pace of fiscal consolidation. Growth was expected to be relatively well maintained in China and India. In China, a gradual shift to a more neutral fiscal policy stance was seen as appropriate given considerations of medium-term sustainability. In India, Directors agreed that the monetary policy easing should be supported by continued improvements in the environment for private investment and a substantial reduction, over the medium term, in the overall public sector deficit.

In *Latin America,* growth had rebounded in 2000, following the sharp slowdown in 1999, in part reflecting strong adjustment measures put in place in many countries. In 2001, the direct impact of weakening external demand on activity was likely to be largest in Mexico and in several countries in the Andean region and Central America, but more moderate in those countries—such as Brazil and Argentina—that were less exposed to the global trade slowdown and where trade links with the United States in particular were less important. Given Latin America's large external financing requirements, however, the impact of the U.S. slowdown on financial markets would be critical. While a number of countries had been able to cover a substantial part of their annual public sector financing needs in early 2001, Directors were concerned that, despite the easing of U.S. monetary policy, financing conditions had deteriorated following the crisis in Turkey and significant difficulties in Argentina—which reflected a rise in investor risk aversion and possible concerns about a slowdown in inward foreign direct investment. With intensifying scrutiny from global financial markets, it was important to maintain prudent fiscal policies, along with structural reforms—particularly in financial and corporate sectors and labor markets. Directors generally welcomed the initiatives to strengthen the policy framework in Argentina, while stressing the need for continued fiscal restraint and strict adherence to the economic program at all levels of government.

In some countries in *Africa,* growth had been constrained by war and civil conflict, weak commodity prices, and, for oil-importing countries, by higher oil prices. While countries that implemented sound macroeconomic and structural policies and maintained political stability had been able to achieve relatively strong rates of growth, Directors were concerned that the outlook for the region could be adversely affected by the global slowdown, particularly through a further weakening of commodity prices. Directors welcomed the strengthening of economic policies in many countries, which were being supported by debt relief through the enhanced HIPC Initiative and the Poverty Reduction and Growth Facility. It was important to sustain the momentum for reform in the years ahead, particularly by improving the environment for private investment, strengthening public service delivery, improving tax administration and infrastructure, and enhancing governance. Directors generally endorsed trade integration in sub-Saharan Africa, noting in particular the scope for further reductions in trade barriers by African countries. They agreed that a lasting improvement in Africa's trade performance would depend on a broader mix of macroeconomic policies and structural reforms critical to improved efficiency and exter-

nal competitiveness, as well as on increased access to industrial country markets. Directors also welcomed the staff's suggestions for rationalizing current regional trade arrangements to allow them to reach their intended objectives.

In the *Middle East,* higher oil prices combined with increased oil production had generally boosted activity and improved fiscal and external balances in 2000. With the windfall gains from higher oil prices having been used prudently, the projected decline in oil prices in 2001 and 2002 appeared generally manageable. Nonetheless, a prudent approach to fiscal policy remained desirable, especially in countries where government debt had to be reduced. More generally, Directors underscored the need for continued reforms to promote economic diversification and growth, including the removal of remaining impediments to trade and foreign direct investment. Growth in most of the non-oil-producing countries in the region was expected to remain stable, although it could be affected by a steeper-than-anticipated global slowdown. Reform of trade and foreign direct investment regimes was also a priority for many of these countries, which had yet to share fully in the benefits of globalization.

Directors observed that the situation in *Turkey* remained very difficult. They welcomed the steps taken to reform the financial system—particularly with regard to state banks—but noted that further decisive policy measures were needed to resolve the problems in the banking sector, strengthen the fiscal accounts, and achieve broad-based structural reforms. In central and eastern Europe, growth was expected to remain reasonably well sustained in 2001, although activity would be vulnerable to a greater-than-expected slowdown in western Europe. Against the background of weakening external demand and large current account deficits, Directors favored a rebalancing of the policy mix toward relatively tighter fiscal policy, which would help restrain domestic demand while limiting upward pressure on interest rates and exchange rates. They also cited the need for further structural and institutional reforms—especially with respect to privatization, enterprise restructuring, and financial regulation and supervision—to promote sustainable growth in the medium term and facilitate accession to the European Union.

Directors welcomed the improvement in growth performance and external positions in the *countries of the Commonwealth of Independent States (CIS),* which reflected mainly higher world energy prices and buoyant growth in Russia. In Russia, growth was expected to moderate from the very rapid pace in 2000, partly the result of lower oil prices and some real appreciation of the ruble, as well as the global slowdown. The government's long-term reform plan was an important step forward, but it had to be both firmly implemented and significantly developed in a number of key areas, including banking reform, nonpayment problems, and the restructuring of infrastructural monopolies. Accelerating structural and institutional reform also remained the central challenge in most other CIS countries.

### *Maintaining Improved Fiscal and Monetary Policies*

Directors noted that the durability of recent fiscal consolidation in the advanced economies was likely to be improved by the associated reductions in public spending (as a share of GDP) and the strengthening of fiscal frameworks over the past decade. They emphasized that fiscal discipline would be vital in the years ahead, given the substantial increases expected in public spending on pensions and health care as populations aged. To meet pension liabilities and enhance output growth as dependency ratios rose, Directors agreed that the policy response should be broad-based, encompassing both pension reform and structural reforms, including labor market improvements. Consideration should be given to directing a part of recent and projected fiscal improvements to increased prefunding of future pension liabilities. Taking a global perspective on population aging, Directors noted that as dependency ratios decline in many developing countries, increased saving by countries with aging populations could support growth in the developing world and future consumption in advanced economies.

With respect to the decline in inflation in emerging market economies in recent years, Directors noted that improved monetary stability in advanced economies and substantial progress in institutional reform in emerging market economies—including more independent central banks and improved knowledge about monetary policy transmission—had played an important role in achieving this outcome. Prudent fiscal policies had also been key in achieving lower inflation and allowing the conduct of a stable monetary policy over the long run. While observing that experience with the more frequent use of inflation targeting to accompany flexible exchange rates had been generally encouraging to date, Directors considered that a more definitive verdict on inflation targeting would need to await further experience, particularly with the maintenance of price stability during sustained periods that included episodes of financial stress and exchange rate instability.

Finally, Executive Directors took the opportunity to express their deep appreciation to Michael Mussa for his outstanding contribution as Economic Counsellor and Director of the Research Department to the IMF's multilateral surveillance over the past 10 years, especially through his oversight and direction of the World Economic Outlook, and his regular informal briefings

on World Economic and Market Developments, which were a highlight of the Executive Board agenda.

## International Capital Markets

Executive Directors held their annual discussion of developments in the mature and emerging capital markets in early August 2000. While they noted that global financial conditions had improved over the previous 12 months, and the global financial system had proven to be adaptable and resilient, Directors saw several risks and vulnerabilities ahead, particularly relating to the major economies and financial systems. Directors also discussed three key systemic issues: the risks to financial stability from over-the-counter (OTC) derivatives markets, efforts to involve the private sector in the prevention and resolution of crises, and the implications of the expansion of foreign-owned banks in many emerging market countries.

The strong performance of the U.S. economy had bolstered global financial markets and investor sentiment, Directors observed. U.S. investment trends were increasingly reflected internationally, notably in the worldwide allocation of funds to the technology, telecommunications, and media sectors and, until March 2000, in the buoyancy of stock prices in these sectors. In Europe, financial market integration had progressed against the background of a depreciating euro and the buoyancy of equity and private bond markets. In Japan, problems in the financial system had stabilized considerably, and the authorities had put in place a potentially effective framework for financial and corporate restructuring. Some Directors, however, felt that the private sector had not made enough progress in implementing the new framework and that further progress was needed to sustain the Japanese recovery.

Directors discussed several risks for the mature financial markets. Some cautioned that a sharper-than-expected pickup in U.S. inflation, or an unanticipated drop in productivity, might give rise to a broadly based deterioration in investor sentiment, further corrections in equity and corporate bond markets, a general repricing of risk, portfolio rebalancing, and exchange rate adjustments. Sharp movements in the major currencies was another risk, which Directors related to mounting external imbalances.

Directors also saw risks for Japan and Europe. Some observed that, in Japan, expansionary policies—while appropriate from a macroeconomic perspective—might be affecting asset pricing and financial flows in Japan's fixed income and money markets, and could be encouraging position-taking that might not be profitably sustained should interest rates adjust more sharply than expected. It was observed that it was critically important for Japan to manage the transition to less stimulative monetary and fiscal policies carefully and transparently.

As to the emerging markets, Directors noted that the terms and conditions of market access had gradually improved over the previous 12 months and that the prices of emerging market assets had strengthened. They attributed much of this improvement to stronger fundamentals in most emerging markets, reflected in stronger economic growth, stable exchange rates, and upgrades in credit ratings by the major international agencies. Directors welcomed the ongoing development of domestic financial markets in many emerging markets and the reduced reliance on external financing that this would entail. They saw as positive developments the continued strength in direct investment, reduced reliance on international bank financing, and lengthening of the average maturities of external financing. They also noted the improved sentiment toward emerging markets on the part of investors in mature markets and the reduced volatility in emerging market asset prices from the high levels seen during the crises.

At the same time, Directors recognized that flows to emerging markets remained substantially below precrisis levels and that borrowing costs remained high, relative to precrisis levels. Furthermore, market access by the poorest emerging markets was still extremely limited. The sharp cutbacks in financing flows associated with the turmoil in mature markets in April and May 2000 had highlighted the dependence of emerging markets on conditions in mature markets. Directors were nonetheless encouraged by the subsequent recovery in prices and financing flows, and considered that, as long as there were no major disturbances from the mature markets, the outlook for emerging markets was generally positive. Several key emerging market countries, however, had to continue strengthening macroeconomic policies and renew structural reform of their corporate and financial sectors. Directors also stressed the potential risks to financial and economic conditions in several key emerging market countries from the spillover effects of either a sharp unanticipated upturn in global interest rates or a large downward correction in mature equity markets.

(As part of its increased study and monitoring of international capital markets, the IMF began publishing on its website quarterly reports on emerging market financing; see Box 2.1.)

### OTC Derivatives Market

Derivatives instruments had yielded substantial benefits to international financial markets and the global economy, Directors acknowledged. They noted the central role that derivatives instruments and markets play in the effectiveness of the global financial system, and

**Box 2.1**
**IMF Publishes Quarterly Reports on Emerging Market Financing**

Beginning in the second quarter of 2000, the IMF began publishing on its website quarterly reports, entitled *Emerging Market Financing*. The reports provide in-depth analyses of the risks and opportunities facing emerging market countries in accessing international capital markets, focusing on developments in equity, loan, and bond markets. Prepared in the IMF's Research Department, the reports are an integral element of the IMF's surveillance over developments in international capital markets. They draw, in part, on a series of regular informal discussions with a broad set of private financial market participants.

their role in supporting pricing, trading, and risk management in all the major bond, equity, and foreign exchange markets. The use of derivatives to unbundle financial risks had created more complete, flexible, and efficient financial markets and improved the pricing and allocation of financial risks.

While some Directors argued against overstating the risks associated with OTC derivatives activities, many believed that they could pose considerable risks to financial stability. They observed that OTC derivatives portfolios expose financial institutions to risks that can be more difficult to assess and manage than the risks in traditional lending and deposit taking. These Directors noted that OTC derivatives activities are ruled mainly by market discipline, rather than official regulation or oversight. Some also noted that, while the private, decentralized, market-disciplining mechanisms seemed, so far, to have safeguarded the soundness of individual, internationally active, financial institutions—in part because the institutions had been well capitalized—these mechanisms might not adequately protect market stability. Certain markets and countries, only remotely related to derivatives activities, had experienced instability because of spillovers and contagion. Some Directors recalled the experience in the period leading up to the near collapse of Long-Term Capital Management (LTCM) in the autumn of 1998 and noted that, while no major financial institution failed, private-market-disciplining mechanisms did not prevent the buildup and concentration of large counterparty risk exposures.

In that regard, Directors noted several features of OTC derivatives markets that could raise concerns about financial instability:

- Gross credit exposures in OTC derivatives transactions are sensitive to changes in information about counterparties and asset prices.
- Information asymmetries, because of limited disclosure and transparency, complicate the assessment of counterparty risk.
- OTC derivatives activities affect the aggregate credit and liquidity available in asset markets.
- Aggregate OTC derivatives activities and counterparty credit exposures are both sizable and highly concentrated in the internationally active financial institutions. This could make these institutions vulnerable to abrupt changes in market conditions.
- OTC derivatives activities closely link institutions, markets, and financial centers, and therefore are possible vehicles for spillovers and contagion.

These features could raise the risk of a rapid unwinding of positions in response to new information or to changes in risk tolerance.

Those Directors who cautioned against overstating the systemic risks associated with OTC derivatives also noted that, while OTC derivatives combine market and credit risks in ways that would never happen in traditional risks, they also generate significant benefits.

Measures in three areas could address imperfections in the infrastructure of OTC derivatives markets and strengthen market stability: First, market discipline might be made more effective, particularly through private efforts to improve transparency and disclosure, supported by official coordination and oversight. Second, legal and regulatory uncertainties might be reduced, particularly those associated with closeout and netting arrangements and with the regulatory status of derivatives instruments in various jurisdictions. Finally, micro- and macroprudential monitoring of OTC derivatives activities could be significantly improved. Banking supervision and market surveillance could pay closer attention to the effects of OTC derivatives activities on risks in financial institutions and markets. Directors agreed that private and public efforts in these three areas, by enhancing market discipline, could strengthen private risk management and thereby reduce systemic risk.

### *Private Sector Involvement in Crisis Resolution*

Directors agreed that efforts at crisis prevention and resolution, which serve to reduce inefficiencies and instability in the international financial system, were in the interests of both the public and private sectors. Because of the relative absence of clearly established rules of the game in the international context, the reaction of the private sector to new information and initiatives concerning the official community's approach to crisis resolution could have potentially profound implications for the nature and structure of international capital flows. Market participants' responses to the

array of crisis prevention and resolution proposals had, in many cases, reflected an incomplete awareness of official sector initiatives. Many Directors therefore stressed the importance of publicizing and clarifying the official community's objectives and initiatives, particularly the work on standards and codes of good practice. The level of communication and understanding between the public and private sectors also needed improvement. In that connection, Directors stressed the need for more active and effective dialogue between the IMF and the private sector. Directors also welcomed the Managing Director's proposal to set up a Capital Markets Consultative Group, to complement and strengthen efforts for a faster and closer involvement of the private sector in crisis prevention and resolution (see Chapter 3 for an expanded discussion of these issues).

Directors recalled that private sector involvement in crisis resolution was not new. The extent of involvement, however, had been related to the nature of capital flows. Most Directors agreed that it was useful to distinguish between potential outflows in a crisis that are generated by direct or portfolio equity instruments and more inflexible outflows generated by instruments that have a predetermined, fixed contractual claim.

A key lesson from the 1980s was that, when particular lending instruments are involved in restructurings, the private sector would seek out new instruments it viewed as having a higher likelihood of repayment and as being insulated from restructurings. Directors noted that the large-scale restructuring of syndicated bank loans, in the aftermath of the 1980s debt crisis, while leaving Eurobonds untouched, had provided impetus for channeling flows to emerging markets through the interbank and international bond markets. The more recent experience with concerted interbank rollovers suggested that such rollovers were more likely to be expected as part of future crisis resolution packages. However, expectations that this would occur might lead some international banks to cut their credit lines and run early in the face of an imminent crisis. Alternatively, the possibility of an imminent crisis could prompt international banks to hedge or offset their exposures in other markets, such as the bond market. Most Directors concluded that undue emphasis could not be placed on interbank rollovers alone, and for them to be effective, they had to be part of comprehensive crisis resolution packages.

Directors welcomed the fact that the most recent string of crises had tarnished the halo surrounding the status of international bonds. The experience with bond restructurings and private sector involvement was continuing to evolve rapidly. Some Directors cautioned, however, that if bond restructurings became more common, private sector creditors would, over time, increasingly seek ways of structuring debt so that it was harder to restructure. Most Directors stressed the importance of involving the private sector in a cooperative and voluntary fashion to discourage the creation of ever more short-term or inflexible debt structures. This would contribute to a more efficient and stable international financial system.

### *Role of Foreign Banks in Emerging Markets*

One of the major structural changes in the banking systems in many emerging markets in recent years was the sharp increase in the degree of foreign ownership, especially in Eastern Europe and Latin America. This change reflected the desire of both large international and regional banks to enter profitable markets and of the local authorities to improve the efficiency and stability of their financial systems, as well as to help reduce the cost of recapitalizing weak domestic banks.

The entry of foreign banks in the emerging market banking systems presented both benefits and challenges to the host country, in terms of efficiency and stability considerations. With regard to efficiency, the entry of foreign banks could improve the efficiency of emerging market banking systems by increasing competition and by introducing a variety of new financial products and better risk management techniques. On the other hand, some Directors noted, foreign banks were less likely to contribute to overall efficiency if they serviced only the most creditworthy corporate and household customers.

With regard to the role of foreign banks as a means of helping stabilize banking systems in emerging markets, Directors offered a range of views. Many argued that foreign banks could play an important role in stabilizing these systems, owing to their more advanced risk management systems, their better access to international capital markets, and the likelihood that the local foreign banks would be supervised on a consolidated basis with their parent. Other Directors, however, noted that the potential contribution of foreign banks would hinge on the circumstances, and might vary. They suggested that recent experience indicated that foreign banks may simply "cut and run" during crisis periods and are thus not a stable source of domestic funding. These Directors saw international banks as managing their exposures to emerging markets on a consolidated basis; a decision by them to cut exposures to an individual country could involve reductions in both cross-border lending and local operations. Moreover, these Directors argued that the presence of foreign banks opened a new channel for transmitting disturbances in mature market banking systems to emerging markets. Directors agreed that the entry of foreign banks into emerging markets would benefit

efficiency and stability most if accompanied by both stronger prudential supervision in emerging markets and enhanced cross-border sharing of information between supervisors in mature and emerging markets. In particular, supervisory authorities would have to upgrade their capacity to acquire information on, and to analyze the implications of, their use of OTC derivatives products.

Some Directors were concerned about the potential banking system concentration that could arise either as foreign banks acquired local banks or as local banks merged to remain competitive. Such concentration could create banks that were too big to fail locally and thus would lead to an extension of the scope and cost of the official safety net. Other Directors argued that any potential problems could be limited by enhanced prudential supervision and suitable antitrust policies.

## Regional Surveillance

### *West African Economic and Monetary Union*

In June 2000, Executive Directors discussed developments and regional policy issues in the West African Economic and Monetary Union (WAEMU). They noted that, following an impressive performance after the 1994 realignment of the CFA franc, the economic and financial situation in the WAEMU had weakened somewhat since 1998. This was due largely to a sharp deterioration in the region's terms of trade, as well as the weakening of policy implementation and political uncertainties in some countries. At the same time, economic integration had progressed during the previous year. To preserve the gains of economic and monetary union, strong political commitment and appropriate policy improvements were essential to reduce financial imbalances, and the structural reform agenda had to be advanced.

Directors welcomed member countries' decisive steps toward closer economic integration and the establishment of a framework for coordinating macroeconomic policies, which could enhance the economic and regulatory environment and speed up growth and poverty reduction. They also welcomed the adoption of a regional convergence pact, which provided a framework for promoting good governance and macroeconomic convergence and strengthening mutual surveillance through periodic reviews and possible sanctions. To be effective, such a system should be accompanied by the introduction of harmonized accounting, reporting, and disclosure standards to enhance transparency and accountability in public finance management. Directors urged national authorities to introduce the necessary legislation.

Most of the elements of a customs union and single market were in place, including a common external tariff with relatively low average rates, which set the stage for eliminating intraregional barriers for eligible originating products. Directors urged the authorities to press ahead with removing the remaining barriers to reap the full benefits of economic integration. Directors stressed that the establishment of a full-fledged customs union and an effective single market would require removing special import surcharges and other safeguard measures, reducing duty exemptions, and abolishing nontariff impediments to free movement of goods and factors.

Despite a less favorable internal and external environment, the monetary policy of the Central Bank of West African States (the BCEAO) had been broadly appropriate in 1998 and in 1999. Directors underscored the need for monetary policy to remain prudent, particularly given the uncertainty about the resumption of adjustment programs in some countries. They welcomed the decision by the Council of Ministers to gradually eliminate central bank statutory advances to governments by 2002; such action would foster the development of a regional market for government securities and thereby increase the effectiveness of monetary policy in WAEMU.

Despite the progress made over the past decade in rehabilitating the banking sector and effectively supervising banks, a number of banks in the region still did not comply with the core prudential ratios. Directors welcomed the introduction of new prudential arrangements similar to the core principles recommended by the Basel Committee. They also welcomed efforts to improve compliance with prudential regulations, and plans to complete the privatization of major banks in several countries. There was still scope, however, to strengthen management of banks and the supervision of the financial system. While welcoming the introduction of a single, zone-wide licensing agreement for banks in the WAEMU, Directors noted that the quality of financial intermediation in the region would benefit from greater competition among financial institutions and from improvements in the judiciary and law enforcement system that would reduce the problems associated with loan recovery.

The authorities had taken important steps in 1998 to encourage the development of a regional financial market and the creation of a more diversified range of financial institutions and instruments to attract available saving and provide the longer-term credit needed to finance business expansion. The new regional stock exchange in Abidjan, together with the supporting regulatory framework placed under the supervision of a Regional Securities Commission, offered an excellent vehicle for mobilizing long-term saving to boost investment and growth in the region. Directors, however,

stressed the need to further develop the operational and regulatory framework of the market to make it more efficient.

Directors supported recent steps to harmonize indirect taxation in the WAEMU, formulate a common investment code, and strengthen business laws in the context of the Treaty on the Harmonization of Business Laws in Africa (OHADA). They encouraged the authorities to move forcefully in addressing the remaining agenda items in that area, including harmonizing the taxation of petroleum products and promoting common tax procedures and methods to control exemptions and improve the taxation of small business.

The external competitiveness of the WAEMU economies appeared to be broadly adequate on the basis of a number of traditional exchange indicators. Directors suggested that those indicators be broadened and closely monitored, given the external current account's demonstrated vulnerability to terms-of-trade fluctuations and to domestic price rigidities and economic inefficiencies. Apart from sound macroeconomic policies, decisive progress in structural reforms was essential in all member countries to boost labor productivity, cut excessive domestic costs, and maintain the region's competitiveness in export markets. In that vein, Directors welcomed efforts to address, at the regional level, the most critical structural barriers to growth in agriculture, industry, transportation, and territorial development. While noting the merit of elaborating common sectoral policies, Executive Board members called for setting priorities in the pursuit of economic integration. Over the longer term, the rate of domestic savings would need to rise, to maintain the recovery in the rate of investment.

Directors welcomed and encouraged the renewed efforts to integrate the WAEMU into the larger regional arrangement of the Economic Community of West African States (ECOWAS)—with a view to creating a large, single regional market and a common monetary framework. They highlighted the need to harmonize trade policies by removing all internal tariffs and introducing a harmonized common external tariff. Directors stressed the importance of setting up an appropriate framework for credible regional surveillance to promote macroeconomic policy convergence in the region. The success of those initiatives would depend critically on strong progress in carrying out sound macroeconomic and structural policies in all ECOWAS countries.

Directors indicated that a strategy for regional integration required timely and reliable regional statistics, especially in the areas of national accounts, domestic debt, trade, and balance of payments, and the adoption of new indices to measure price and factor cost movements.

## Monetary and Exchange Policies of the Euro Area and Trade Policies of the European Union

Executive Directors met in October 2000 to discuss the monetary and exchange rate policies of the euro area, and recent developments in trade policies of the European Union.

### Policies of the Euro Area

While noting that favorable external developments and strong macroeconomic fundamentals had produced robust growth in the euro area, Executive Directors cautioned that the persistence of high and volatile oil prices had heightened downside risks and might affect the otherwise favorable prospects for growth in the short run.

Directors were more uncertain about medium- and longer-term prospects and emphasized that lasting reductions in unemployment in the euro area would be possible only if the ongoing expansion were sustained. They saw risks both in a sharp reversal of the favorable external shocks that had helped propel the euro-area upturn and in the area's structural rigidities, which in the past had often interacted with insufficiently countercyclical fiscal policies to undercut upswings and worsen downturns.

The monetary union had strengthened the euro area's macroeconomic structure, including by bringing about euro-area-wide monetary policy, better coordination of fiscal and structural policies, and greater awareness at the national level of the implications of wage developments for competitiveness. They stressed, nonetheless, that those changes had not yet been tested by adversity, and that the prevailing favorable economic circumstances provided an important opportunity to forge ahead with needed reforms.

The most pressing challenge, from a regional as well as a global standpoint, was to implement policies that both sustained the expansion and made it more resilient. In particular, Directors urged euro-area policymakers to adhere closely to the key requirements of safeguarding price stability; establishing structurally balanced fiscal positions and avoiding procyclical fiscal policies thereafter; and strengthening the supply side through a balanced and proactive strategy of tax, spending, and structural reforms.

Monetary management in the euro area had been suitably cautious; the rise in interest rates had helped preserve medium-term price stability during a period of unexpectedly large and protracted oil price increases and euro weakness. As the effects of the external influences that had contributed to the firming of the recovery and the buildup of cost pressures dissipated or were reversed, and if inflation showed signs of declining, the symmetric approach that had to date shaped policy would call for interest rates to be adjusted appropri-

ately. In that context, the monetary authorities should focus on core inflation and be rather cautious in interpreting headline inflation.

As to the level of the euro, Directors noted that the misalignment of the euro, both vis-à-vis the U.S. dollar and in effective terms, remained large. The misalignment should eventually correct itself, in part as cyclical divergences narrowed and as underlying portfolio adjustments ran their course, but Directors' views differed over the significance and nature of those portfolio adjustments. They agreed that the concerted intervention in support of the euro in September 2000 had helped stabilize the exchange rate by sending a signal that market participants would have to bear in mind in the future. They also considered that monetary decision making should take into account movements in the exchange rate to the extent that they posed a threat to medium-term price stability.

Directors agreed that the key fiscal challenge was to implement supply-enhancing tax cuts while avoiding procyclical fiscal policies. In that connection, they regretted that the prevailing stance was somewhat procyclical in the aggregate and risked becoming increasingly so if the pace of consolidation did not keep up with the expansion. In future, closely integrated tax and spending policies should ensure that tax reductions did not run ahead of offsetting permanent cuts in public spending.

More broadly, Directors stressed that the pursuit of at least neutral fiscal policies required evaluating fiscal positions relative to the cycle, thus targeting budgetary surpluses when activity was above potential. This would enhance the effectiveness of the monetary union by strengthening the policy mix and meeting the Stability and Growth Pact's[1] objective of close to balance or surplus in the medium term—which would also afford scope for countercyclical policies when growth weakened.

National fiscal strategies should also encompass tax and spending objectives that effectively bolstered the growth potential of the euro area. In that context, tax cuts had to be carefully targeted to achieve the most beneficial supply-enhancing effects, and spending policies should focus on increasing the efficiency of public services. Progress on this front had been mixed, especially with regard to spending reforms.

While acknowledging that structural reforms had advanced, Directors stressed that further efforts were essential to create scope for growth and to avoid capacity constraints from again choking off the expansion prematurely. In that connection, they welcomed the Lisbon summit decision to put structural reforms at the top of the European Union's policy agenda.

In labor markets, Directors stressed the importance of strengthening effective labor supply, including by tightening eligibility for benefits and sharpening the incentives for job search, as well as by fostering in many cases more flexibility in wage determination.

In product markets, there was room to promote competition in key sectors and remove administrative barriers to business formation as well as to some cross-border activities. On the financial sector, Directors welcomed the intention of the euro-area authorities to keep the prevailing supervisory arrangements under review in order to ensure they continued to work effectively, particularly as the interbank market became more closely integrated and pan-European institutions resulted from ongoing consolidation. Directors also discussed whether some consolidation or strengthened coordination of the existing institutional arrangements would be desirable and expressed a variety of views on that matter. It was also noted that further steps were needed to increase the integration of capital markets and the transparency of banking institutions in the euro area, for example, by addressing the relatively weak disclosure rules and by instituting more uniformity in the provision of accounting information, including better reporting of nonperforming loans.

European Union (EU) internal surveillance over structural reforms had proven to be helpful, but Directors argued that its effectiveness depended on its candor. As for EU surveillance over fiscal policies, they agreed the annual appraisals of stability programs by the Commission and the Economic and Finance Council of Ministers of the European Union (ECOFIN) had proved beneficial and should continue. In that connection, Directors also noted the increasing role of the Euro Group as a forum for peer review, policy coordination, and harmonization.

Directors acknowledged the adequacy of existing statistical data for surveillance purposes, but called for strengthening the euro area's statistical base in the dimensions most critical for monetary policy decision making.

### *Recent Developments in EU Trade Policies*

Directors welcomed the EU's commitment to an early launch of a new round of multilateral trade negotiations, and the EU Commission's initiative in promoting free access for the exports of the world's poorest countries. They urged the EU to put in place quickly its latest proposal in favor of these countries. Directors recognized, however, that support for new multilateral negotiations would be strengthened if the EU also addressed the most restrictive and complex aspects of

[1]The European Council's June 1997 agreement to secure budgetary discipline in member states during the final stage of European Economic and Monetary Union; it also called for annually updated, medium-term stability programs.

its own trade regime—including through a faster liberalization of agricultural, textile, and clothing markets, a reduction of subsidies, and a review of antidumping policy.

Looking ahead, the impact of the EU's policies on trade also had to be kept in mind as the EU was enlarged. Directors welcomed the EU's reliance on the procedures of the World Trade Organization's Dispute Settlement Body to resolve its bilateral trade disputes and encouraged it to abide by the Dispute Settlement Body's rulings. Directors also called on the EU to minimize the potential for regional and bilateral trade agreements to lead to trade diversion by pursuing multilateral trade liberalization at a similar pace.

CHAPTER 3

# Strengthening the International Financial System

During FY2001, the IMF made progress on a range of initiatives launched over the past several years to strengthen the architecture of the international financial system—and to strengthen the IMF as a center of excellence for the stability of the international financial system. These efforts were reinforced at its 2000 Annual Meetings in Prague when the membership endorsed the Managing Director's vision of focusing the IMF's work on promoting international financial stability as a global public good—especially through stronger efforts to prevent financial crises, but also by helping resolve crises more effectively when they occur. Subsequently, the IMF intensified its efforts to foster the implementation of reforms by members, including strengthening their financial sectors.

Among the major steps taken toward strengthening the IMF were:

- further increasing the transparency of the IMF's operations and policy deliberations and of its members' economic policymaking and data;
- moving beyond the pilot phase of the Financial Sector Assessment Program (FSAP)—the joint IMF–World Bank program designed to help strengthen member countries' financial sectors—with the goal of covering about 24 countries each year;
- taking steps to improve the IMF's analytical framework for assessing countries' external vulnerability to financial crisis, developing a framework for evaluating the adequacy of reserves, and with the World Bank, developing guidelines for both public debt and foreign exchange reserves management;
- establishing a new International Capital Markets Department to improve the IMF's understanding of international financial markets and financial flows;
- establishing a Capital Markets Consultative Group as a channel for regular, informal, and constructive dialogue with private sector representatives;
- moving forward with assessments of offshore financial centers and, at the request of the International Monetary and Financial Committee and in collaboration with the World Bank, enhancing the IMF's contribution to international efforts to combat money laundering.

Also critical to strengthening the international financial system and improving crisis prevention has been the work on internationally recognized standards and codes of good practice in policymaking, in areas that directly benefit macroeconomic policies and the functioning of financial markets. Throughout FY2001, the IMF continued to work with countries to improve the availability and quality of data needed for the analysis of vulnerability to crisis—particularly through wider use of the IMF's Special Data Dissemination Standard (SDDS) and the General Data Dissemination System (GDDS)—and to work on assessing and implementing standards of transparency in fiscal, monetary, and financial sector policies. In January 2001, the Executive Board agreed on a list of international standards and codes relevant for IMF surveillance (see Table 3.1) and how staff assessments of members' implementation of these standards and codes would be discussed in the context of surveillance and made public, while paying due regard to their voluntary nature. Reports on the Observance of Standards and Codes (ROSCs) were established as the principal tool for assessing members' implementation.

Also during the financial year, a framework for the involvement of the private sector in crisis prevention and management was agreed in Prague. The IMF subsequently gained experience in the practical issues involved in applying the framework in two emerging market countries facing financial crises: Argentina and Turkey. Work also advanced on two issues that have a bearing on the development of the framework—restructuring international sovereign bonds and corporate sector workouts.

A central element of strengthening the international financial system—and the IMF itself—is improved provision of information to the markets. The IMF made further strides in FY2001 with its own transparency initiatives, most notably through an Executive Board

Table 3.1
**Standards and Codes Useful for IMF and World Bank Operational Work**

**Group 1: The initial set of areas defined as within the IMF's direct operational focus when the ROSC pilot was initiated.**

***Data Dissemination:*** IMF's Special Data Dissemination Standard/General Data Dissemination System (SDDS/GDDS).

***Fiscal Transparency:*** IMF's Code of Good Practices on Fiscal Transparency.

***Monetary and Financial Policy Transparency:*** IMF's Code of Good Practices on Transparency in Monetary and Financial Policies (usually assessed under the FSAP).

***Banking Supervision:*** Basel Committee's Core Principles for Effective Banking Supervision (BCP) (usually assessed under the FSAP).

**Group 2: These additional areas are assessed under the FSAP.** The IMF's focus on financial sector monitoring under surveillance, and the development of the FSAP as the principal means to conduct that monitoring, combined with the World Bank's responsibility for financial sector development, also make these areas of direct operational focus for both institutions.

***Securities:*** International Organization of Securities Commissions' *Objectives and Principles for Securities Regulation*.

***Insurance:*** International Association of Insurance Supervisors' *Insurance Supervisory Principles.*

***Payments Systems:*** Committee on Payments and Settlements Systems' *Core Principles for Systemically Important Payments Systems.*

**Group 3: These areas were highlighted as important for the effective operation of domestic and international financial systems by the IMF Executive Board and are now being assessed by the Bank under the ROSC pilot.**

***Corporate Governance:*** OECD's *Principles of Corporate Governance.*

***Accounting:*** International Accounting Standards Committee's *International Accounting Standards.*

***Auditing:*** International Federation of Accountants' *International Standards on Auditing.*

***Insolvency and Creditor Rights:*** various.

decision allowing voluntary publication of all staff country reports and other country documents. Key policy documents on a wide range of topics have also been released publicly, and a vast array of data on the IMF's finances are published regularly, including the IMF's quarterly financial transactions plan. The chairman of the Executive Board also now issues a statement summarizing Board discussions of loan requests. In addition, the Executive Board continued to encourage members to be more transparent about their economic and financial policies, and roughly 95 percent of country policy documents—in which countries borrowing from the IMF set out in advance their policy program—were released publicly during FY2001.

At its April 2001 meeting, the IMFC welcomed the program outlined in the Managing Director's report on the "IMF in the Process of Change." It strongly endorsed the IMF's strengthened efforts to put crisis prevention at the heart of its activities and the moves to strengthen the IMF's focus on financial markets. Noting in particular the work on implementing standards and codes, assessing external vulnerability, improving transparency, and strengthening financial sector surveillance, the Committee welcomed the continued progress in implementing previous IMF initiatives. Looking forward, the IMFC called for more work on applying the framework for private sector involvement, early warning indicators, and action by the IMF on combating money laundering. (The IMFC communiqué appears in Appendix VI.)

This chapter describes progress during FY2001 on the IMF's agenda of initiatives to strengthen the international financial system. More detailed and up-to-date information can be found on the IMF website.

## Financial Sector Assessment Program

The role that financial sector weaknesses have played in the eruption and spread of financial crises in recent years, and the important links between the financial sector and a country's overall economic health, have led the IMF to intensify its focus on financial sector surveillance. Assessment of the vulnerability of member countries' financial sectors has been strengthened through the joint IMF–World Bank Financial Sector Assessment Program (FSAP; see Box 3.1), which was initially launched as a pilot program in May 1999. The FSAP is intended to strengthen the monitoring and assessment of financial systems in the context of IMF country surveillance and the World Bank's financial sector development work.

The value of the FSAP lies in the significant improvement in financial sector oversight it will engender. In addition, several benefits flow from its joint IMF-World Bank sponsorship, as well as from the expert support it receives from more than 50 cooperating institutions, including central banks, supervisory

**Box 3.1**

### IMF–World Bank Financial Sector Assessment Program

The 1997 Asian financial crisis highlighted once again how a nation's vulnerability to currency crisis depends on the health of its financial sector. In the wake of the crisis, the IMF and World Bank launched the *Financial Sector Assessment Program (FSAP)*. The FSAP is a comprehensive health checkup of a country's financial systems. Financial systems consist of the whole range of financial institutions, such as banks, mutual funds, and insurance companies, as well as the financial markets themselves, that is, securities, foreign exchange, and money markets. Financial systems also include the payments system and the regulatory, supervisory, and legal frameworks that underlie the financial institutions and markets.

The FSAP seeks to alert member countries to likely vulnerabilities in their financial sector and to help the Bank and the IMF—and the international community—formulate the appropriate assistance. Joint teams of Bank and IMF staff—supported by experts from a range of cooperating central banks, national supervisory agencies, and international standard-setting bodies—conduct the assessment. Countries' participation in the program is voluntary.

#### The Checkup

The FSAP teams examine the strengths, risks, and vulnerabilities of a country's financial system by assessing:

- the stability of the financial system, including macroeconomic elements that could affect the system's performance and conditions in the system that could affect macroeconomic developments;
- the extent to which relevant financial sector standards, codes, and good practices are observed; and
- the reform and development needs of the financial sector.

#### Methods and Tools

Some of the FSAP teams' methods and tools have been fine-tuned especially for the program.

- *Stress testing and scenario analysis.* How well would the country's financial institutions handle trouble? Stress tests and scenario analysis show whether individual institutions, and the banking sector as a whole, would remain solvent in the face of shocks such as large changes in world interest rates or movements in exchange rates, or a bursting asset price bubble.
- *Macroprudential analysis.* The FSAP also provides a reading on indicators—called "macroprudential indicators"—that have in the past signaled crises. For example, high short-term borrowing in foreign currencies (more than a country's foreign exchange reserves) has been associated with many past crises. High readings on such indicators that have signaled crises in the past may suggest the need for remedial measures.
- *Standards assessment.* To what extent does the country follow internationally accepted standards and codes, such as the Basel Core Principles for Effective Banking Supervision? This assessment allows the government to compare its regulatory, supervisory, and other practices against internationally accepted standards and codes of good practice elsewhere in the world. It also provides a basis to judge how well supervisors are managing risks and vulnerabilities in the financial system.

#### A Full Program

Assessments conducted under the FSAP are not ends in themselves. Their primary use is by member country authorities, who use the results to diagnose potential weaknesses in their financial systems. In addition, analysts integrate the results of this checkup into the work of the IMF and World Bank. At the IMF, staff members prepare a *Financial System Stability Assessment (FSSA)* summarizing the main results of the FSAP for the IMF's Executive Board. The FSSA is considered in the context of the country's Article IV consultation discussion. Thus, the FSSAs link the findings of the program to the monitoring of financial systems under IMF surveillance.

agencies, and other institutions and standard-setting bodies. This ensures consistency of policy advice by the IMF and the Bank, economizes on scarce expert resources, and enhances the program's legitimacy.

In its pilot phase, the FSAP involved a dozen countries that ranged widely in the degree of development of their financial systems—from such industrial countries as Canada and Ireland to such emerging market and transition countries as South Africa and Kazakhstan, and such developing economies as Cameroon and El Salvador.

The Executive Directors of both the IMF and the World Bank first reviewed the pilot program in the spring of 2000, when they agreed to expand the program to about 24 countries over the following 12 months. After the completion of the missions to all 12 pilot countries, the work with the second round of country cases, and the feedback and support received from participating countries and cooperating institutions, the Executive Boards of the IMF and the World Bank further reviewed the program in December 2000 and in January 2001, respectively. The FSAP received strong support from both Boards; for the IMF's part, its Executive Board found that the program provided a coherent and comprehensive framework to identify financial system vulnerabilities and strengthen the analysis of macroeconomic and financial stability issues, to assess financial sector development needs and priorities, and to help authorities develop policy responses.

The Board also considered that a variety of criteria could appropriately be employed to establish priorities in selecting country cases in the face of limited

resources, including a country's systemic importance; its vulnerability to a currency or balance of payments crisis; the nature of its exchange rate and monetary regime; and geographic balance among countries. All in all, Directors agreed that the country selection should be such as to help maximize the program's contribution to the strengthening of national and international financial stability. Most Directors noted that within any one year, giving high priority in the FSAP country selection process to systemically important countries would be warranted. It was noted that prioritization in this sense means a difference in timing, not treatment. At the same time, Directors continued to stress the merit in maintaining broad country coverage in the program.

Based on these reviews, the Executive Boards of the IMF and the Bank established guidelines for the program in the period ahead.

- The program should continue at a similar or somewhat higher intensity than before (up to 24 country assessments a year). Within any one year, priority would be given to countries of systemic importance and those with external sector weaknesses or financial vulnerability. The ultimate goal, however, would be to assess the entire membership so that all countries have the opportunity to benefit from the program.
- With a view to maintaining adequate monitoring of financial sector systems in years between full assessments, for countries that have already participated in the FSAP, focused updates of Financial Sector Stability Assessment (see Box 3.1) findings could be undertaken in the context of subsequent country (Article IV) consultations. In cases where a country volunteers to participate in the program, but cannot be accommodated immediately, or if a country chooses not to participate in the program, country consultation (Article IV) mission teams could be reinforced with financial sector experts. Nevertheless, the full FSAP exercise remains the preferred vehicle for conducting financial sector assessments as input to IMF surveillance.
- IMF staff, in collaboration with other international organizations and standard-setting bodies, will further develop analytical techniques for use in the program, including macroprudential indicators, stress tests and scenario analysis, and methods for assessing financial sector standards.
- To emphasize the importance of follow-up by the Bank and the IMF, both institutions will seek to ensure that the strategic components of the assessment are reflected in other aspects of country work, and that appropriate technical assistance and other support be provided to national authorities requesting it to help them build the necessary institutional capacity.
- At the December 2000 review, the IMF's Executive Board decided that FSSAs could be published after the conclusion of the associated country consultation, if the member concerned so requests. In light of the conditions under which the Board approved the pilot study, however, publication of the FSSAs for the 12 countries participating in the program pilot was not authorized.

## Standards and Codes

One of the principal means for reducing the risk of financial crises has been the development of international standards and codes of economic and financial good practice, and the promotion of their implementation. This work was begun as far back as 1988, when the Basel Core Principles for Effective Bank Supervision were issued. Indeed, many countries—especially those with developed financial markets—have long had *national* standards and codes. In the last two years, the work has accelerated toward articulating new standards that are *internationally* recognized and so allow for greater cross-country comparability and benchmarking, with much of the work done at the IMF and World Bank along with the Financial Stability Forum. At the same time, greater rigor, context, and focus have been added to the standards themselves and to the assessment of their implementation.

### *Experience with Basel Core Principles Assessments*

The Basel Core Principles Assessments by the IMF and World Bank, with assistance from a number of cooperating institutions, aim to judge the adequacy of member countries' rules for banking supervision and of the supervisors' ability to monitor and limit major risks run by banks.[1] In May 2000, Executive Directors reviewed the experience with 26 assessments. They considered Core Principles Assessments to be a crucial element of the broader financial sector assessment program (FSAP; see above). At its May discussion, the Board noted the following:

- Results from the 26 Basel Core Principles Assessments demonstrated serious weaknesses in banking supervision in many countries, especially in risk management, implementation of corrective actions, and consolidated supervision. Additional

[1]The 25 Core Principles cover seven broad areas: (1) preconditions for effective banking supervision (which differ from the general preconditions, and cover issues such as independence, responsibilities, legal framework, and information sharing); (2) licensing and structure; (3) prudential regulations and requirements; (4) methods of ongoing supervision; (5) information requirements; (6) the formal powers of supervisors; and (7) cross-border banking.

sources of weakness arose from defects in many of the preconditions for effective banking supervision—loan valuation procedures, accounting systems, legal processes, and market discipline.
- The Basel Committee's detailed methodology for compliance assessment had improved the quality of assessments, bringing out more clearly the weaknesses in the framework for effective supervision, and had contributed to consistency and uniformity of approach across the membership.
- While self-assessments had tended to be more optimistic than Basel Core Principles Assessments conducted by the IMF and the World Bank, they could be valuable if prepared on the basis of the new methodology and if followed by an independent assessment.
- There were advantages in doing Basel Core Principles Assessments in the context of a broader Financial Sector Assessment Program in providing better perspectives on financial vulnerabilities. Nonetheless, stand-alone assessments continued to have a role as part of a technical assistance program, or in the course of drawing up a reform agenda, or as modules for ROSCs.

Directors urged national authorities in the 26 countries to take needed corrective actions expeditiously. They agreed that technical assistance should focus on addressing these weaknesses, and that resources for this purpose should continue to be carefully evaluated and increased as needed.

### Assessing the Implementation of Standards

The IMF initiated a pilot program in January 1999 for summary assessments of members' implementation and observance of internationally recognized standards in those areas of direct concern to the IMF, and where it had relevant technical expertise. These summary assessments were later named Reports on the Observance of Standards and Codes (ROSCs).

In September 1999, the Executive Board agreed to an approach to ROSCs whereby different institutions could be invited to take primary responsibility for undertaking assessments in their respective areas of competence. The World Bank subsequently identified areas in which it would be prepared to experiment with the preparation of ROSC assessments, namely, corporate governance, accounting and auditing, and, when standards are available, insolvency and creditor rights.

During FY2001, the pace of preparation of ROSCs picked up. Many more countries volunteered for ROSCs and sought technical assistance to help with implementation. By the end of April 2001, 114 ROSCs had been completed and 75 published, an increase of 25 percent over September 2000.

In January 2001, Executive Directors reviewed the experience to date with assessing and implementing standards and discussed the next steps. They agreed that developing and implementing standards in areas relating to members' economic and financial systems was central to strengthening the architecture of the international financial system. While the work on standards was not new, increased attention to standards, and the introduction of standards assessments, would help sharpen the focus of IMF policy discussions with national authorities and strengthen the functioning of markets. Directors saw the broad-based participation of member countries in the initiative, together with closer contact with standard setters and growing interest in the private sector, as a sign of the increasing momentum of the work on standards (see Box 3.2).

In response to a request from the IMFC, Executive Directors agreed on modalities by which members' observance of standards and codes should be discussed in the context of Article IV surveillance. Directors endorsed a list of 11 areas where standards were considered important for surveillance (see Table 3.1)—while noting that not all standards were relevant for all countries at all times. They also agreed that ROSCs should be established as the principal tool for assessing implementation, that ROSCs would feed into surveillance, and that the reports could be made public with the member's agreement.

During the discussion, Directors stressed the importance of:
- maintaining the voluntary nature of standards and preparation of Reports on the Observance of Standards and Codes;
- avoiding the use of pass-fail grades in ROSCs;
- maintaining a standardized format for all ROSCs; and
- giving credit for progress achieved rather than just highlighting areas where more work was needed.

Directors emphasized that ROSCs should reflect the different conditions across the membership while at the same time preserving consistency across countries and maintaining the universality of standards. There was also a call for more outreach to the private sector, more research on the link between implementing standards and crisis prevention, and for greater prioritization in assessments.

While recognizing the need to preserve consistent definitions across countries, a number of Directors were concerned about the process of developing and assessing standards. They stressed the importance of ownership and of ensuring that all members had a role in shaping and guiding the work on standards; the key aspect of achieving this aim would be regular reviews by the Board of the modalities under which assessments take place and of the list of standards used for such assessments. Directors welcomed the steps already taken to address the concerns raised by some members,

**Box 3.2**
### Outreach on Standards and Codes

During FY2001, the IMF and World Bank staff launched an outreach program of seminars and other activities to explain the role of standards and codes in helping countries develop sound economic and financial systems, describe progress in developing standards, provide information on the results of assessments of compliance with standards and codes (summaries of which are available as ROSCs), and seek feedback on this work. These sessions were complemented by participation in events organized by other bodies. Among the highlights:

- The initial round of IMF-Bank regional seminars (in Tokyo, Hong Kong SAR, Bangkok, and Singapore in July 2000) attracted almost 200 representatives of the financial and nonfinancial private sector, media, academics, and government officials. While knowledge of the work under way was relatively limited before the seminars, participants showed considerable interest in and support for the efforts on standards.
- The IMF and Bank coordinated their outreach activities with an informal dialogue on market incentives conducted by the Financial Sector Forum's Follow-up Group on Incentives to Implement Standards. Almost 100 financial institutions from 11 jurisdictions (Argentina, Australia, Canada, France, Germany, Hong Kong SAR, Italy, Japan, Sweden, the United Kingdom, and the United States) took part in the exercise.
- The IMF and World Bank jointly hosted a conference in Washington in March 2001 on international standards and codes. The conference provided an opportunity for representatives of a number of emerging market and developing countries to voice their concerns about the way in which some standards were developed and the appropriate pace of implementation. Despite these concerns, all participants agreed on the value of standards to macroeconomic stability, economic performance, and improved financial decision making, with a number of market participants strongly advocating the benefits of greater transparency.
- Subsequent rounds of seminars (held in the Czech Republic, Argentina, Belgium, Brazil, Chile, Egypt, South Africa, the United Kingdom, Australia, the Philippines, Bahrain, and Hong Kong SAR) found a much higher level of familiarity with international standards and codes than at previous seminars. There was a fundamental acceptance of the value of international standards and codes for guiding good economic and financial practices. Private sector participants suggested that the markets' use of ROSCs would be closely linked to the timeliness with which ROSCs are produced and disseminated, their standardization, and the availability of substantive updates on a regular basis.

These outreach exercises have demonstrated growing interest in the work on standards. A number of financial institutions have begun incorporating the results of standards assessments into their risk assessments. One private sector organization is setting up an extensive database that will track countries' observance of international standards, and major financial institutions have already subscribed to this service. Many market participants have suggested ways to improve the usefulness of ROSCs, including comprehensive coverage of countries, more frequent assessments, and consistent treatment and language between countries, as well as in the packaging of information.

including prioritizing assessments so that members were assessed against only those standards relevant to their situation; and the fact that, in several cases, standard setters had adopted a multitrack approach, setting out benchmarks for countries at different stages of development. They also welcomed the proposal to include authorities' views on ROSC assessments. To ensure uniform treatment, Directors agreed on the importance of filling the current gap in procedures so that industrial countries could be assessed against standards for which the World Bank was in the lead. Staff should experiment with ways to fill this gap, including by allowing Bank experts to prepare assessments in the context of IMF missions.

A further overall review of experience with standards assessments should take place in two years, Directors agreed. In the meantime, the list of standards could be revised by the Board as appropriate. The Board subsequently agreed that the Financial Action Task Force (FATF) 40 Recommendations be recognized as the appropriate standard for combating money laundering (see below, under "Other Efforts to Strengthen Financial Sectors"). Periodic reviews of individual standards would also continue.

During the outreach activities and Board discussions, there were calls for more, and better coordinated, technical assistance to support members' implementation of standards. At a Board meeting in January 2001 on technical assistance, Executive Directors identified standards as one of the six priority areas for IMF technical assistance. They also suggested that the IMF should intensify coordination and collaboration with other providers of technical assistance, including with respect to technical assistance relating to standards and codes.

In March 2001, the IMF Board approved a revision of the *Code of Good Practices on Fiscal Transparency* as well as the accompanying *Manual on Fiscal Transparency* with the objective of placing greater emphasis in the code on the importance of fiscal data quality.

## Data Provision to the IMF for Surveillance Purposes

In June 2000, Executive Directors discussed proposals to strengthen members' data provision to the IMF for surveillance purposes, including the establishment of benchmarks for the provision of certain data. They recognized that recent financial crises had reinforced the importance of accurate, comprehensive, and timely economic data—especially on international reserves and external debt—for the assessment of countries' external vulnerabilities and as an essential element for IMF surveillance. Directors were thus encouraged that a large majority of members provided data on core statistical indicators on a timely basis. For some countries, however, progress toward timely and accurate reporting had been slow, owing to resource constraints and the long gestation period needed for statistical capacity building.

Directors agreed with a staff proposal to establish benchmarks for data on reserves, foreign currency liquidity, and external debt, although it was generally accepted that some elements of the benchmarks would not always be relevant for all members given countries' different circumstances and phases of development. Directors noted that the data required for adequate IMF surveillance in some cases may be more detailed and timely than implied by the benchmarks. In this sense, the benchmarks should be viewed as neither a compulsory floor nor a ceiling, but rather as a framework to help assess members' data provision to the IMF. Many Directors emphasized that staff reports should compare countries' practices with these benchmarks, indicating the reason for any differences, their significance, and, if appropriate, the member's plans for strengthening data provision in these areas. Some Directors were concerned that the benchmarks could gradually become de facto obligatory standards, and that this would inappropriately burden already scarce resources, especially in developing countries. Most Directors agreed that the approach of using benchmarks, rather than absolute standards, was appropriate in view of the diversity of members' circumstances.

The detailed specification of the benchmarks was warranted by the importance of the need for comprehensive, timely, and comparable information. Most Directors agreed that the Special Data Dissemination Standard (SDDS) prescription for reserves and foreign currency liquidity should be adopted as the benchmark for provision of these data to the IMF. Most Directors also supported adoption of the prescribed and encouraged elements of the SDDS for external debt as the benchmark for these data. Still, many Directors stressed that providing data on the debt-service schedule for the private nonbank sector was difficult for many countries, and they encouraged the staff to bear this difficulty in mind.

The benchmark approach would increase resource costs to the IMF and member countries. Directors emphasized that the IMF would need to provide technical assistance to help countries strengthen their data systems in line with the benchmarks.

The Board also emphasized the critical importance of high-quality, accurate, and comparable fiscal data, and urged the staff to continue working to improve members' provision of fiscal data to the IMF. Establishing a benchmark for fiscal data similar to the ones for reserves and external debt would be a difficult task at present; nonetheless, many Directors underscored the importance of continuing to work expeditiously on the methodological issues related to the development of such a benchmark. Directors also encouraged the staff to continue providing technical assistance to help member countries strengthen their fiscal data.[2]

Directors underlined the importance of establishing a practical framework for assessing the quality of data and welcomed the staff's intention to carry forward its work in this area.

## External Vulnerability

During the financial year, much was done to sharpen the focus of IMF surveillance on member countries' vulnerability to crises. Work proceeded on helping member countries in the assessment of reserve adequacy and reserve management, and in identifying principles for prudent external liability management. The IMF is also improving its work on vulnerability indicators and early warning system (EWS) models to help inform discussions with authorities on fiscal, monetary, and exchange rate policies.

### *Reserves Adequacy and Management*

The IMF stepped up its efforts to assist members in the assessment of reserves adequacy, an essential aspect of preventing liquidity-related crises. Because the provision of accurate, comprehensive, and timely data on international reserves is essential to the analysis of external vulnerability, the IMF promoted members' use of the data template on international and foreign currency liquidity, which was developed jointly by the IMF and the BIS and provides a benchmark to assess the adequacy of provision of data to the IMF on official foreign currency reserves and their liquidity. The adequacy of the level of reserves itself is increasingly being analyzed within an extended framework highlighting capital-account-based measures for countries with market access—in addition to the traditional current-account-based ratios. The IMF, in collaboration with

[2]Later in the year, the Board approved a revision of the *Code of Good Practices on Fiscal Transparency* and the accompanying *Manual on Fiscal Transparency* with the aim of placing greater emphasis in the code on the importance of fiscal data quality.

the World Bank, hosted roundtables and hands-on working groups to help national authorities assess reserve adequacy and held a Policy Forum on reserves during the Spring 2001 Meetings. Stress testing the balance of payments is another promising component of the analysis of liquidity requirements. More generally, judgments on reserve adequacy will need to take full account of other country-specific factors, in particular macroeconomic fundamentals.

In May 2000, the Executive Board discussed the role of debt- and reserve-related indicators of external vulnerability in crisis prevention (Box 3.3). These and other quantitative indicators were agreed to be important tools for strengthening the analysis of vulnerability and for indicating the need for adjustment in macroeconomic and prudential policies by aiding a structured and more systematic discussion of individual cases. The Board also, however, considered that exclusive reliance on such indicators was unwise and that they must be interpreted carefully, in the context of a complete analysis of a country's external position and overall macroeconomic prospects.

Guided by the Board's May discussion, the IMF staff worked on a set of draft guidelines on foreign exchange reserve management. The work benefited from an outreach meeting held in July 2000 with representatives of reserve management authorities from about 30 member countries, as well as the BIS and the World Bank. Participants at that meeting endorsed the idea of preparing a set of broad guidelines on reserve management that would articulate objectives and principles as well as institutional and operational foundations to guide practices, while recognizing that there is no unique set of reserve management practices or institutional arrangements that is best for all countries or situations.

Preliminary guidelines have been circulated to this outreach group and their comments were also made available to the IMF's Executive Board. After incorporation of comments received, the draft guidelines will be further developed through consultations with a broader range of participants through regional outreach meetings. Revised draft guidelines are expected to be submitted to the Executive Board before the September 2001 IMFC Meetings.

**Box 3.3**
### A Quiet Revolution in Reserves Policies

In May 2000, Executive Directors discussed a staff paper entitled *Debt- and Reserve-Related Indicators of External Vulnerability*. The paper elaborated on the idea—put forward by a number of academics and policymakers—that reserve adequacy depends not only on the current account transactions of a country (as in the conventional ratio of reserves to imports), but also on its capital needs (especially, short-term debt servicing). Specifically, the paper proposed to use coverage of short-term debt by remaining maturity as a new rule of thumb, or starting point, for analyzing the adequacy of reserves and targeting its level for countries with significant but not fully certain access to capital markets. Indeed a "quiet revolution" has taken place, moving the assessment of reserve adequacy away from trade-related indicators as many countries have raised reserve levels in relation to short-term debt.

## Debt Management Guidelines

The IMF and the World Bank worked together to develop a set of guidelines to assist countries in their efforts to improve their public debt management practices. An early draft of the guidelines was discussed by the Executive Boards of the two institutions. Staff subsequently revised the guidelines to reflect views of Directors and comments received during an extensive consultation with more than 300 representatives from 122 countries and 19 institutions. The exercise was designed to strengthen the ownership of the guidelines by IMF members and to help ensure that they are in line with sound practices and well understood and accepted by policymakers, debt managers, and market participants.

At a Board meeting in March 2001, Executive Directors welcomed the revised guidelines as a useful instrument to assist countries in their efforts to improve their public debt management practices and reduce financial vulnerability. Directors emphasized the importance of coordination among debt management, fiscal, and monetary authorities, and indicated that the implementation of the guidelines will vary with a country's circumstances and institutional constraints. They also stressed the important role that technical assistance from the Bank and IMF will play in helping countries implement the guidelines. They noted that the guidelines at times can serve as useful benchmarks for both country authorities and the IMF in the context of country surveillance.

The guidelines have been published by the IMF and World Bank on their external websites. A report containing sample case studies of countries that have developed strong systems of public debt management will be prepared by IMF and World Bank staffs in due course.

## Early Warning Systems and Vulnerability Indicators

The IMF has continued its work to improve its methods for assessing the likelihood of foreign exchange crises. Early Warning Systems (EWS)—formal models that estimate the probability of crises from a set of variables—are important tools to monitor risks that arise from conditions in member countries and international markets. Staff have increasingly used results of EWS work and analyses of relevant indicators to inform and

strengthen surveillance discussions, including periodic World Economic and Market Development presentations to the Board. The work on EWS has also provided analytical support for the use of key indicators of vulnerability now reported in staff country reports. Staff have also had some direct contact with authorities interested in developing national or regional EWS. Nevertheless, while EWS and indicators of vulnerability are helpful tools in discussions of vulnerability with country authorities, the results must be qualified by individual country circumstances. The limitations of these models and of vulnerability indicators as crisis predictors has necessitated continued caution in their use for country surveillance.

Efforts to strengthen and systematize further the IMF's approach to analyzing external vulnerability continue, including through empirical research, internal working groups, and external outreach, such as collaboration with the Financial Stability Forum. Work on vulnerability is also conducted in the context of the work on standards and the Financial Sector Assessment Program. The establishment of an International Capital Markets Department (see Box 3.4) is also intended to strengthen the IMF's work on identifying and reducing members' vulnerability.

## Involving the Private Sector in Resolving Financial Crises

Private sector involvement in the resolution of financial crises refers to the participation of private creditors in the financing of a stabilization program. This can take a variety of forms, including spontaneous new inflows, the direct provision of new money, and arrangements for creditors to maintain exposure, including coordinated rollover of interbank credit, bond exchanges and reschedulings, and restructurings. Such private sector involvement is important to ensure that programs are fully financed, against the background of limitations on the availability of IMF financing, and for strengthening market discipline. Requiring creditors to bear risks also helps prevent moral hazard—the danger that investors' expectations of official rescues encourages risky lending.

During the first half of FY2001, the Executive Board built on the guidelines provided to them in April 2000 by the International Monetary and Financial Committee and took steps toward refining a framework for private sector involvement. In the second half of the financial year, the IMF gained experience in the practical issues involved in applying the framework to two major emerging market members facing financial crises: Argentina and Turkey. To develop the framework on private sector involvement, the IMF also discussed the modalities of international sovereign bond restructurings and corporate workouts. In both cases the catalytic approach to mobilizing financing was complemented by agreements and understandings with specific creditors—international banks in the case of Turkey, and international and domestic banks and pension funds in the case of Argentina.

### Developing the Operational Framework

Reviewing the status of the framework in September 2000, the Board agreed that views had converged on many topics. Valuable experience had been gained with involving the private sector in the resolution of individual cases, and with lessons learned by debtors, private creditors, and the official sector. This experience had highlighted the strengths, as well as the limits, of the tools currently available to the international community for securing private sector involvement. Notwithstanding that progress, Directors concurred that more needed to be done to make policies in this area opera-

**Box 3.4**
**IMF Creates International Capital Markets Department**

On March 1, 2001, the Managing Director announced plans to establish a new International Capital Markets Department in the IMF to enhance its surveillance, crisis prevention, and crisis management activities. The new department will consolidate activities and operations previously spread among three departments (Policy Development and Review, Monetary and Exchange Affairs, and Research). The new department is also expected to have some added responsibilities, including systematic liaison with the institutions that supply or intermediate the bulk of private capital worldwide. The department will also play a central role in the IMF's conceptual work related to the international financial system and to capital market access by member countries.

The new department will play a vital part in the ongoing efforts to strengthen the international financial architecture, and in particular to strengthen the IMF's role in preventing financial crises. In announcing the decision, Managing Director Horst Köhler indicated that the establishment of the department sends a clear signal that the IMF is serious about its commitment to being a center of excellence for work on financial markets issues. The new department will:

- deepen the IMF's understanding of capital market operations, and of the forces driving the supply of capital;
- strengthen the IMF's capacity for addressing systemic issues related to capital market developments;
- enable the institution to conduct more effective surveillance at both the national and international levels;
- enhance the IMF's capabilities in providing early warning of potential stress in the financial markets; and
- strengthen the IMF's ability to help member countries gain access to international capital markets, and to deal with and benefit from interactions with international capital markets.

tional, in order to strike the right balance between the clarity needed to guide market expectations and the operational flexibility anchored in clear principles needed to allow the most effective response in each case. It was also important for the official sector to discuss the implications of the emerging framework openly with the private sector and, in this connection, Directors welcomed the establishment of the Capital Markets Consultative Group (see Box 3.5).

Directors stressed that the first line of defense against a financial crisis continued to be a country's pursuit of sound policies, good debt management, and effective supervision over financial systems, and that the IMF's primary tool for prevention was surveillance. Beyond the traditional policy areas, surveillance was now focusing on enhancing the environment for private sector decision making through measures to improve the transparency of members' policies, the development and strengthening of standards and codes, and the assessment and reduction of members' vulnerability to financial crises.

Despite the adoption of preventive measures, Directors recognized that members might at times face serious stress in their external accounts. Voluntary solutions to emerging payments difficulties—if feasible—offered the best prospect of mobilizing financing in a way that minimized harmful effects for the member's prospects of regaining spontaneous access, and for the efficient workings of capital markets more generally. If efforts to reach agreement on a voluntary approach were not successful, however, concerted private sector involvement might be required to achieve an orderly resolution.

Directors discussed an operational framework suggested by staff for involving the private sector. They agreed that, under the suggested framework, the IMF's approach would need to be a flexible one, and the complex issues involved would require the exercise of considerable judgment. They called on the staff, in bringing program documentation to the Board, to be clear about the financing that is expected to come from the private sector for the member's program.

- In cases where the member's financing needs are relatively small or where, despite large financing needs, the member had good prospects of regaining market access in the near future, the combination of strong adjustment policies and IMF support should be expected to catalyze private sector involvement.
- In other cases, however, when an early restoration of market access on terms consistent with medium-term external sustainability was judged to be unrealistic, or where the debt burden was unsustainable, more concerted support from private creditors might be necessary, possibly including debt restructuring.

Directors agreed that the assessment of a member's prospects for regaining access to international capital

**Box 3.5**
### Capital Markets Consultative Group

Just before the September 2000 Annual Meetings in Prague, the IMF set up, at the behest of the Managing Director, a Capital Markets Consultative Group (CMCG) to foster a regular dialogue between IMF management and senior staff and representatives of the private financial sector. Part of the IMF's broader effort at constructive engagement with the private sector, the CMCG complements other channels, such as those involved in the staff's preparation of the *International Capital Markets* report and occasional regional meetings with financial sector participants. The overall aim of these meetings is to maintain a dialogue with the private sector in good times as well as bad, and to build on experience.

The CMCG meets several times a year, at various locations around the world, principally in the major financial centers. Representatives come from a range of financial institutions, including banks, investment houses, and institutional investors. All regions of the world are represented. The meetings are private and informal in nature.

Discussion at CMCG meetings covers a wide range of topics, and members speak candidly about their perspectives on developments in the global financial system. Specific topics covered include:

- developments and issues in financial markets and capital flows that may be of systemic or regional importance or have a bearing on IMF policies;
- measures and practices that could promote a more stable and efficient international financial system, including discussion of innovations in financial instruments and institutions, foreign direct investment, data dissemination, and possible market-based approaches to lessen and resolve financial distress;
- attitudes of the investment community toward developments in the global financial system and trends in investor perceptions;
- possible ramifications of initiatives of the IMF and of the official community more generally; and
- ways to promote the IMF's outreach and increase awareness in the private sector of measures and initiatives taken by the IMF.

Discussions in the CMCG do not address operational issues specific to a particular country or group of countries, nor do they involve the release of sensitive data or information to the members of the group. No policy commitments are made or suggested, and discussions and statements at the meetings may not be construed as implying such commitments.

markets in the near future was a critical element of the framework. They broadly agreed on the elements that would be relevant to assessing a member's prospects for regaining market access; these included the characteristics of the member's economy, including the profile of debt service and debt stock, and the strength of the fiscal accounts and the financial system; previous levels of market access and market indicators; the strength of macroeconomic and structural policies; the authorities' commitment to the reform program; the level of reserves and availability of financing; and the stage of the crisis and experience with creditor-debtor relations. Directors called on the staff to continue its work on the analytic issues involved, with a view to strengthening the ability to assess medium-term external vulnerability and the pace and magnitude of a resumption of market access by countries emerging from crisis.

The Board made progress toward agreeing on the circumstances in which the use of IMF resources would be conditioned on action to secure private sector involvement, although differences remained on the question of a formal link between the level of access to IMF resources and concerted private sector involvement. All Directors agreed that IMF operations should, to the extent possible, limit moral hazard and that the availability of IMF financing was limited. Directors also agreed that reliance on the catalytic approach at high levels of access to IMF resources presumed substantial justification, both in terms of its likely effectiveness and of the risks of alternative approaches.

### Standstills

As part of the September 2000 review, Directors also held a preliminary discussion of issues associated with the possible use of "standstills" in the context of resolving financial crises. Because little empirical evidence on the effects of standstills exists, the discussion was somewhat speculative. Directors noted that the term standstill covered a range of techniques for reducing net payment of debt service or net outflows of capital after a country has lost spontaneous access to international capital markets. These range from voluntary arrangements with creditors limiting net outflows of capital, to various concerted means of achieving this objective.

Directors considered that, when creditors are reasonably homogeneous and have an interest in maintaining a long-term relationship with the borrower, voluntary agreements to contain private capital outflows might be feasible. But they noted that, in extreme circumstances, if it were not feasible to agree on a voluntary standstill, a member might find it necessary, as a last resort, to impose one unilaterally. Nevertheless, Directors underscored that the approach to crisis resolution must not undermine the obligation of countries to meet their debt in full and on time. They stressed that the imposition of a standstill by one systemically important country could lead to substantial spillover effects on other countries, but the strength and duration of those effects would depend on circumstances. They noted that the complex operational issues that standstills raised warranted further consideration.

### Restructuring International Sovereign Bonds

In January 2001, Executive Directors reviewed the experience gained with the restructuring of international sovereign bonds by Ecuador, Pakistan, and Ukraine, and gave preliminary consideration to a private sector proposal on bond restructuring. Directors noted that financial markets now generally recognize that international sovereign bonds are not immune from debt restructuring, and that, if borrowers face severe liquidity crises, bondholders, along with other creditors, might need to contribute to the resolution of such crises. Directors also observed that recourse to restructuring sovereign bonds should be guided by the same principles that guide recourse to restructuring of other claims (that is, it should be limited to exceptional circumstances when financing needs are large, and the prospects for a member in crisis regaining voluntary market access are poor). Voluntary collective action clauses in bond contracts could play a useful role in the orderly resolution of crises; their explicit introduction in bond documentation would provide a degree of predictability to the restructuring process. Exit consents, as used in the Ecuador exchange, provided an innovative, albeit controversial, initiative that could be used in the context of restructuring international sovereign bonds that do not contain collective action clauses. While recognizing that it was premature to assess the impact of different processes used to restructure international sovereign bonds, Directors were concerned that some processes might have harmful spillover effects and could influence the efficient operation of international capital markets. They therefore urged those members that need to restructure bonds to make good faith efforts to reach collaborative agreements with their creditors.

### Corporate Workouts

In an informal workshop in January 2001, the Board discussed corporate sector workouts—in particular, their relevance for resolving corporate sector indebtedness during a systemic crisis in a fashion that would help restore financial sector stability and pave the way toward a resumption of sustainable growth. They also considered the role of workout mechanisms in promoting financial system stability.

## Practical Application of the Framework

In both Argentina and Turkey, the IMF's approach to private sector involvement was based on the expectation of continued market access by these countries,

their underlying payments capacity, and the risks of alternative approaches. The specific actions to strengthen support were:

- For Argentina, private sector commitments in December 2000 included agreement with local financial institutions to roll over maturing bonds and purchase new public issues (at market prices) of $10 billion; understandings with institutional investors on the purchase of new public issues of $3 billion; and liability management operations covering $7 billion of total debt (expected to reduce financing needs in 2001 by $2.7 billion). As of the end of April 2001, these commitments were being fulfilled despite difficult market conditions.
- For Turkey, a voluntary commitment was obtained in December 2000 from foreign banks to maintain aggregate exposure of $18 billion in the form of interbank and trade-related credit lines extended to the Turkish banking system at the December 11 level. (At the meetings in Frankfurt and New York, foreign banks were also asked to maintain exposure on trade lines provided directly to the nonfinancial corporate sector.) Until late January 2001, there were encouraging signs that bank lines were maintained, but the commitment had been conditional on continued stability in Turkey. When the February 2001 crisis developed, banks withdrew $3 billion of exposure.

### *Future Work*

Work is continuing in FY2002 to help strengthen the analytic underpinnings of the IMF's policy of involving the private sector in the resolution of financial crises. The Executive Board has asked for further work on promoting constructive relations between members and their creditors. It will also consider papers on strengthening the basis of assessing the pace and magnitude at which countries in crisis can regain market access. In developing further its work on the restructuring of the claims of private creditors, the Board will consider a paper concerning comparability of treatment between Paris Club and private sector claims.

## Other Efforts to Strengthen Financial Sectors

### *Offshore Financial Centers*

In July 2000, the Executive Board discussed the issues for the work of the IMF concerning offshore financial centers (OFCs). Directors underscored that the IMF's role with respect to OFCs should be seen in the context of its responsibility to help all members identify and reduce vulnerabilities arising from weaknesses in financial systems. While there was only limited evidence to date of the direct risks posed to the global financial system by OFCs (and offshore financial vehicles), the IMF had to take into account the potential risks for financial stability if standards of financial supervision were inadequate, and comprehensive risk analysis was hampered by a lack of reliable data on the activities of OFCs.

The Board agreed that the focus of IMF assessments of OFCs should be on financial supervision, covering banking, insurance, and securities, as appropriate. It also emphasized the need to address the robustness of consolidated supervision in relevant onshore centers vis-à-vis activities conducted in OFCs. Directors stressed that effective anti-money-laundering measures are important for the integrity of the financial system, and noted that such measures are included in the assessments by the IMF and the Bank staff in FSAP reports and in Basel Core Principles Assessments. Closer collaboration between the IMF and the OFCs would need to evolve in a manner consistent with the IMF's mandate, expertise, and resources.

At their meeting, the Board asked IMF staff to extend financial sector work to include OFCs through a program of voluntary assessments encompassing three possible modules:

*Module 1*: Self-assessments by OFCs of relevant standards.

*Module 2*: Stand-alone IMF assessments of relevant supervisory standards.

*Module 3*: Comprehensive assessments of risks, vulnerabilities, institutional preconditions, and standards observance within an FSAP-type framework.

As a first step, the IMF held three outreach meetings, in St. Kitts, Sydney, and Paris, in late August and early September 2000, attended by virtually all OFCs. The purpose was to encourage a collaborative approach to assessments and help ensure ownership of the process by OFCs.

By the end of March 2001, 17 OFC missions had been fielded. Of the 17 missions, all were either Module 1 or exploratory in nature in preparation for future assessments. These missions were intended to determine the nature and scale of the financial services industry and to gather information on financial sector regulation and supervision. The missions found that most OFCs were keen to begin with an assisted self-assessment of relevant standards, and to have an opportunity to make changes both to legislation and supervision, before embarking on an IMF-led Module 2 or Module 3 assessment. Several OFCs also asked for technical assistance to strengthen their financial sectors.

The IMF plans to send missions to about 25 jurisdictions in 2001. Priorities include those OFCs willing to undergo a Module 2 assessment and those OFCs most keen to involve the IMF in their plans for raising standards. The work on OFCs is being developed in

consultation with other relevant bodies, such as offshore supervisory groupings and other national supervisory agencies. This cooperation aims to minimize the administrative burden on OFCs and to enhance access by IMF-led missions to supervisory experts, including some from OFCs.

### Combating Money Laundering

At the request of the International Monetary and Financial Committee, in April 2001 the Executive Board discussed money laundering and how the IMF could enhance its contributions to global anti-money-laundering efforts. At their meeting, the IMF Board agreed that money laundering was a problem of global concern, affecting major and smaller financial markets, and that international cooperation had to be stepped up to address it. It was further agreed that the IMF had an important role to play in protecting the integrity of the international financial system, including through efforts to combat money laundering. The IMF's involvement in this area, Directors agreed, would be strictly confined to its core areas of competence and would not extend to law enforcement activities.

Directors agreed the IMF would take the following steps to enhance international efforts to counter money laundering:

- intensify its focus on anti-money-laundering elements in all relevant supervisory principles;
- work more closely with major international anti-money-laundering groups;
- increase the provision of technical assistance;
- include anti-money-laundering concerns in its surveillance and other operational activities when relevant to macroeconomic issues; and
- undertake additional studies and publicize the importance of countries acting to protect themselves against money laundering.

The IMF's efforts would continue to be on principles of financial supervision with intensified focus on their anti-money-laundering elements to help ensure that financial institutions have in place the management and risk control systems needed to deter money laundering. As part of this process, a methodology for enhancing the assessment of financial standards relevant to countering money laundering would be developed and could be used to prepare a new section in reports for the Financial Sector Assessment Program.

Directors generally agreed that the Financial Action Task Force (FATF) 40 Recommendations[3] be recognized as the appropriate standard for combating money laundering, and that work should go forward to determine how the recommendations could be adapted and made operational to the IMF's work. Directors stressed that the FATF process needs to be made consistent with the IMF's Reports on the Observance of Standards and Codes (ROSC) process—that is, the FATF standard needs to be applied uniformly, cooperatively, and on a voluntary basis—and that once this was done, the FATF could be invited to participate in the preparation of a separate ROSC module on money laundering. They called on the staffs of the IMF and the World Bank to contribute to the ongoing revision of the FATF 40 Recommendations and to discuss with the FATF the principles underlying the ROSC procedures and come back to the Board with a report and proposals.

### Transparency of the IMF and Its Members

Greater openness and transparency in economic policymaking and in the dissemination of data on economic and financial developments are key elements of the international community's efforts to prevent financial crises. They promote the orderly and efficient functioning of financial markets, reduce the likelihood of shocks, and enhance the accountability of policymakers. Many countries have taken steps toward such increased transparency in recent years, and the IMF has made its operations and policy deliberations more open to the public while safeguarding its role as confidential adviser to governments and central banks. Enhanced public scrutiny of members' policies, and of IMF assessments of those policies, bring broader dialogue and contribute to better IMF surveillance and program design.

In August 2000, the Executive Board reviewed the transparency initiatives undertaken by the IMF since mid-1999 and agreed to broaden its authorization for the publication of documents. The Board formally adopted a decision to implement these policies in January 2001; at the same time, it agreed on a Statement of Guiding Principles for the IMF's Publication Policy (see Appendix V).

### Background

#### *1999 Discussions*

The Executive Board made a number of key decisions in 1999 aimed at opening its own activities as well as

[3]The recommendations deal with financial regulation and supervision and with legal/criminal enforcement matters. The primary lead in anti-money-laundering efforts rests with the specialized agencies that have the mandate and the expertise in this area. The Financial Action Task Force and the regional anti-money-laundering task forces lead the international efforts in directly combating money laundering. The task force consists of the Group of Ten and the EU, the European Union Commission itself, plus Argentina, Australia, Brazil, the Gulf Cooperation Council, Hong Kong SAR, Iceland, Mexico, New Zealand, Norway, Singapore, and Switzerland; both the IMF and the World Bank are nonmember observers. Interpol, national financial intelligence units, the UN, and other international and national organizations also undertake direct efforts to counter money laundering.

the policies of its members to public scrutiny. Most noteworthy, the Board decided to authorize publication of staff country (Article IV) reports, when the country concerned agreed, in an experimental pilot project that provided certain safeguards against concerns raised by Directors. The Board stopped short of authorizing publication of staff reports related to IMF loans—referred to as Use of Fund Resources (UFR) staff reports—but agreed to revisit this issue in light of the experience with transparency in other areas. It also created a new communications vehicle—a Chairman's Statement issued as a news release—to summarize the key points of Board discussions of requests and reviews related to lending. In addition, documents produced by a member country setting out its intentions for policies to be supported by the use of Fund resources—Letters of Intent, Memoranda of Economic and Financial Policies, and other such documents—would be presumed to be published.

These decisions sought to balance the role of the IMF as confidential advisor with the desirability of providing timely and accurate information to the public. Executive Directors had emphasized the importance of greater transparency to the functioning of markets in an environment of increased private capital movements and member countries' growing integration into international capital markets. While Directors were unanimous on the benefits of transparency and an open publications policy in principle, they were also concerned that the potential costs of such a policy be weighed carefully. Given its concerns, the Board asked for a review of the experience with the new initiatives so that next steps could be considered.

### *The 2000 Review*

The review requested by the Board was conducted in August 2000. It focused on evaluating experience with the publication of Article IV reports under the pilot program. It had several components:

- surveys of national authorities by IMF staff on Article IV missions to member countries;
- an evaluation conducted by a consultant based on feedback from Executive Directors and national authorities, financial markets, academics, civil society, and IMF staff;[4]
- surveys and interviews conducted by IMF staff with media representatives and financial markets (in London, Hong Kong SAR, New York, and Tokyo) and with civil society;[5]
- a pilot project website mailbox and online surveys as part of the outreach to the public; and
- for insight on a range of concerns expressed by Directors, extensive background analysis by staff, including comparisons of published and unpublished reports.

The Board's review of the experience with the various transparency-related initiatives provided reassurance on the benefits of transparency. In particular, experience under the pilot project for the voluntary release of Article IV and combined Article IV/Use of Fund Resources staff reports mitigated concerns about how publication would affect the IMF's confidential relationship with its members. Indeed, the review concluded that the prospect of publication had generally not significantly changed the candor of consultation discussions and in several instances had in fact served to improve the discussions and the quality and analysis of reports. Given the concern that a loss of candor might materialize over time, however, the impact of publication on candor will continue to be closely monitored and periodically reviewed.

The Board decided to adopt new publication policies in some areas and to continue existing arrangements in others. Directors agreed on the following:

- on a policy of voluntary publication (that is, publication with the agreement of the country concerned) of IMF staff reports and other country papers; these would include Article IV staff reports, staff reports on Use of Fund Resources, and combined Article IV/Use of Fund Resources staff reports. Publication of Use of Fund Resources reports could bolster the credibility of IMF-supported programs as well as enhance the IMF's catalytic role in channeling private capital flows to countries with market access;
- within this framework of voluntary publication, to continue the presumption in favor of releasing documents stating national authorities' policy

[4]Winston Cox, former Governor of the Central Bank of Barbados and Alternate Executive Director, World Bank, and recently appointed as Deputy Secretary-General of the Commonwealth Secretariat, served as the consultant. Mr. Cox held interviews with the authorities, the private sector and media representatives, and members of civil society in 18 countries on the impact of the publication of staff reports, using questionnaires designed in collaboration with IMF staff to reflect the concerns of Executive Directors. He also interviewed Directors for their informal views on publication issues as well as IMF mission chiefs and other IMF staff.

[5]The IMF's External Relations Department surveyed the major news wires; nongovernmental organizations; financial market participants affiliated with major U.S. investment banks; Washington, D.C., metropolitan area university professors specializing in the fields of economics, business, and political science who have had longtime exposure to IMF publications and contacts with IMF personnel; and key specialists who have worked on IMF-related issues for a number of years. In addition, the consultant interviewed representatives of more than 15 major international banks, five local banks, nearly 20 newspapers and press agencies, two rating agencies, and various other non-official IMF observers in various parts of the world.

intentions in IMF-supported programs. This policy would apply to Letters of Intent (LOIs), Memoranda of Economic and Financial Policies (MEFPs), and Technical Memoranda of Understanding (TMUs) with policy content;

- that staff would not recommend Board endorsement of an Interim Poverty Reduction Strategy Paper (I-PRSP) or Poverty Reduction Strategy Paper (PRSP) unless the document was published;
- to adopt a set of principles for the publication of country papers to ensure that frankness in policy discussions and reporting is maintained, the appropriate balance between transparency and confidentiality on sensitive issues in the IMF's dialogue with its members is preserved, and the quality of staff reports is continually improved;
- to reaffirm the expectation that documents relating to the Initiative for Heavily Indebted Poor Countries (HIPCs) and Joint Staff Assessments of PRSPs would be published;
- on voluntary publication of Public Information Notices (PINs) following Article IV consultations and Executive Board discussions on regional surveillance papers; concluding statements of Article IV and other IMF missions representing the views of the IMF staff mission teams; background surveillance documentation such as Recent Economic Developments papers, Selected Issues papers, and Statistical Appendices; Reports on the Observance of Standards and Codes; and staff papers and IMF mission concluding statements for staff-monitored programs;
- that country papers would be subject to a uniform deletions policy, with deletions kept to a minimum and limited to highly market-sensitive information, mainly views on exchange rate and interest rate matters. The application of this policy will be closely monitored to ensure even-handed and transparent implementation; and
- to facilitate the greater use of Public Information Notices following discussions on policy issues and on a more systematic procedure to release policy papers in order to encourage a more informed public debate on IMF policies.

### Implementation of the Transparency Policy

Reflecting the major increase in the transparency of the IMF and its member countries, by the end of April 2001, 73 members had agreed to the publication of 86 Article IV staff reports since June 1999 when the Board decided to authorize their release. Public Information Notices summarizing the Board's discussion of each country consultation—introduced in 1997—were published for more than three-quarters of the IMF membership in 2000. In addition, Board discussions of regional surveillance papers; concluding statements of Article IV and other IMF missions representing the view of IMF staff; background papers (Recent Economic Developments, Selected Issues, Statistical Appendixes); ROSCs; and staff papers and IMF mission concluding statements for staff-monitored programs are now routinely published.

Transparency has also increased with respect to documents on the use of IMF resources. From January 2001, when the decision was reached to authorize publication of staff reports for lending program requests and reviews through the end of April 2001, 23 such staff reports were published. Released Chairman's Statements summarize for the public the Board's view on all lending programs supported by the IMF.

This progress has been matched by the greater use of Public Information Notices following discussions on policy issues and a more systematic release of policy papers. During the financial year, papers by management and staff and related Board discussions were released for reviews of governance, standards and codes, the Financial Sector Assessment Program, and IMF facilities. In February 2001, the IMF released for public comment a set of papers on the reform of its conditionality practices.

### Other Transparency Efforts

The IMF has also continued to improve the transparency of its own financial activities. The IMF's financial statements now conform fully with international accounting standards and clearly identify the key components of the IMF's assets and liabilities. The IMF's external website provides current information about the IMF's financial accounts, member countries' financial positions in the IMF, and the institution's liquidity position. The IMF has also continued its efforts to explain its work better and be more transparent with regard to its operations and policy deliberations.[6]

At the same time, the IMF has been actively seeking the views of civil society, the private sector, and other segments of the public. In FY 2001, comments from the public were sought on the IMF's concessional lending facility; the joint IMF–World Bank debt relief initiative; various transparency-related pilot projects; work related to standards and codes; the new draft guidelines for public debt management; and, as mentioned above,

[6]Including through more regular press briefings and the release of various policy documents and Executive Board decisions, quarterly reports on emerging market financing, and IMF research. In addition, more public announcements are being made about operational issues, such as the formation of a working group on the process of selecting the IMF's Managing Director.

**Box 3.6**
### First Annual IMF Research Conference

Distinguished academics, policymakers, and IMF staff gathered at the IMF's Washington headquarters on November 9 and 10, 2000, to participate in the inaugural IMF Research Conference. The conference, launched to provide a forum for the discussion of current issues in international finance, focused on whether policy interest rates should be lowered at the onset of a financial crisis; whether IMF programs encourage risky behavior by investors; whether IMF and World Bank policies raise poverty and inequality; and what impact exchange rate regimes have on macroeconomic performance.

The conference also featured two special lectures. Nobel-prize-winner Robert Mundell reviewed the history of the Mundell-Fleming model—the workhorse model of international economics and a product of Mundell and J. Marcus Fleming when both were members of the IMF's Research Department in the 1960s. And Maurice Obstfeld offered a follow-up, "Beyond the Mundell-Fleming Model." With Ken Rogoff, Obstfeld has played a critical role in developing the so-called New Open Economy Macroeconomics.

Selected papers from the conference are posted on the IMF website and slated to appear in a special issue of *IMF Staff Papers.* The second annual conference is scheduled to take place at IMF headquarters in Washington, D.C., on November 29 and 30, 2001.

its conditionality practices. In addition, the IMF has convened consultative meetings of academic experts, private sector representatives, and relevant international and regional organizations to guide various aspects of its work on assessing external vulnerability. An annual research conference series was inaugurated in November 2000 to provide a forum for discussion of current issues of interest (see Box 3.6). And throughout the year, staff worldwide discuss the work of the IMF and related issues—on a formal and informal basis—with representatives of civil society, including nongovernmental organizations.

As part of these efforts, the IMF website now carries information on a wide range of IMF activities and policies, including significant amounts of material on IMF advice to members. In excess of 5 million "hits" per month are being recorded on the IMF website, up from fewer than 600,000 at the end of 1997.

### *Cooperation with Investigations by Auditing Institutions of Members*

In another transparency-related move, in February 2001 the Board formalized a set of procedures for cooperating, upon request, with agencies of member countries that are preparing reports on the IMF and its activities. (See Appendix III on Principal Policy Decisions of the Executive Board.)

CHAPTER 4

# IMF Lending Policies and Conditionality

The IMF provides financial support to member countries under a variety of policies and lending instruments ("facilities"; see Table 4.1). Most forms of IMF financing are made conditional on the member adopting policy reforms to address the balance of payments problem that gave rise to the request for IMF support.

In FY2001, the IMF took steps to update its lending policies and revisit its policy conditionality. Specifically, it made efforts to:

- restructure its regular lending facilities to allow the IMF to support more effectively its members' efforts to resolve crises, and also to prevent crises arising from contagion, and to help ensure a more efficient use of IMF financial resources;
- streamline its policy conditionality to increase its effectiveness and promote strong country ownership of IMF-supported programs; and
- reaffirm its role in promoting good governance in member countries.

Chapters 3 and 5 discuss other important IMF efforts to refocus its work to enhance its overall effectiveness, and Chapter 6 covers other developments in IMF financial operations and policies during FY2001.

## Review and Reform of IMF Facilities

During the financial year, the Executive Board approved some important changes in the IMF's financial facilities. In March 2000, the Board initiated a general review of IMF financial facilities, eliminating a number of little used or obsolete facilities and seeking ways to better adapt the remaining lending instruments to changes in the global economy. In November 2000, the Board concluded its review and agreed on several measures to sharpen the focus of IMF lending on crisis resolution and prevention and to make more efficient use of IMF resources. Among other actions, the Board:

- made the terms of the Contingent Credit Line (CCL) facility more attractive to potential users. The CCL offers countries with sound economic policies a precautionary line of credit that can be quickly activated to help them counter contagion effects on their economies from financial crisis elsewhere;
- approved measures to encourage early repayment of IMF loans and discourage excessive use of IMF funds. These measures will reduce reliance on the IMF as a source of longer-term financing and free up funds for use by other members; and
- strengthened its monitoring of countries' economic policies after conclusion of IMF-supported programs, particularly in cases where there is substantial credit outstanding to the IMF. This provides additional safeguards for IMF funds and helps preserve the achievements of IMF-supported programs.

### *Contingent Credit Lines (CCLs)*

The CCL was conceived in 1999 as a precautionary line of defense to help protect countries pursuing strong policies in the event of a balance of payments need arising from the spread of financial crises. In meetings in September and November 2000, the Board acknowledged that changes were needed to make the CCL more attractive to potential users. Directors agreed on the following modifications of the facility:

- Monitoring arrangements for members that had strong track records on policies and that qualified for the CCL would be less intensive than for members under other IMF arrangements. Accordingly, in its request for a commitment of CCL resources, the member should present a quarterly quantified framework to guide its macroeconomic policies that would be a basis for monitoring, but there would be no need for a detailed definition of program targets. Also, while the initial consideration of the member's eligibility should include an assessment of its structural program and the progress expected under that program, formal structural benchmarks would not be necessary. Finally, in appropriate cases, the midterm review of arrangements with CCL resources could be completed on a lapse-of-time basis (without formal discussion by the IMF's Executive Board). Between reviews, staff and management would remain in close touch with the member and inform the Board if there were concerns that

Table 4.1
**IMF Financial Facilities**

| | | | | | | Repurchase (Repayment) Terms[3] | | |
|---|---|---|---|---|---|---|---|---|
| **Credit Facility** | **Purpose** | **Conditions** | **Phasing and Monitoring[1]** | **Access Limit[1]** | **Charges[2]** | **Obligation schedule (years)** | **Expectation schedule (years)** | **Installments** |
| **Credit Tranches and Extended Fund Facility[4]** | | | | | | | | |
| Stand-By Arrangements (1952) | Short-term assistance for countries with balance of payments difficulties of a short-term character | Adopt policies that provide confidence that the member's balance of payments difficulties will be resolved within a reasonable period | Quarterly purchases (disbursements) contingent on observance of performance criteria and other conditions | Annual: 100% of quota; cumulative: 300% of quota | Basic rate plus surcharge (100 basis points on amounts above 200% of quota; 200 basis points on amounts above 300%)[5] | 3¼–5 | 2¼–4 | Quarterly |
| Extended Fund Facility (1974) | Longer-term assistance to support members' structural reforms to address balance of payments difficulties of a long-term character | Adopt 3-year program, with structural agenda, with annual detailed statement of policies for the next 12 months | Quarterly or semiannual purchases (disbursements) contingent on observance of performance criteria and other conditions | Annual: 100% of quota; cumulative: 300% of quota | Basic rate plus surcharge (100 basis points on amounts above 200% of quota; 200 basis points on amounts above 300%)[5] | 4½–10 | 4½–7 | Semiannual |
| **Special Facilities** | | | | | | | | |
| Supplemental Reserve Facility (1997) | Short-term assistance for balance of payments difficulties related to crises of market confidence | Available only in context of regular arrangement with associated program and with strengthened policies to address loss of market confidence | Facility available for one year; frontloaded access with two or more purchases (disbursements) | No access limits; access under the facility only when access under associated regular arrangement would otherwise exceed either annual or cumulative limit | Basic rate plus surcharge (300 basis points rising by 50 basis points a year after first disbursement and every 6 months thereafter to a maximum of 500 basis points) | 2–2½ | 1–1½ | Semiannual |
| Contingent Credit Line (1999) | Precautionary line of defense that would be made readily available against balance of payments difficulties arising from contagion | Eligibility Criteria: (1) absence of balance of payments need from the outset, (2) positive assessment of policies by the IMF, (3) constructive relations with private creditors and satisfactory progress in limiting external vulnerability, (4) satisfactory economic program | Resources approved for up to one year. Small amount (5%–25% of quota) available on approval but not expected to be be drawn. Presumption that one-third of resources are released on activation, with the phasing of the remainder determined by a postactivation review | Expected access: 300%–500% of quota | Basic rate plus surcharge (150 basis points rising by 50 basis points at the end of the first year and every 6 months thereafter to a maximum of 350 basis points) | 2–2½ | 1–1½ | Semiannual |
| Compensatory Financing Facility (1963) | Medium-term assistance for temporary export shortfalls or cereal import excesses. (A provision for use in cases of other contingencies was eliminated in 2000) | Available only when a member has an arrangement with upper credit tranche conditionality, or when its balance of payments position is otherwise satisfactory | Typically disbursed over a minimum of 6 months in accordance with the phasing provisions of the arrangement | 55% of quota | Basic rate | 3¼–5 | 2¼–4 | Quarterly |
| Emergency Assistance | Quick, medium-term assistance for balance of payments difficulties related to: | | None, although postconflict assistance can be segmented into two or more purchases made available in exceptional cases | Generally limited to 25% of quota, though larger amounts can be made available in exceptional cases | Basic rate | 3¼–5 | Not applicable | Quarterly |
| (1) Natural disasters (1962) | (1) To help finance recovery efforts and support economic adjustment programs after natural disasters | (1) Reasonable efforts to overcome balance of payments difficulties | | | | | | |
| (2) Postconflict (1995) | (2) To help establish macroeconomic stability in the aftermath of civil unrest, political turmoil, or international armed conflict | (2) Focus on institutional and administrative capacity building to pave the way toward an upper credit tranche arrangement or PRGF | | | | | | |
| **Facility for Low-Income Members** | | | | | | | | |
| Poverty Reduction and Growth Facility (1999) (Replaced the Enhanced Structural Adjustment Facility) | Longer-term assistance for deep-seated balance of payments difficulties of structural nature; aims at sustained poverty-reducing growth | PRGF-supported programs are based on a Poverty Reduction Strategy Paper (PRSP) prepared by the country in a participatory process, and integrating macroeconomic, structural, and poverty reduction policies | Semiannual (or occasionally quarterly) disbursements contingent on observance of performance criteria and reviews | Expected: first-time users, 90%; others, 65% of quota. Maximum 140% of quota; exceptional 165% of quota | 0.5 % a year | 5½–10 | Not applicable | Semiannual |

[1]The IMF's lending is financed from the capital subscribed by member countries; each country is assigned a *quota* that represents its financial commitment. A member provides a portion of its quota in foreign currencies acceptable to the IMF—or in SDRs—and the remainder in its own currency. An IMF loan is disbursed or drawn by the borrower *purchasing* foreign currency assets from the IMF with its own currency. Repayment of the loan is achieved by the borrower *repurchasing* its currency from the IMF with foreign currency. See Box 6.1 on the IMF's Financing Mechanism.

[2]The *basic rate* of charge on funds disbursed from the General Resources Account (GRA) is set as a proportion of the weekly interest rate on SDRs and is applied to the daily balance of all outstanding GRA drawings during each IMF financial quarter. In addition to the basic rate plus surcharge, an up-front commitment fee (25 basis points on committed amounts up to 100% of quota, 10 basis points thereafter) is charged on the amount that may be drawn during each (annual) period under a Stand-By or Extended Arrangement. The fee is, however, refunded on a proportionate basis as subsequent drawings are made under the arrangement. A one-time service charge of 0.5 percent is levied on each drawing of IMF resources in the General Resources Account, other than reserve tranche drawings, at the time of the transaction.

[3]For purchases made after November 28, 2000, members are expected to make repurchases (repayments) in accordance with the schedule of expectations; the IMF may upon request by a member amend the schedule of repurchase expectations if the Executive Board agrees that the member's external position has not improved sufficiently for repurchases to be made.

[4]*Credit tranches* refer to the size of purchases (disbursements) in terms of proportions of the member's quota in the IMF; for example, disbursements up to 25 percent of a member's quota are disbursements under the *first* credit tranche and require members to demonstrate reasonable efforts to overcome their balance of payments problems. Requests for disbursements above 25 percent are referred to as *upper* credit tranche drawings; they are made in installments as the borrower meets certain established performance targets. Such disbursements are normally associated with a Stand-By or Extended Arrangement. Access to IMF resources outside of an arrangement is rare and expected to remain so.

[5]Surcharge introduced in November 2000.

slippages in the member's policies might make it vulnerable to crises. The Board agreed that the IMF must continue to have the means to make a member exit formally from the CCL—primarily in the form of the limited (one-year) commitment period under the CCL and the midterm review.

- A member approved for a CCL could request financing at any time, which would lead to a special "activation" review by the Board. In September 2000, Directors agreed to simplify the conditions for completing the activation review to assure members using the CCL of greater automaticity in the disbursement of resources. The activation review would be divided into an "activation" review and a "postactivation" review. The former would be completed quickly and would release a predetermined, large amount of resources—normally a third of the total commitments—and the member would be given the strong benefit of the doubt as to any required policy adjustments. In the postactivation review, phasing and conditionality would be specified for access to the remaining resources.
- One formal condition for the completion of the activation review would be eliminated. Under the original policy, the Board had to agree that "up to the time of the crisis, the member has successfully implemented the economic program that it had presented to the Board as a basis for its access to CCL resources." This condition was intended to guard against the possibility that the member's own policies had contributed to the buildup of its balance of payment difficulties. The Board agreed to omit this as a separate condition because this possibility would not be consistent with the member's difficulties being judged to be largely beyond its control (a separate condition for the activation review).
- The overall rate of charge and the commitment fee on CCL resources was reduced. The initial surcharge was lowered from 300 basis points to 150 basis points (half of the surcharge under the Supplemental Reserve Facility, or SRF). The surcharge would then rise with time, to a ceiling of 350 basis points. The commitment fee on the CCL (and other large arrangements) was reduced by replacing the prevailing flat commitment fee of 25 basis points with a new schedule—to be applied to all IMF arrangements—of 25 basis points on amounts up to 100 percent of quota, and 10 basis points for amounts in excess of 100 percent of quota. This structure recognizes the importance of fixed costs in setting up an arrangement.

To allow for a meaningful period of experimentation with the revised facility, the Board extended the sunset clause on the CCL until November 2003. The Board will conduct its next review of the CCL in November 2002. As of the end of FY2001, no member had requested an arrangement under this facility.

### Expectation of Early Repayment of Loans

In their review of ways to ensure the efficient use of IMF resources, Executive Directors agreed that prolonged use following the resolution of a balance of payments problem should be addressed through the introduction of *time-based repurchase expectations.* These would come into force before the standard *repurchase* (or repayment) *obligations.* For Stand-By Arrangements, members would be expected to begin repayments 2¼ years after each purchase and complete repurchases after 4 years, while repurchase obligations would continue to span 3¼ to 5 years. Under the Extended Fund Facility (EFF), members would begin repurchases after 4½ years, as at present, but expected repurchases would be completed in 7 years, rather than 10 years under the obligation schedule. The new early repurchase expectations apply to all purchases in the credit tranches and under the EFF made after November 28, 2000.

The design of IMF-supported programs will be guided by the requirement that the member should be able to meet repurchase obligations. The member's ability to meet the repurchase expectations would signal as a general rule a stronger-than-expected improvement in its external position.

Members may request an extension of repurchase expectations at any time. Should a member fail to meet a repurchase expectation not extended by the Board, its right to make further drawings, including under ongoing arrangements, would be automatically suspended.

The Board agreed to review the operation of early repurchase expectations by November 2005.

### Surcharges on Heavy Use of IMF Credit

To discourage unduly large use of IMF resources, the Board agreed in September 2000 to introduce surcharges on credit outstanding above a threshold level in the credit tranches and under the Extended Fund Facility. The use of credit above 200 percent of quota would carry a surcharge of 100 basis points above the regular rate of charge, and the surcharge would rise to 200 basis points for credit outstanding above 300 percent of quota.

The level-based surcharge applies only to the amount of credit above each threshold, not to the total amount of outstanding credit. Credit outstanding at the time the policy changes were made effective (November 28, 2000) would be "grandfathered" so that surcharges would not apply. Credit outstanding under the SRF or a CCL is also exempt from the new surcharge because these facilities have their own system of graduated charges (see Table 4.1).

### Emergency Assistance

Directors agreed that financing made available as emergency assistance for natural disasters or for countries emerging from conflicts would not be subject to the level-based surcharge, nor be taken into account for the purpose of calculating the surcharge applicable to other resources. They also agreed that resources available under both types of emergency assistance should not feature time-based repurchase expectations. These decisions were put into effect by establishing emergency assistance as a special policy distinct from the IMF's other general lending.

In addition, the IMF made efforts to put its emergency postconflict assistance on concessional terms. These efforts were welcomed by the Joint Session of the International Monetary and Financial Committee and the Development Committee in their April 2001 communiqué.

### Compensatory Financing Facility

The Compensatory Financing Facility (CFF) was reviewed and streamlined in early 2000. In November 2000, Directors agreed that drawings under the CFF should be subject to the same repayment expectations that govern lending under Stand-By Arrangements: 2¼–4 years. They would not, however, be subject to the level-based surcharge nor counted toward outstanding obligations that give rise to that surcharge.

### Extended Fund Facility

During the review of IMF facilities, the Executive Board underscored that arrangements under the Extended Fund Facility (EFF) would be granted only in cases that fully meet the terms and spirit of the 1974 decision establishing the EFF. These would be cases where there is reasonable expectation that the member's balance of payments difficulties were relatively long term, for example, because of limited access to private capital and a need for a strong structural program to deal with the entrenched institutional or economic weaknesses. The Board agreed that extended arrangements should generally not be formulated on a precautionary basis. While the EFF remains available to all members meeting the eligibility criteria, it was seen as especially appropriate for countries graduating from the Poverty Reduction and Growth Facility and for transition countries that did not have access—or sufficient access—to capital markets.

### Post-Program Monitoring

The Board decided that enhanced post-program monitoring, with more formal involvement of the Board, was important in certain cases to provide an early warning of policies that could call into question a member's continued progress toward external viability. To that end, Directors agreed that there should be a presumption that when a member's credit outstanding at the end of an arrangement exceeds 100 percent of quota, management would be expected to recommend to the Board an enhanced monitoring of economic developments until credit falls below this threshold. The Board's discussions of post-program monitoring papers would be summarized in a Public Information Notice (PIN) when the member agreed to such publication. The member could also allow publication of the post-program monitoring papers on a voluntary basis.

### Review of Conditionality in IMF-Supported Programs

The IMF extends financing to a member country with balance of payments difficulties on the condition that the country has put in place a program of policy adjustments to address its external payments problem. Conditionality gives the country assurance that it will continue to receive IMF financing as long as it carries out the policies or achieves outcomes envisaged in the program. At the same time, conditionality safeguards the revolving character of the IMF's resources by extending financing only if the country concerned is committed to policy adjustments that, by improving its external position, will enable it to repay the IMF.

Conditionality has evolved over the course of the IMF's history. Until the 1980s, policy conditions were limited mainly to macroeconomic variables, but beginning in the late 1980s the scope of conditionality began to broaden. This reflected, in part, an increasing emphasis on economic growth as a goal of IMF-supported programs, but also the IMF's expanding involvement in countries where severe structural problems were impeding the achievement of a sustainable balance of payments position.

The expanding scope of conditionality has raised concerns that excessively broad and detailed policy conditions may undermine a country's "ownership" of a policy program, which is essential for the program's successful implementation. Moreover, extensive conditionality may strain a country's administrative capacity, thus undermining the implementation of truly essential policies. These concerns prompted the Managing Director of the IMF to give high priority to streamlining and more sharply focusing IMF conditionality and to strengthening national ownership. In September 2000, he issued to IMF staff an *Interim Guidance Note on Streamlining Structural Conditionality in IMF-Supported Programs* (see Box 4.1), which set out general principles to be revisited in 2001 in light of experience and Board discussions.

In March 2001, the Executive Board discussed the general principles and issues related to conditionality. Directors agreed that conditionality remained indispensable but that it had to be streamlined and focused

Box 4.1

## Interim Guidance Note: Streamlining Structural Conditionality in IMF-Supported Programs, September 2000

1. This note has been prepared by an Inter-Departmental IMF Working Group on streamlining structural conditionality in IMF-supported programs. The general principles set out below are preliminary and will be reviewed in early 2001 in light of the initial experience and the Executive Board's discussion of the forthcoming papers on "The Experience with Structural Conditionality in Fund-Supported Programs" and "Ownership, Conditionality, and Policy Implementation."

2. The Reform Task Force in its interim report on "The Future Role of the Fund" recommends that IMF programs should henceforth be formulated on the "presumption that structural conditionality will be limited to a core set of essential measures that are macro-relevant and in the Fund's core area of responsibility, with a broader approach requiring justification based upon the specific country situation."[1] The report further notes that "the Fund may continue to advise on a broader range of structural reforms in some cases, but they would not generally be part of conditionality.''

3. This note outlines some principles to assist staff in determining the appropriate scope of structural conditionality in Fund arrangements in the general resources account, as well as in arrangements under the Poverty Reduction and Growth Facility (PRGF). These principles are inevitably fairly general and will need to be applied judiciously on a case-by-case basis. However, they should be seen as establishing a general presumption that structural conditionality in Fund-supported programs should be selective and justified by the program's overall macroeconomic objectives. This should not weaken the quality of Fund-supported programs; rather, it should help strengthen conditionality and ownership in those areas that are critical for the program's success.

4. The authorities' policy commitments in the structural area are laid down in a member country's Letter of Intent (LOI) or the Memorandum on Economic and Financial Policies (MEFP). Implementation of these policy commitments is monitored through performance criteria, structural benchmarks, prior actions, or in the context of program reviews. The form of monitoring depends on the importance of certain structural reforms for the program's objectives as well as the nature of the measures involved. Applying performance criteria requires that specific measures can be clearly and unambiguously defined, and that these measures in and of themselves are sufficiently important to warrant holding up the arrangement in cases of noncompliance. Structural benchmarks too are applied to individual, well-defined measures, but they do not assign the same weight to these measures as do performance criteria; rather they serve as markers in the assessment of progress with the implementation of reforms in a given area. Finally, reviews provide a framework for an assessment of structural reforms against established benchmarks or of reforms that are either less critical or characterized by a series of smaller steps, which may be of moderate significance individually and have to reach a critical mass to signify progress. Reviews provide considerable scope for judgment and, hence, flexibility to the Fund, but they imply less clearly defined assurances for the borrowing country regarding the conditions under which purchases can continue.

5. Sometimes, the authorities and/or staff find the LOI a useful vehicle to set out the authorities' broader policy agenda for either national or international audiences. In these instances, only part of the LOI may constitute firm policy commitments under the program in the form of performance criteria or benchmarks. In such cases, review clauses need to indicate clearly the areas that will be covered by program reviews. The principles outlined in the following paragraphs focus on structural reforms that constitute policy commitments in the sense that they are subject to some form of monitoring under the program. Issues related to the broader coverage of structural measures in LOIs or MEFPs are briefly discussed in paragraph 12.

6. *Fund conditionality should cover only structural reforms that are relevant for a program's macroeconomic objectives.* There are, however, no clear rules for classifying structural reforms according to their macroeconomic relevance. While all Fund-supported programs ultimately seek to achieve medium-term external viability together with strong and sustainable growth, the conditions that determine what needs to be done to achieve these objectives vary considerably across programs. For example, in recent financial crises, the overriding goal of Fund-supported programs was to restore market confidence, ensure orderly external adjustment, address the weaknesses that had made these countries vulnerable to a crisis, and create the conditions for growth to be resumed. In the transition economies, completing the transformation into a competitive market economy while restoring or maintaining stable macroeconomic conditions has been the key challenge. PRGF arrangements seek to promote poverty reduction by removing impediments to strong, sustainable growth and a viable external position. While macroeconomic relevance needs to be

[1] Core areas of responsibility include "macroeconomic stabilization, monetary, fiscal and exchange rate policy, including the underlying institutional arrangements and closely related structural measures; and financial sector issues, including the functioning of both domestic and international financial markets."

established on a case-by-case basis, it will be important to make this assessment explicit in program documents.

7. *Not all structural reforms that meet the macroeconomic relevance test will typically be subject to program conditionality.* In order to determine which reforms should be covered, it is useful to distinguish between structural reforms that are essential or critical for the program's macroeconomic objectives and reforms that are macroeconomically relevant but do not have the same degree of importance. Distinguishing between the two is obviously a matter of judgment. One way to do so is to ask the question: If the reforms in question were not carried out, would achievement of the program's macroeconomic objectives, including the restoration of sustainable growth, be seriously jeopardized, regardless of progress in other areas? If the answer is no, the reforms in question may be macroeconomically relevant but are probably not critical.

8. *Structural reforms that are critical for the achievement of the program's macroeconomic objectives will generally have to be covered by Fund conditionality.* If measures can be identified that are specific, well-defined, and monitorable, and mark important steps in the whole reform process, they would likely be subject to performance criteria or prior actions. For structural reforms that are critical for a program's macroeconomic objectives but are defined by a series of individual small steps that have to reach a critical mass, monitoring would typically rely on benchmarks and/or program reviews, with review clauses highlighting the relevant area.

9. *If certain structural reforms are critical for the program's success but outside the Fund's core areas of responsibility, the Fund will have to seek assistance from the World Bank or another institution* to provide input in designing and monitoring the reform measures and, if necessary, give technical advice on implementation to the country. In these cases, the Fund would still bring these measures under its own conditionality and decide on the adequacy of implementation on the basis of assessments provided by the World Bank or other relevant institution.[2]

10. *Structural reforms that are relevant—but not critical—for the program's macroeconomic objectives and within the Fund's core areas of responsibility may be subject to conditionality.* Whether such reforms should be included and in what form they should be monitored is a matter of judgment and depends on their relative importance for the program's objectives and the nature of the measures involved. However, the presumption would be that structural performance criteria would not be used in these cases, and that prior actions or structural benchmarks would be used sparingly and would require justification. In most instances, structural policy commitments to the Fund that fall into this category would be monitored in the context of reviews as part of an overall assessment of progress under the program.

11. *If structural reforms meet the macroeconomic relevance test but are neither critical nor in the Fund's core areas of responsibility, Fund conditionality would generally not apply.* If these measures are covered by the World Bank, the Fund may, and in many cases would, take note of the Bank's assessment of progress with implementation in forming a judgment on the country's adjustment effort.[3]

12. The general principles outlined above focus on structural conditionality, i.e., policy commitments to the Fund in the structural area that are subject to some form of monitoring under the program. As noted in paragraph 5, however, LOIs or MEFPs may include the authorities' broader policy agenda. In these cases, review clauses need to delineate the areas that are covered by Fund conditionality beyond those covered explicitly by performance criteria. The breadth as well as the level of detail of the measures covered by LOIs or MEFPs should continue to be determined by what is most useful in each country context. Nevertheless, in some cases, MEFPs containing large and detailed policy matrices have raised concerns about excessive intrusiveness of Fund conditionality. Such detailed matrices should be avoided unless they are considered necessary by the authorities to express their policy commitment or by the staff to monitor policy implementation.

[2]In the case of PRGF-supported arrangements, the respective areas of responsibility of the IMF and the World Bank will be delineated in the Poverty Reduction Strategy Paper. It is intended that the IMF would "not apply conditionality in areas outside the Fund's mandate and expertise, with the possible exception of measures that are critical to the country's fiscal and/or external targets" (see *Key Features of PRGF-Supported Programs* (SM/00/193, 8/17/00, para. 18). It is recognized, however, that changes at the World Bank—in particular, the development of the Poverty Reduction Support Credit—and the nature of the World Bank's current lending operations in specific countries will affect how quickly it will be possible to move in this direction. In the interim, PRGF conditionality may cover additional measures that are critical for the program's objectives.

[3]In the case of PRGF arrangements, it is envisaged that the Fund will take into account the World Bank's assessment in all areas for which the Bank has responsibility under the PRSP (or Interim PRSP).

to give greater scope for national ownership, while ensuring that the essential objectives of IMF-supported programs—including safeguarding the IMF's financial resources and their revolving character—were achieved.

### Areas of Consensus

Directors agreed that the widening scope of conditionality in recent years reflected, in part, the increasing emphasis on economic growth as a policy objective. This emphasis was driven by the view that demand management alone could not address the pressing economic problems of member countries. Moreover, the IMF had been intensively supporting countries in increasingly varied economic situations—including low-income and transition countries, where the correction of sometimes massive structural distortions and weaknesses in governance was seen as fundamental to addressing macroeconomic and external imbalances. More recently, the IMF had supported programs to deal with capital account crises stemming in large part from structural weaknesses in countries' financial sectors. Addressing these weaknesses was an essential element of the policy response, intended both to achieve a sound medium-term position and to help restore market confidence.

The broadening scope of IMF-supported programs had been accompanied by changes in the way the IMF monitored policy implementation. In particular, the IMF had increasingly relied on program reviews in monitoring policy performance. Structural benchmarks were being used extensively to map out steps in the implementation of particular structural policies. Prior actions—policy actions taken by the authorities before approval of an IMF arrangement or before the completion of a program review—had also become increasingly important in program monitoring.

In discussing the growing scope and detail of structural conditionality, some Directors felt that IMF conditionality had generally remained focused on its core areas of responsibility, while other Directors noted that the application of some conditionality outside these areas raised concerns that the IMF was overstepping its mandate and expertise. They also cited concerns that IMF-supported programs sometimes short-circuited national decision-making processes and failed to take adequate account of the authorities' ability to muster public support for the policies envisaged, and of their administrative capacity to carry out these policies. Considering that national ownership was essential to the successful and sustained implementation of a program of economic policies, Directors underscored the importance of avoiding ill-focused or unduly intrusive conditionality that could detract from national ownership. Concerns were also raised about the application of conditionality consistent with the IMF's existing guidelines, including uniformity of treatment of members. In addition, the boundaries of conditionality had become blurred, owing to the increasing use of structural benchmarks and Letters of Intent, which spell out the details of a country's overall reform program. This had made it more difficult for both the IMF and outsiders to ascertain exactly which policy measures the IMF's financing was conditioned upon.

Directors agreed that the aim should be to leave the maximum scope for countries to make their own policy choices, while ensuring that the IMF's financing was provided only if those policies essential to the purposes of the IMF continued to be implemented.

Directors therefore supported the broad thrust of the Managing Director's Interim Guidance Note on Streamlining Structural Conditionality. This note indicated that structural reforms critical to achieving a program's macroeconomic objectives would generally have to be covered by IMF conditionality; a more focused and parsimonious application of conditionality was envisaged for structural reforms that were relevant—but not critical—to the program's macroeconomic objectives. While these principles need to be intepreted carefully on a case-by-case basis, they shift the presumption of coverage from one of comprehensiveness to one of parsimony—thus requiring a stronger burden of proof for the inclusion of specific structural measures as conditions in an arrangement, particularly where these measures are outside the IMF's core areas. Directors also agreed that the appropriate coverage and content of conditionality were likely to differ, depending on countries' circumstances, as well as between programs supported by different IMF facilities.

A clear division of labor and enhanced cooperation with other international agencies—especially the World Bank—was an important element of the streamlining. Directors welcomed the progress made in this direction with regard to low-income countries supported by the Poverty Reduction and Growth Facility.

The Executive Board endorsed the change in the role of program reviews over the past two decades. These reviews were now being used for both forward- and backward-looking assessments of countries' economic policies. They reflected, first, the increased uncertainty of macroeconomic relationships in a world of volatile global capital markets, which made it more difficult to specify macroeconomic performance criteria for more than a brief period ahead. Second, the reviews reflected the growing prevalence of structural policies, which were less suitable for assessment based on simple quantified performance criteria. At the same time, Directors underscored the importance of ensuring that the increasing prevalence of reviews did not unduly weaken assurances to member countries about the conditions under which they would continue to have access to IMF resources.

Directors agreed that structural benchmarks, which had become an increasingly important tool of conditionality, were useful in tracking progress in implementing structural reforms that take time to come to fruition. As such, benchmarks did not constitute formal conditions for IMF financing but were a tool of program monitoring. At the same time, Directors saw a need for structural benchmarks to be used more sparingly, by limiting each benchmark to an important and representative step toward a policy outcome. This would also help avoid the impression of micromanagement.

As to Letters of Intent, Directors shared the view that they should distinguish more clearly between the authorities' overall policy program and the part of the program subject to IMF conditionality. They agreed that the Letters of Intent should either focus only on those aspects of policy covered by conditionality or, in cases in which the authorities wished to use the Letters of Intent to present their broad policy agenda, should indicate clearly which elements of the program constitute IMF conditionality.

### Issues Requiring Further Consideration

The following issues, the Executive Board agreed, would need to be revisited in the period ahead:

- The approach to streamlining proposed in the Interim Guidance Note on Streamlining Structural Conditionality left open the question of where to draw the line between measures critical to program objectives and those relevant but not critical. Most Directors favored interpreting this criterion rather narrowly, while others, favoring a broader interpretation, were concerned that some recent programs might have gone too far in eliminating conditionality related to important elements of structural reform.
- Most Directors considered that any application of conditionality outside the IMF's core areas of responsibility and expertise should be limited to measures critical to a program's achievement of its macroeconomic objectives. Others, however, maintained that measures relevant to these objectives might also be included. The Board agreed that care would need to be taken to ensure that the authorities received adequate advice—from the World Bank or other agencies—to guide implementation of any measure outside the IMF's core areas to be included under IMF conditionality. Limiting the IMF's conditionality to its core areas, while ensuring that measures critical to program objectives are carried out, would also require further progress in developing a framework for coordination with the World Bank and other agencies.
- On program design, Directors saw a need for further consideration of the pace and sequencing of structural reforms, and for continuing work to adapt conditionality to the implementation capacity of the country.
- In considering the extent to which the IMF should and could be more selective in providing financial support for programs suffering from weak country ownership, Directors agreed that the IMF should limit its financing in such cases, since conditionality could not compensate for a lack of program ownership. A number of Directors noted, however, that this principle was difficult to apply, because the costs for the country of the IMF holding back support might be large and because of the difficulty of assessing the level and breadth of ownership. In this connection, it was suggested that prior actions could be a helpful tool to test country ownership, especially in cases where past performance had been weak. Directors also stressed that the IMF had to continue to take part in member countries' institution-building efforts, including by providing technical assistance.
- Directors expressed a range of views on the scope for greater use of "results-based" conditionality, under which IMF financing would be provided only after certain key policy outcomes had been achieved. A number of Directors thought this approach would give countries greater flexibility in choosing the best means of achieving desired results. At the same time, the point was made that a wholesale move to results-based conditionality would create tensions with the need to synchronize policy implementation with IMF financing, unless financing were significantly more back-loaded.

In the latter regard, Directors discussed the role of standards and codes in specifying desired policy outcomes in IMF-supported programs. Standards and codes could be a useful element in program design, and members' adherence to best practices in several areas could limit the need for specific conditionality to safeguard program objectives. The application of standards and codes in IMF-supported programs, however, would need to respect their voluntary nature.

### Next Steps

At its April 2001 meeting, the International Monetary and Financial Committee reaffirmed that the main goal of streamlining was to make conditionality more efficient, effective, and focused, without weakening it, and welcomed the progress to date. The process of streamlining conditionality will continue in the coming months, and will benefit from input received from outside the IMF. This external input will take the form of comments solicited from the public on a set of papers on conditionality (posted on the IMF website in February) and from seminars, to be held in the summer of 2001, in which country officials, academic experts, and representatives of other organizations will offer their

views on IMF conditionality. In addition, the Board will take into account a staff review of the experience to date with applying the Interim Guidance Note on Streamlining Structural Conditionality.

The objective is to ensure that the IMF's guidelines on conditionality reflect the new realities and give due emphasis to the need for streamlining. Until the completion of this review, Directors agreed, the Interim Guidance Note would continue to apply.

## Review of Experience with Governance Issues

In July 1997, the Executive Board approved a Guidance Note on the Role of the IMF in Governance Issues. The note was prepared in recognition of the importance of good governance for economic efficiency and growth. It called for greater attention by the IMF to issues of governance, such as the quality of public resource management and the transparency and stability of the economic and regulatory environment.

In February 2001, the Board reviewed the IMF's experience in governance issues and concluded that the 1997 Guidance Note remained generally appropriate. Directors welcomed the proactive role of the IMF, and the World Bank, in increasing their attention to governance as a key element influencing economic performance. This heightened involvement was facilitated by the growing consensus in the international community on the importance of good governance at the national level.

The Board reaffirmed that the IMF's involvement in governance is founded on its mandate to promote macroeconomic stability and sustained noninflationary growth through surveillance, programs of financial support, and technical assistance. Directors stressed that the IMF should exercise judgment and sensitivity as it moves forward, keeping in mind the need for evenhandedness and country ownership in improving governance. The IMF's involvement should be limited to economic aspects of governance that could have a significant macroeconomic impact. In this regard, many Directors called for further efforts to apply the test of macroeconomic relevance more explicitly, and encouraged staff members to do additional analysis and research on how to apply this test more meaningfully across the IMF membership.

Directors supported the IMF's initiatives to promote good governance for all members plus specific measures to address particular instances of poor governance and corruption. Prevention should be the centerpiece of the IMF's governance strategy, Directors agreed. They were encouraged by the IMF's progress in developing and applying its instruments to promote good governance—policy advice, technical assistance, and dissemination of codes and best practices aimed at strengthening institutions and systems and the functioning of markets. Directors agreed that the IMF should continue to respect the voluntary nature of members' participation in many components, including standards and codes. In this regard, they emphasized the critical importance of timely and well-targeted technical assistance to help relieve constraints on institutional capacity.

Directors agreed that in some instances the IMF would have to use specific remedial measures in order to achieve the macroeconomic objectives of a members' reform program and to safeguard the IMF's resources. Governance issues with macroeconomic significance should also continue to be raised in the context of IMF surveillance.

Many Board members saw merit in the IMF's approach of applying judgment within relatively broad boundaries. Such an approach allowed the IMF to be appropriately involved in cases that more precisely defined boundaries might rule out. A number of Directors, however, preferred to set narrower boundaries for involvement in specific instances of poor governance, to reduce the risk of mission creep and to ensure a focus on the IMF's core areas of expertise. Directors generally agreed on the need to retain some flexibility and to exercise judgment and stressed that the rationale for such action in each case should be laid out clearly for the Board's consideration.

Addressing governance issues in areas outside the IMF's core responsibilities was a complex matter. In some cases, complementary governance-related measures were vital and Directors underlined the importance of seeking the involvement of—and collaborating closely with—other international organizations that have the relevant expertise. When the multilateral organization with the relevant expertise was unable to provide input, under established procedures IMF staff might need to be involved in the short term. Several Directors cautioned, however, that the IMF should avoid getting drawn into these areas given its own resource constraints and possible lack of relevant expertise.

Directors generally believed that the IMF should explore ways to pay more attention to the two-sided nature of corruption, including following up in country consultations on the status of implementation of OECD-led initiatives to combat bribery of foreign public officials, and on similar initiatives.

Directors stressed that the approach to conditionality in governance-related areas should be consistent with the approach to conditionality in general. They also agreed that further reviews of the IMF's experience with governance should be integrated into future reviews of surveillance, technical assistance, and conditionality.