ANNUAL REPORT 2002

CHAPTER I

World Economic and Financial Developments in FY2002

In 2001 the world economy experienced a synchronized, widespread slowdown after the unusually strong expansion of the previous year, with growth slowing in every major region except Africa (Table 1.1 and Figure 1.1). The slowdown reflected a series of intertwined developments in 2001, including the downward adjustment in equity prices (particularly in the information technology sector), a rise in energy prices, and the tightening of monetary policy in industrial countries in response to evidence of rising demand pressures. The already weakening international economy was further affected by the September 11 terrorist attacks in the United States, which had a substantial—although largely temporary—influence on macroeconomic conditions. In the first few months of 2002, however, there were increasing signs that the slowdown was bottoming out in most regions and that growth was turning up in some—most notably North America and a number of east Asian countries. This reflected, at least in part, the significant easing of macroeconomic policies in the advanced countries in 2001, especially in the United States and in a number of emerging countries in Asia, as well as the completion of ongoing inventory cycles. Partly mirroring the weakening of growth in 2001, inflation remained extremely low almost everywhere. Indeed, ongoing deflation in Japan continued to worsen already difficult economic conditions.

Financial flows to emerging market economies followed a broadly similar pattern, being weak through much of 2001 as investors became more concerned about risk, particularly in the wake of the crisis in Turkey early in the year, the September terrorist attacks, and mounting difficulties in Argentina. The impact of the terrorist attacks, however, proved less durable than had been initially feared and the crisis in Argentina led to relatively little immediate contagion to other countries in late 2001. As a result, in the first quarter of 2002, flows to emerging markets strengthened and risk spreads, as reflected in the EMBI+, came down to levels not seen since before the Russian crisis in 1998.

Global Economic Environment

A series of fluctuations in the price of oil—reflecting both demand and supply factors—dominated *developments in commodity markets.* Oil prices remained in the Organization of Petroleum Exporting Countries' (OPEC) reference band of US$22–28 a barrel range through much of 2001 as falling demand due to slowing growth was essentially offset by OPEC production cuts. The terrorist attacks in September led to an extremely brief spike in prices on fears of supply disruptions, after which prices rapidly dropped below the lower bound of the OPEC reference range as slowing activity led to a fall in actual and anticipated demand, bottoming out at around US$19 per barrel. This weakness was largely reversed in early 2002 as demand revived while OPEC and some non-OPEC members responded to price weakness with further production cuts. During April prices remained highly volatile around US$25 a barrel when a series of largely noneconomic factors raised concerns about supply disruption, including increased tensions in the Middle East and political developments in Venezuela.

Nonoil commodity prices were generally depressed through 2001 and early 2002 as slowing activity reinforced longer-term price weakness caused largely by supply factors, as well as industrial country subsidies. Early 2002 saw some increases in prices, particularly in the more cyclically sensitive metals, but overall nonoil commodity prices remained below their levels at the start of 2001. Prices of semiconductors—the market for which is rapidly gaining the same characteristics as those for "traditional" commodities—fell rapidly through 2001 as demand for information technology goods slumped before showing some revival in early 2002 on evidence of a recovery in growth.

World trade volumes fell in 2001, reflecting the weakness in economic activity, particularly in manufacturing and, more specifically, information technology—sectors that are relatively trade-intensive. Owing to the generalized and synchronized nature of the economic slowdown, all regions were affected, with

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

	1994	1995	1996	1997	1998	1999	2000	2001
World output	**3.7**	**3.6**	**4.0**	**4.2**	**2.8**	**3.6**	**4.7**	**2.5**
Advanced economies	3.4	2.7	3.0	3.4	2.7	3.3	3.9	1.2
Major advanced economies	3.1	2.3	2.8	3.2	2.8	2.9	3.5	1.1
United States	4.0	2.7	3.6	4.4	4.3	4.1	4.1	1.2
Japan	1.1	1.5	3.6	1.8	–1.0	0.7	2.2	–0.4
Germany	2.3	1.7	0.8	1.4	2.0	1.8	3.0	0.6
France	1.9	1.8	1.1	1.9	3.5	3.0	3.6	2.0
Italy	2.2	2.9	1.1	2.0	1.8	1.6	2.9	1.8
United Kingdom	4.7	2.9	2.6	3.4	3.0	2.1	3.0	2.2
Canada	4.7	2.8	1.6	4.3	3.9	5.1	4.4	1.5
Other advanced economies	4.6	4.3	3.8	4.3	2.2	5.0	5.3	1.6
Memorandum								
European Union	2.8	2.4	1.7	2.6	3.0	2.7	3.4	1.7
Euro area	2.4	2.3	1.5	2.5	2.9	2.7	3.5	1.6
Newly industrialized Asian economies	7.7	7.5	6.3	5.8	–2.4	8.0	8.5	0.8
Developing countries	6.7	6.1	6.5	5.8	3.5	3.9	5.7	4.0
Africa	2.3	3.0	5.6	3.1	3.4	2.6	3.0	3.7
Developing Asia	9.6	9.0	8.3	6.6	4.0	6.1	6.7	5.6
China	12.6	10.5	9.6	8.8	7.8	7.1	8.0	7.3
India	6.8	7.6	7.5	5.0	5.8	6.7	5.4	4.3
ASEAN-4[1]	7.6	8.1	7.3	3.4	–9.4	2.9	5.1	2.6
Middle East and Turkey[2]	0.5	4.2	4.8	5.6	3.9	1.0	5.8	2.1
Western Hemisphere	5.0	1.8	3.6	5.2	2.3	0.2	4.0	0.7
Brazil	5.9	4.2	2.6	3.3	0.2	0.8	4.4	1.5
Countries in transition	–8.5	–1.5	–0.5	1.6	–0.8	3.6	6.6	5.0
Central and eastern Europe	3.0	5.6	4.0	2.6	2.3	2.2	3.8	3.1
Commonwealth of Independent States and Mongolia	–14.5	–5.5	–3.3	1.1	–2.8	4.6	8.3	6.2
Russia	–13.5	–4.2	–3.4	0.9	–4.9	5.4	9.0	5.0
Excluding Russia	–16.6	–8.6	–3.1	1.5	1.7	2.8	7.0	8.8
Memorandum								
World growth based on market exchange rates	3.1	2.8	3.3	3.5	2.3	3.0	4.0	1.4
World trade volume (goods and services)	**8.8**	**9.7**	**6.8**	**10.5**	**4.2**	**5.3**	**12.4**	**–0.2**
Imports								
Advanced economies	9.5	8.7	6.4	9.3	5.9	7.8	11.6	–1.5
Developing countries	6.5	19.1	9.6	11.7	–0.8	1.3	16.0	2.9
Countries in transition	6.0	11.2	8.9	15.2	–0.2	–7.0	13.2	10.8
Exports								
Advanced economies	8.6	8.3	6.0	10.5	4.0	5.2	11.7	–1.3
Developing countries	11.6	11.0	9.6	13.8	4.8	4.3	15.0	3.0
Countries in transition	3.0	9.4	6.6	9.0	3.6	–0.7	14.6	6.3
Commodity prices (U.S. dollars)								
Oil[3]	–5.0	7.9	18.4	–5.4	–32.1	37.5	57.0	–14.0
Nonfuel (average based on world commodity export weights)	13.4	8.4	–1.3	–3.0	–14.7	–7.0	1.8	–5.5
Consumer prices								
Advanced economies	2.6	2.6	2.4	2.1	1.5	1.4	2.3	2.2
Developing countries	55.3	23.2	15.4	10.0	10.6	6.9	6.1	5.7
Countries in transition	252.5	133.8	42.5	27.3	21.8	44.1	20.2	15.9
Six-month London interbank offered rate (LIBOR, percent)								
On U.S. dollar deposits	5.1	6.1	5.6	5.8	5.5	5.5	6.6	3.7
On Japanese yen deposits	2.4	1.3	0.7	0.7	0.6	0.2	0.3	0.2
On euro deposits	5.7	5.7	3.7	3.5	3.7	3.0	4.6	4.1

Source: IMF, *World Economic Outlook,* April 2002.
[1]Indonesia, Malaysia, the Philippines, and Thailand.
[2]Includes Malta.
[3]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil.

the decline in exports being most marked in emerging Asia (excluding China and India), because of the importance of information technology production in the region. In contrast to other measures of activity, such as industrial production, there was little evidence of a pickup in trade volumes in early 2002.

Financial flows to emerging markets declined in 2001, with portfolio flows being especially affected by outflows from the crises in Argentina and Turkey, the deflation of the information technology bubble, and the economic slowdown in the United States, which resulted in a generalized move of investors to higher-quality assets. Indeed, in the aftermath of the September 11 terrorist attacks, bond markets were relatively closed to new issuers. In the closing months of the year, however, equity markets and then fixed-income markets revived as signs of a global recovery started to appear, and emerging market access and volumes picked up. Despite a drop in global foreign direct investment (FDI) and a fall in cross-border mergers and acquisitions activity, net FDI flows to emerging market countries are estimated to have increased to $175 billion. Emerging markets continued to pay down their external debt to international banks over the year.

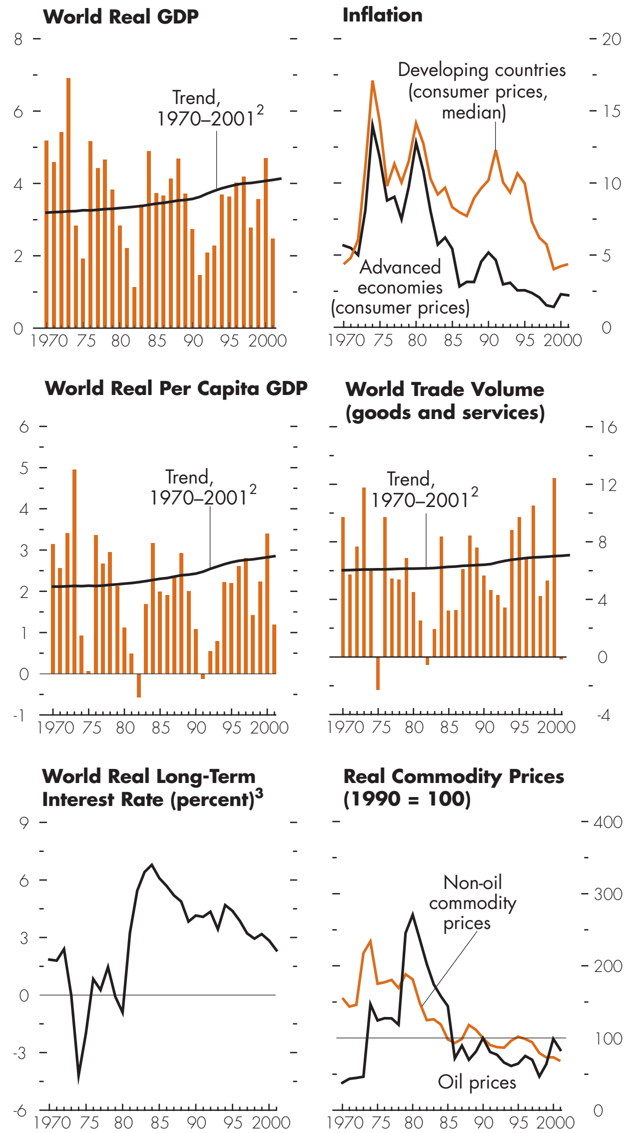
In *fixed-income markets*, the slopes of the yield curves in the United States and euro zone became quite steep, reflecting the anticipation of economic recovery. In contrast, the steeper yen yield curve pointed to renewed concerns about the health of the banking sector in Japan. Optimism about a U.S. recovery was also apparent in the corporate bond market, as credit spreads narrowed over the last two months of the year. The strength in long-term credit markets contrasted with the turbulence in short-term markets, and borrowers continued to replace short-term debt with longer-term issues as commercial paper markets became increasingly expensive.

New bond issuance by emerging market entities fell in 2001, mainly because two of the larger sovereign issuers, namely Argentina and Turkey, were affected by financial crises and were unable to maintain their traditionally large issuance programs. In the first quarter of 2002, bond issuance to emerging markets moved back in line with historical levels, as a number of sovereigns successfully tapped international markets.

In fixed-income emerging markets, the direct fallout from the Argentina crisis and default was initially limited, in part owing to more discriminating investment behavior by market participants. Other factors limiting contagion included the generally more appropriate economic policies adopted by many emerging market countries, including the use of more flexible exchange rate regimes. However, events at the beginning of financial year 2003 showed emerging markets were vulnerable as investors turned more risk averse and concerns over policy continuity and the debt structure of certain key emerging market borrowers mounted. These developments affected Latin American countries in particular as the effects of contagion were felt through banking sector channels and difficult access to new borrowing.

In *global and emerging stock markets*, a rally in January 2001 prompted by the surprise cut in U.S. interest

Figure 1.1
Global Indicators[1]
(Annual percent change unless otherwise noted)



Source: IMF *World Economic Outlook*, April 2002.
[1]Aggregates are computed on the basis of purchasing-power-parity weights unless otherwise indicated.
[2]Average growth rates for individual countries, aggregated using purchasing- power-parity weights; these shift over time in favor of faster growing countries, giving the line an upward trend.
[3]GDP-weighted average of the 10-year (or nearest maturity) government bond yields less inflation rates for the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada. Excluding Italy prior to 1972.

rates quickly fizzled in February and March on continuing evidence of U.S. economic slowing and poor corporate earnings reports. Another rally in April and May 2001 also gave way to a sell-off in June. In the months before the September 11 terrorist attacks, unfavorable economic indicators caused severe weaknesses in global stock markets. After falling sharply in the two weeks following the attacks, stock prices regained pre-attack levels by mid-October. In fact, the rally that started in late September 2001 and continued well beyond the year was the longest sustained rally since April 2000. By mid-November, most major stock markets were returning to double-digit growth rates following increased investor confidence on expectations of an imminent economic recovery. The increased confidence partly reflected the rapid monetary policy response in industrial countries. However, in the first quarter of 2002, equity prices were broadly unchanged in the United States and Europe, despite an improved global outlook owing to concerns over the quality of reported earnings in the wake of the unexpected collapse of Enron and other large corporations. Emerging economy equity markets strongly outperformed mature equity markets during the first quarter of 2002, with emerging Asia performing best, on the back of impressive gains by technology companies.

In *foreign exchange markets*, the U.S. dollar remained remarkably strong in 2001, notwithstanding the economic downturn of the fourth quarter. This strength continued in the first quarter of 2002 because markets expected that the U.S. economy would be the first to rebound from the global slowdown. However, in April 2002, with sentiment toward the dollar becoming mixed, and against the background of increased uncertainty in the outlook for corporate earnings, the dollar softened. The euro remained weak relative to the dollar throughout 2001 and first quarter of 2002 but began to strengthen in April, whereas the Japanese yen remained strong, limiting the dollar's gains. In emerging markets, the Turkish lira fell more than any other currency in 2001, after Turkey was forced to float its currency early in the year. The South African rand and to a lesser extent the Egyptian pound, the Brazilian real, and the Chilean peso also weakened significantly during the year. In contrast, the Mexican peso and the currencies of the Czech Republic, Hungary, and Poland strengthened notably. In early 2002, Argentina was forced to abandon its currency board arrangement, and the Argentine peso weakened sharply. As of May 2002, the South African rand had recovered from its 2001 low in the wake of stronger commodity prices to be the emerging market currency with the largest appreciation in the early months of 2002, followed by the Indonesian rupiah, which benefited from progress in implementing reforms.

Key Developments in Emerging Market and Industrial Countries

In *Latin American* emerging market economies, growth slowed through much of 2001. This slowdown reflected the slowdown in industrial countries; difficult external financing conditions—particularly important given the region's large external funding requirements—that came to a head during the Argentine crisis in late 2001; and a range of country-specific factors. After the onset of the Argentine crisis, economic developments diverged, with extremely difficult conditions in Argentina but increasing signs that the slowdown was ending elsewhere, particularly in those countries with the closest trading ties with the United States, including those of Central America and the Caribbean. Inflation remained low, mirroring both weak activity and improved policy frameworks.

The countries in *emerging Asia*, with the important exceptions of China and India, generally experienced sharp falls in growth rates in 2001, but began to show signs of a turnaround in 2002, while region-wide inflation remained low. The path has been largely driven by the external environment including the downturn in the global information technology industry and oil price movements. For most oil-importing countries, high prices in late 2000 and much of 2001 contributed to the weakening of incomes and demand in many countries. Subsequently, weak oil prices in late 2001 and early 2002 provided support for recovery, although in early 2002 price increases reduced this impetus. The opposite pattern is true for the region's oil producers. Poorer external conditions during 2001 also spread to domestically exposed sectors, further lowering demand, confidence, and employment, with economic and political uncertainties in some countries putting downward pressure on growth. In contrast, activity remained relatively buoyant in China and to a lesser extent in India, largely because both economies are less dependent on external trade than other economies in the region, but also because of strong domestic demand, although they too have seen some slowing in growth since 2000.

Economic performance in *central and eastern Europe* generally held up well compared with other emerging market regions during the global slowdown. Not surprisingly, exports—which are largely directed to the European Union—weakened in 2001 and early 2002 as external demand slowed, partly offset by gains in market share in some cases. The loss in external demand was largely offset in most cases by relatively robust domestic demand, generally underpinned by lower inflation and interest rates, strong investment spending (often driven by foreign direct investment), and fiscal stimulus in several countries. There was an important exception to this pattern. Turkey suffered its worst recession in over fifty years in 2001, with the events of September 11 setting back the tentative signs of recovery that had emerged following the economic and financial crisis at the start of the year, particularly through their impact on trade, tourism, and financial market confidence. Real and financial indicators in late 2001 and early 2002 suggested that conditions were again improving: capacity utilization increased throughout the second half of 2001, interest rates fell significantly after mid-October, and the exchange rate and stock market also strengthened.

Growth rates in the *countries of the Commonwealth of Independent States* remained remarkably resilient to the global slowdown in 2001, falling only slightly to an average of 6¼ percent, the highest growth rate among the major developing and transition country regions. This was underpinned by continued robust growth in the largest economies, which provided significant support to the rest of the region given the strong trade and financial linkages. In many cases, improved macroeconomic stability and policy implementation, as well as country-specific factors, supported robust growth.

Growth in *Africa* also held up relatively well in 2001 and early 2002 compared with other parts of the world, despite the weak external environment. The key influences on the outlook for much of the region continued to be the interaction between commodity market developments, the conduct of economic policies, and the extent of armed conflict and other forms of civil tension. Fluctuations in oil prices have had varying effects, with higher oil prices supporting activity in oil producers but having a harmful effect on the many other commodity exporters in the region. These include many of the poorest countries, which have also been affected by weakness in nonoil commodity prices. That said, both strong and weak performers can be found within each of these groups, with the quality of domestic policies and the extent of conflict having a key impact on whether countries have been able to resist the external downturn.

Growth in the *Middle East* slowed considerably in 2001 and early 2002, largely reflecting the global slowdown, lower oil production, and, after the September 11 terrorist attacks, the regional security situation. The curtailment of oil production associated with OPEC agreements to support flagging oil prices depressed real GDP in the oil-exporting countries, while the security situation dampened activity, including tourism, in particular in Egypt, Israel, Jordan, and the Syrian Arab Republic.

In the *industrial countries*, growth was weak in 2001. The slowdown was especially marked in the United States and Canada, in part because growth had been more robust over 2000. Both economies saw clear evidence of recovery in the early months of 2002—with positive growth in the last quarter of 2001 and a substantial acceleration in the first quarter of 2002. Europe also saw a significant deceleration in activity. Within Europe, activity was particularly weak in Germany and Italy, and relatively more robust in France and the United Kingdom, with the performance of domestic demand accounting for many of these variations across countries. Activity in Australia and New Zealand remained relatively strong, largely reflecting buoyant domestic demand. In contrast, Japan suffered its third and most severe recession of the last decade. While external factors promoted the slowdown, weakness in domestic demand was also a contributing factor. By early 2002, however, there were signs that the economy was bottoming out.

CHAPTER 2

IMF Surveillance in Action

In today's global economy, where economic developments and policies in one country affect other countries and financial market information is transmitted around the world instantaneously, the IMF's role in monitoring economic and financial developments and policies in member countries is more vital than ever before. The IMF has the mandate under its Articles of Agreement to oversee the exchange rate policies of its member countries to ensure the effective operation of the international monetary system. It exercises this "surveillance" responsibility 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 surveillance has evolved over time to reflect changing global realities, and both the practice and the underlying principles of IMF surveillance are reviewed by the Executive Board every two years (see Box 2.1). A central task is to make surveillance a more effective vehicle for preventing crises and promoting a global economic environment conducive to sustainable growth. The goal is neither the unrealistic aim of eliminating all risks of future crises nor an impractical promise to deliver definitive warnings about all future crises. Rather, the IMF's efforts focus on strengthening incentives for country authorities and market participants to assess risks appropriately and to base their policies and investment strategies on these assessments. A well-functioning market economy draws its strength and dynamism from a continuous search by producers, investors, and consumers for better results. This will always lead to some degree of overshooting and correction, particularly in asset markets. Thus the IMF encourages governments to adopt policies, including institutional reforms, to strengthen the resilience of members' economies in the face of harmful developments and financial stress—notably through appropriate exchange rate regimes; sound fiscal policies; prudent borrowing and debt management strategies; deeper, stronger, and more diversified financial systems and domestic capital markets; and more effective social safety nets.

Equally important are policies that promote sustainable growth and an open trade environment because growth, trade, debt-servicing capacity, and external viability are inextricably linked. The IMF thus has a role to play in promoting trade liberalization and has been moving toward increased coverage of market access issues in its surveillance consultations with member countries. It also encourages countries to liberalize trade by providing technical assistance to member countries in its areas of expertise that lay the groundwork for increased trade and by providing financial support for countries developing more open trade regimes.

Effective surveillance and crisis prevention have two key ingredients: sound policy advice and incentives to ensure that this advice has an impact. The IMF is continuing to strengthen its analytical capacity to identify sources of vulnerability as they emerge and to develop strategies to reduce vulnerabilities, promote stability, and foster growth. At the same time, it is paying greater attention to the factors that determine the effectiveness of its policy advice.

* * *

The IMF conducts surveillance in several ways—country (or bilateral) surveillance and global and regional (or multilateral) surveillance.

- *Country surveillance.* As mandated in Article IV of its Articles of Agreement, the IMF holds "Article IV" consultations, normally once every year, with each member country about its economic policies. These consultations are complemented by regular analysis of economic and financial developments provided by IMF staff, informal contacts with staff and national authorities, and interim Board discussions as needed.
- *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

Box 2.1
IMF Biennial Surveillance Review

The Executive Board reviews the principles and the implementation of the IMF's surveillance approximately every two years. The latest biennial review of surveillance activities was completed in large part in April 2002. The review took stock of the evolution of surveillance—both the framework within which surveillance takes place and the actual conduct of surveillance.

Directors noted that further discussions on the review of surveillance and on various surveillance-related issues—including the IMF's transparency policy—would continue, but the review so far had yielded a number of important conclusions. First, the coverage of surveillance had expanded over the years—from concentrating narrowly on monetary, fiscal, and exchange rate policies, to a broader purview encompassing external vulnerability assessments, external debt sustainability analyses, financial sector vulnerabilities, and structural and institutional policies (see Chapter 3)—and that broadened framework constituted a necessary and appropriate adaptation of surveillance to a changing global environment, most notably to the rapid expansion of international capital flows. Second, IMF surveillance had generally succeeded in embracing wider coverage without losing focus. The issues that were covered in individual Article IV consultations were generally determined by their macroeconomic relevance in country-specific circumstances. The current system of multilateral (or global) surveillance was working well and multilateral surveillance of capital markets had been improved by the creation of the International Capital Markets Department (ICM).

Given this overall record of coverage and focus, a number of specific areas were identified where further efforts were needed to ensure that IMF policy advice was sound and persuasive.

- More candid and comprehensive assessments of exchange arrangements and exchange rates within the framework of macroeconomic policies should become the normal practice throughout the membership.
- Coverage of financial sector issues should be brought up to par with coverage of other areas of surveillance. Voluntary participation in Financial Sector Assessment Programs (FSAPs) had provided for in-depth coverage of financial sector issues. However, in the absence of a member's participation in an FSAP, the quality of financial sector surveillance had been uneven across member countries, and mechanisms had to be found to improve that situation.
- To strengthen vulnerability assessments, analysis of debt sustainability had to be improved, particularly through the use of meaningful stress tests and alternative scenarios. Also, greater attention had to be paid to the private sector's balance-sheet exposure to interest rate, exchange rate, and general macroeconomic shocks, and to collecting the data required to assess that vulnerability.
- Coverage of institutional issues, such as public sector and corporate governance in certain countries, had sometimes been hampered by a lack of expertise and should be strengthened. Reports on the Observance of Standards and Codes (ROSCs) and, generally speaking, the work on standards and codes were important inputs to meeting this objective.
- Structural issues outside the IMF's traditional areas of expertise were, at times, key to a country's macroeconomic situation and, thus, had to be addressed by the IMF. To tackle such cases, the IMF should make effective use of the expertise of appropriate outside institutions, in particular the World Bank.
- There was some scope for enhancing the focus of surveillance in individual cases and areas. In particular, coverage of trade policies should be strengthened by concentrating on countries whose trade policies either had appreciable global or regional influence or had significant deleterious effects on domestic macroeconomic prospects.
- The results of multilateral (or global) surveillance exercises and the IMF's comparative advantage in cross-country analyses should be reflected in bilateral (or country) surveillance in a comprehensive and consistent manner. Particular attention should continue to be paid to the systemic impact of the policies of the largest economies in Article IV consultations with those countries.
- Article IV consultations with countries with IMF-supported programs should provide an effective reassessment of economic conditions and policies; that required a freshness of perspective and appropriate distance from day-to-day program implementation.

Directors stressed that, in many instances, the IMF could usefully complement sound advice on economic policy objectives with discussions with country authorities of alternative ways to achieve those objectives. An important component of such discussions would be consideration of social, political, and institutional factors to enhance ownership of policy recommendations and increase the likelihood of successful policy implementation.

IMF staff usually twice a year, and reports on international financial markets. 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 also increased their participation in regional initiatives of member countries—including

Box 2.2
IMF Launches Quarterly Report on Global Financial Markets

On March 14, 2002, the IMF issued the inaugural *Global Financial Stability Report*—a new publication on the health of the world's financial system. The report, which will be published quarterly, aims at providing timely and comprehensive coverage of both mature and emerging financial markets as part of the IMF's stepped-up tracking of financial markets.

The rapid expansion of financial markets during the past decade underscores the role that private sector capital flows play as an engine of world economic growth. But these flows can also be at the heart of crisis developments. In an effort to head off future crises, the *Global Financial Stability Report* seeks to deepen policymakers' understanding of the potential weaknesses in the system and to identify the fault lines that have the potential to lead to crises.

The March 2002 issue weighed the stability of the international financial system in light of an emerging global economic recovery, paying particular attention to risks posed by a slower-than-expected economic recovery and by the recent surge in the use of complex credit risk transfer mechanisms, such as credit derivatives and debt swaps. The report also examined the accuracy of selected early warning systems—statistical models designed to predict financial crises—and reviewed some alternative debt instruments that emerging market borrowers could use to tap global capital markets.

The report is prepared by the IMF's International Capital Markets Department, which was established in 2001 to enhance the IMF's surveillance, crisis prevention, and crisis management activities. It replaces both the annual *International Capital Markets* report, which has been published since 1980, and the quarterly *Emerging Market Financing* report, published since 2000.

the Southern African Development Community, the Common Market of Eastern and Southern Africa, the Manila Framework Group, the Association of South East Asian Nations, the Meetings of Western Hemisphere Finance Ministers, and the Gulf Cooperation Council (see also Appendix IV).

- IMF management and staff also take part in policy discussions of finance ministers, central bank governors, and other officials in such country groups as the Group of Seven major industrial countries, the Asia-Pacific Economic Cooperation forum, and the Mahgreb countries associated with the European Union (Algeria, Morocco, and Tunisia).

Country Surveillance

An IMF staff team meets with government and central bank officials of each member country, as well as other groups—such as trade unions, employer groups, academics, legislative bodies, and financial market participants—generally once 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, structural economic policies and governance.

To provide the basis for 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 the findings of the staff team, 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 policies. The Executive Board, where the entire membership is represented, 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 (a Deputy Managing Director), 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). Otherwise, a PIN alone may be issued. In FY2002 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.

(For more details of the IMF's bilateral surveillance, such as Financial Sector Stability Assessments, see Chapter 3, under "Crisis Prevention.") In addition, the Board assesses economic conditions and policies of member countries borrowing from the IMF through discussions of the lending arrangements that support the member countries' economic programs (see Chapter 4).

Global Surveillance

The Executive Board's conduct of global surveillance relies heavily on staff reports on the *World Economic Outlook* and international financial markets (see Box 2.2), as well as sessions on world economic and market developments.

World Economic Outlook

The *World Economic Outlook* reports feature comprehensive analyses of prospects for the world economy, individual countries, and regions, and also examine topical issues. These reports are prepared by the staff and discussed by the Executive Board usually twice a year (and later published), but they may be produced and discussed more frequently if rapid changes in world economic conditions warrant.

In FY2002 the Board discussed the World Economic Outlook on three occasions: two regular discussions were held in September 2001 and March 2002, and an additional discussion was held in December 2001 in the aftermath of the terrorist attacks in the United States of September 11, 2001. The two discussions during the 2001 calendar year focused on signs of a slowdown in world economic growth, sharply albeit temporarily exacerbated by the events of September 11. By March 2002, however, there were encouraging indications that the slowdown had bottomed out and that global economic growth was recovering.

At its *September 2001* meeting on the World Economic Outlook, the Board agreed that prospects for global growth had weakened since the last World Economic Outlook report had been released the previous May. In particular, Directors noted the substantial decline in growth in the United States over the past year; the serious deterioration in economic prospects for Japan; the weaker conditions and outlook in Europe; and the reduction in the projections for growth for most developing country regions. Slower GDP growth in almost all regions had been accompanied by a sharp decline in trade growth, Directors noted. Financing conditions for emerging markets had also deteriorated, although Board members were encouraged that the effects of contagion had been more moderate than in preceding episodes.

Directors considered that a number of interrelated factors had contributed to the slowdown, including a reassessment of corporate profitability and an associated adjustment in equity prices, higher energy and food prices, and tightening of monetary policy to contain demand pressures in the United States and in Europe. More broadly, the faster-than-expected slowdown also reflected the strong cross-country trade and financial linkages that were increasingly evident across countries.

At their *December 2001* meeting on revised projections for the World Economic Outlook, Directors discussed the impact of the September 11 attacks on the world economy. They observed that, before the attacks, there appeared to be a reasonable prospect for recovery in late 2001. However, more recent data, on which the interim World Economic Outlook revisions were based, indicated that the situation before the attacks was weaker than had earlier been projected in many areas, including in the United States, Europe, and Japan. Directors accordingly concluded that the tragic events of September 11 had exacerbated an already very difficult situation for the global economy.

In the aftermath of the September 11 attacks, consumer and business confidence had weakened further across the globe, Directors observed. There was a significant initial impact on demand and activity, particularly in the United States. In financial markets, there had been a generalized shift away from risky assets in both mature and emerging markets, including a substantial deterioration in financing conditions for emerging market economies. Between the end of September and early December 2001, however, financial markets strengthened, as equity markets recovered and the earlier flight to quality was reversed. Movements in major exchange rates had been moderate, while commodity prices had fallen back further, especially for oil, as the outlook for global growth had weakened.

The economic slowdown and worsening financing conditions had adversely affected many emerging market economies, Directors noted. Net capital flows, including foreign direct investment, were constrained. Those countries that required substantial external financing were vulnerable to reassessments of economic prospects and to further shocks in international capital markets.

Board members expressed concern that developing countries and, in particular, the poorest countries were being hurt by weaker external demand and falling commodity prices, with the oil exporters being particularly affected. Nonfuel commodity exporters would also be affected by further weakness in already depressed prices, although, for some, the benefits from lower oil prices would limit the increase in their requirement for external financing. Thus, while growth was projected to be relatively well sustained for the group as a whole, Directors were of the view that the prospects for individual countries varied widely.

Given the limitations of monetary policy in the then prevailing environment of weak confidence and excess capacity, most Directors agreed in their December discussion that fiscal policy should also play a role, particularly through the operation of the automatic stabilizers.

Directors also pointed out that the agreement reached at the World Trade Organization meetings in Doha, Qatar (see Box 2.3 below), in November 2001 to launch new trade negotiations was of particular importance, as they could be expected to contribute substantially to global economic growth over the medium term.

There had been a marked improvement in global economic prospects by the time of the Board's *March 2002* discussion. Directors welcomed the increasing signs that, since December 2001, the slowdown had

Table 2.1
Article IV Consultations Concluded in FY2002

Country Name	Board Date	PIN Issued	Staff Report Published
Albania	July 13, 2001	July 27, 2001	July 27, 2001
Algeria	August 29, 2001	September 19, 2001	September 19, 2001
Angola	March 29, 2002		
Antigua and Barbuda	March 15, 2002		
Armenia	May 21, 2001	April 2, 2002	April 2, 2002
Aruba	August 22, 2001	September 7, 2001	September 7, 2001
Austria	June 11, 2001	June 14, 2001	June 14, 2001
Azerbaijan	February 20, 2002	March 8, 2002	March 8, 2002
Bahamas	August 1, 2001	August 14, 2001	August 27, 2001
Bangladesh	April 29, 2002	May 15, 2002	June 7, 2002
Barbados	November 26, 2001		
Belarus	January 23, 2002	February 19, 2002	February 19, 2002
Belgium	March 1, 2002	March 13, 2002	March 13, 2002
Belize	July 9, 2001	August 2, 2001	August 27, 2001
Bhutan	May 7, 2001	May 23, 2001	
Bolivia	June 8, 2001	June 25, 2001	June 25, 2001
Bosnia & Herzegovina	February 25, 2002	March 22, 2002	March 22, 2002
Brazil	January 23, 2002	February 7, 2002	
Brunei Darussalam	March 4, 2002		
Burkina Faso	July 2, 2001	July 16, 2001	
Burkina Faso	April 9, 2002	May 1, 2002	May 1, 2002
Cambodia	February 6, 2002	March 1, 2002	March 1, 2002
Cameroon	July 16, 2001	July 26, 2001	August 6, 2001
Canada	February 4, 2002	March 12, 2002	March 12, 2002
Cape Verde	June 15, 2001	October 3, 2001	October 3, 2001
Chad	January 16, 2002	February 25, 2002	February 25, 2002
Chile	July 16, 2001	July 27, 2001	July 27, 2001
China, P.R. of	July 23, 2001	August 24, 2001	
Comoros	July 18, 2001	July 31, 2001	August 9, 2001
Congo, Democratic Rep. of the	July 13, 2001	July 20, 2001	July 30, 2001
Congo, Rep. of	February 6, 2002	February 25, 2002	
Costa Rica	July 30, 2001	April 24, 2002	April 24, 2002
Côte d'Ivoire	August 31, 2001	October 2, 2001	October 2, 2001
Czech Republic	July 16, 2001	July 25, 2001	July 25, 2001
Djibouti	November 30, 2001		
Dominica	June 15, 2001	July 13, 2001	July 20, 2001
Egypt	October 31, 2001	November 5, 2001	
El Salvador	July 23, 2001		
Equatorial Guinea	August 31, 2001	October 11, 2001	
Eritrea	November 26, 2001		
Estonia	June 27, 2001	July 9, 2001	July 9, 2001
Finland	November 9, 2001	November 21, 2001	November 21, 2001
France	October 26, 2001	October 31, 2001	November 5, 2001
Gabon	April 1, 2002	May 3, 2002	May 3, 2002
Gambia, The	July 13, 2001	July 26, 2001	August 20, 2001
Georgia	October 26, 2001	October 31, 2001	November 26, 2001
Germany	October 24, 2001	November 7, 2001	November 7, 2001
Ghana	June 27, 2001	August 9, 2001	August 9, 2001
Greece	February 22, 2002	March 1, 2002	March 15, 2002
Grenada	July 11, 2001	July 20, 2001	August 1, 2001
Guatemala	May 14, 2001	May 25, 2001	
Haiti	January 18, 2002	February 8, 2002	February 8, 2002
Honduras	October 5, 2001	October 26, 2001	
Hungary	May 4, 2001	May 18, 2001	
Iceland	May 2, 2001	May 24, 2001	June 12, 2001
India	June 20, 2001	August 14, 2001	
Indonesia	April 26, 2002		
Iran, Islamic Rep. of	September 6, 2001	September 18, 2001	
Ireland	August 1, 2001	August 13, 2001	August 13, 2001
Israel	July 30, 2001	August 6, 2001	August 3, 2001
Italy	November 5, 2001	November 20, 2001	November 20, 2001
Jamaica	May 30, 2001	June 6, 2001	June 14, 2001
Japan	August 3, 2001	August 10, 2001	August 10, 2001
Jordan	April 29, 2002	May 3, 2002	
Kazakhstan	January 23, 2002	February 5, 2002	March 19, 2002
Kenya	March 15, 2002	April 19, 2002	April 19, 2002

Table 2.1 *(concluded)*

Country Name	Board Date	PIN Issued	Staff Report Published
Kiribati	June 25, 2001	September 21, 2001	September 21, 2001
Korea	February 11, 2002	February 12, 2002	
Kuwait	June 27, 2001	June 29, 2001	July 20, 2001
Kyrgyz Republic	November 30, 2001	December 19, 2001	December 19, 2001
Latvia	January 18, 2002	January 25, 2002	January 25, 2002
Lebanon	October 17, 2001	October 29, 2001	
Lesotho	March 18, 2002	March 21, 2002	May 3, 2002
Liberia	February 25, 2002	July 18, 2002	July 18, 2002
Lithuania	January 16, 2002	January 24, 2002	January 24, 2002
Macedonia, FYR	March 4, 2002	March 8, 2002	March 8, 2002
Madagascar	December 5, 2001	December 13, 2001	
Malaysia	August 29, 2001	November 2, 2001	
Maldives	August 30, 2001		
Mali	December 17, 2001	January 9, 2002	January 9, 2002
Malta	July 30, 2001	August 3, 2001	August 3, 2001
Marshall Islands, Rep. of the	January 18, 2002	February 22, 2002	
Mauritania	May 9, 2001		
Mauritius	May 14, 2001	May 22, 2001	May 22, 2001
Mexico	August 2, 2001	September 27, 2001	October 25, 2001
Morocco	July 11, 2001	August 2, 2001	November 13, 2001
Namibia	February 11, 2002	February 22, 2002	
Nepal	August 31, 2001	September 21, 2001	October 3, 2001
Netherlands	June 6, 2001	July 6, 2001	July 6, 2001
Netherlands Antilles	May 7, 2001	May 17, 2001	May 17, 2001
New Zealand	March 22, 2002	March 27, 2002	March 27, 2002
Nicaragua	September 19, 2001	October 2, 2001	October 2, 2001
Niger	February 8, 2002	March 1, 2002	March 1, 2002
Nigeria	June 29, 2001	August 6, 2001	August 6, 2001
Norway	March 1, 2002	March 7, 2002	March 7, 2002
Palau	January 4, 2002	March 28, 2002	March 28, 2002
Paraguay	May 11, 2001	May 18, 2001	June 15, 2001
Portugal	March 25, 2002	April 26, 2002	April 26, 2002
Russian Federation	March 8, 2002	April 4, 2002	April 4, 2002
St. Vincent and the Grenadines	January 28, 2002	February 19, 2002	February 19, 2002
Samoa	May 9, 2001	July 11, 2001	
San Marino	December 5, 2001	December 21, 2001	December 21, 2001
São Tomé & Príncipe	January 30, 2002	February 28, 2002	February 28, 2002
Saudi Arabia	October 10, 2001	November 7, 2001	
Senegal	September 28, 2001	October 18, 2001	October 24, 2001
Sierra Leone	March 11, 2002		
Singapore	June 25, 2001		
Slovak Republic	July 27, 2001	August 1, 2001	August 6, 2001
Slovenia	May 11, 2001	May 21, 2001	May 21, 2001
Slovenia	March 20, 2002	April 4, 2002	April 4, 2002
Spain	February 1, 2002	February 28, 2002	March 13, 2002
Sudan	November 14, 2001		
Suriname	May 9, 2001	May 24, 2001	
Swaziland	March 20, 2002		
Sweden	August 31, 2001	September 25, 2001	September 25, 2001
Switzerland	May 9, 2001	May 21, 2001	May 21, 2001
Syrian Arab Republic	December 3, 2001		
Tanzania	September 24, 2001		
Thailand	August 2, 2001	August 16, 2001	
Tonga	September 4, 2001	October 31, 2001	
Trinidad & Tobago	July 6, 2001	July 17, 2001	July 24, 2001
Turkey	April 15, 2002	April 19, 2002	
Ukraine	April 24, 2002	May 8, 2002	
United Arab Emirates	October 12, 2001		
United Kingdom	March 4, 2002	March 7, 2002	March 7, 2002
United States	July 27, 2001	August 14, 2001	August 14, 2001
Uzbekistan	March 11, 2002		
Vietnam	November 21, 2001	January 4, 2002	January 9, 2002
Zambia	November 7, 2001	December 6, 2001	
Zimbabwe	December 14, 2001	June 19, 2002	June 25, 2002

bottomed out, and that a global recovery was under way. This recovery was evident in the United States and Canada, and, to a lesser extent, in Europe and in some countries in Asia. Financial markets had bounced back strongly after the September 11 shock, commodity prices had begun to pick up, and emerging market financing conditions had strengthened markedly. Nevertheless, different but serious concerns remained in a number of countries, notably Japan and Argentina.

Directors observed that several factors underpinned the recovery. Most important was the substantial easing of macroeconomic policies in advanced economies—particularly the United States—and also in a number of emerging economies, especially in Asia. The scope for such policy support owed much to earlier progress in lowering inflation, strengthening fiscal positions, and reducing other sources of vulnerability, which enabled the membership to respond promptly and effectively to the difficult situation that the world economy had faced the previous year. Directors also noted that the adjustment in inventories appeared to be well along in the United States and some other advanced economies, and that this would also help boost production in the period ahead. The recovery in the major currency areas had also been supported by lower oil prices, although this was less of a factor following the strong pickup in prices since late February 2002. Directors underscored the importance of stable oil prices for a durable world economic recovery.

Overall, Directors agreed that the risks to the outlook had become more evenly balanced since their December 2001 discussion. Indeed, recent indicators of confidence, employment, and activity in the United States had been surprisingly positive, suggesting that the recovery would be stronger than earlier projected.

At the same time, a number of potential downside risks in the outlook required continued attention, Directors noted. First, in part because of the synchronized slowdown, relatively little progress had been made in reducing persistent imbalances in the global economy—notably, the high U.S. current account deficit and surpluses elsewhere, the low U.S. personal saving rate, the apparent overvaluation of the dollar and undervaluation of the euro, and the relatively high household and corporate debts in a number of countries. With the United States leading the recovery, Directors considered that these imbalances could, at least in the short term, widen further.

In discussing the implications of this prospect for the global outlook, Directors observed that the continued favorable outlook for U.S. productivity growth and capital inflows might reduce the risk of a disorderly unwinding of the current account imbalances. Most agreed that in the major currency areas, policies—especially structural policies—should be formulated to ensure an orderly reduction of current account imbalances that would enhance the sustainability of the global recovery.

Directors noted a second source of risk to the outlook. Following the strong rebound in past months, global equity prices again appeared to be richly valued and might reflect an excessively optimistic outlook for corporate earnings. If earnings growth were to prove disappointing, there would be a renewed risk of a weakening in financial markets, confidence, and activity. The analysis of the impact of asset prices on consumption, provided in Chapter 2 of the April 2002 *World Economic Outlook*, indicated that asset prices, in particular equity prices, had become more important over time as a determinant of consumer spending. Given the aging of populations in industrial countries, as well as continued financial market development, this trend was likely to continue, suggesting that developments in asset prices might have become increasingly important in the formulation of macroeconomic policies.

Specific concerns highlighted by Directors included the adverse effects the continuing economic difficulties in Japan and Argentina—while different in nature—could have on other countries in their regions. Most Directors regretted the decision by the U.S. authorities in early 2002 to raise tariffs on steel imports and the prospect of retaliation by other countries. They reiterated the critical importance for all countries to resist protectionist pressures and to ensure that substantive progress is made with multilateral trade negotiations under the Doha round.

Directors concurred that macroeconomic policies in most industrial countries should remain generally supportive of the emerging recovery. However, they noted that, with the exception of Japan, there appeared little need for additional policy easing and that, in countries where the recovery was more advanced, attention should turn in time toward reversing earlier monetary policy easing. Over the medium term, policy should seek to support sustainable growth, while aiming for an orderly reduction in global imbalances. This would require continued structural reforms to encourage growth in the euro area and in some Asian emerging markets; decisive action in Japan to reinvigorate the economy; and for the United States to ensure that medium-term fiscal targets were met. Directors also underscored the importance of using the recovery to make further progress in reducing vulnerabilities, including through accelerated efforts to address looming problems created by the aging of the populations of industrial countries; a sustained effort to achieve balanced budgets in the euro area; development of a medium-term fiscal consolidation plan in Japan; reform of the corporate and financial sectors in Asia; and medium-term efforts to strengthen fiscal positions in China, India, and many Latin American countries.

Sustained broad-based economic growth would be crucial to achieve higher living standards and an enduring reduction in poverty in the developing countries, Directors agreed. They noted that, despite encouraging progress in a number of countries, GDP growth in sub-Saharan Africa remained well below what would be needed to reduce poverty significantly. National policies would have to play the lead in improving economic performance, especially those designed to improve the conditions for savings, investment, and private sector activity. Stronger international support of sound policies would also be essential. In this connection, Directors welcomed the progress made at the Monterrey, Mexico, Conference on Financing for Development in March 2002 (see Box 5.6), including the announcement of increased aid targets by the European Union and the United States. They stressed, in particular, the vital importance of phasing out trade-distorting subsidies and giving greater access in world markets to exports from developing countries.

Major Currency Areas. On the prospects for the major currency areas, Directors agreed that recent indicators increasingly pointed to recovery in the *United States.* Confidence and equity markets had picked up, household spending had remained strong, and manufacturing output had stabilized. Some Directors considered that activity could pick up even more rapidly than currently projected, especially given the size of the policy stimulus in the pipeline and the continued resilience of productivity growth. Some other Directors, however, pointed to the possibility of a less sustained or less resilient upturn, for example if low corporate profitability or excess capacity constrained investment growth, equity prices failed to sustain recent gains, or households rebuilt savings.

Given the balance of risks, Directors supported the U.S. Federal Reserve Board's decision to keep interest rates on hold for the time being. While they noted that monetary policy should not be tightened prematurely, they agreed some tightening would be required if economic activity continued to strengthen. Directors agreed that no further fiscal stimulus was warranted at this stage. While recognizing that the deterioration in the fiscal position over the past year was the result of a combination of factors—including tax cuts, a stimulus package, and the emergency and security spending measures taken in the aftermath of September 11—Directors considered that the time had come to turn attention to the efforts needed over the medium term to preserve fiscal balance and address pressures stemming from the social security system.

Directors expressed serious concern about economic conditions and prospects in *Japan*. The economy was in its third recession in a decade, confidence and activity remained very weak, and the banking sector experienced severe strains. While welcoming initiatives and noting some signs of a possible bottoming out in the fall of activity, Directors urged the authorities to push ahead vigorously with measures directed at bank and corporate sector restructuring, which would remain the key to restoring confidence and reestablishing prospects for solid growth. Although there was little scope for further macroeconomic stimulus, they also agreed that monetary policy needed to remain focused on ending deflation. Given the high public debt and rising long-term interest rates, Directors stressed the need for a clear and credible commitment by the Japanese authorities to medium-term fiscal consolidation, backed by reforms to the tax system, public enterprises, and the health sector.

Directors were encouraged that recent business confidence surveys and a pickup in industrial production pointed to an emerging recovery in the *euro area*. While the recovery was likely to be somewhat slower and to come later than in the United States, a number of Board members pointed to the contribution that Europe's strong fundamentals had made to global stability. Building on recent progress, further policy reforms to support a strong and sustained recovery should nevertheless have continued to receive the highest priority. Directors emphasized the need for euro area economies to move ahead with structural reforms, in particular in the financial sector, labor markets, and pension systems. They noted that the introduction of euro notes and coins in January 2002 meant that such structural reforms should be even more beneficial. Directors supported the European Central Bank's monetary policy stance, which was to keep interest rates on hold while being ready to move in either direction as macroeconomic developments unfolded. On the fiscal side, they said that countries with sizable structural deficits would need to strengthen their fiscal positions as growth picked up, both to provide scope for the automatic stabilizers to function during subsequent slowdowns, and to help tackle rising fiscal pressures from aging populations.

Emerging Markets. Directors noted that the prospective recovery in industrial countries should play a central role in supporting activity in *emerging markets*, along with continued efforts to strengthen economic fundamentals to reduce vulnerability and enhance productivity growth. In Asia, which—with the exception of China and India—was particularly hard hit by the global slowdown, there were clear signs of a pickup in activity, aided by a nascent strengthening in the electronics sector and easier macroeconomic policies in a number of countries. The emerging recovery would need to be supported by ongoing reforms across the region, especially in financial and corporate sectors. In India, structural fiscal reforms were needed to back the substantial consolidation required, Directors considered, while China should move ahead with reforms to address the competitive challenges arising from WTO membership and, in particular, tackle difficulties in the state-owned enterprises, the banking sector, and the pension system.

Directors considered the diverse prospects facing Latin America. They noted with concern that the situation in Argentina remained very difficult, and that a significant contraction in output in 2002 appeared unavoidable. While Directors noted the steps the authorities had taken to address the difficult economic situation, they stressed the need to rein in the fiscal deficit and strengthen the banking system, and urged the authorities to move quickly to put in place a sustainable economic program that could receive financial support from the international community. Spillovers from Argentina on other regional economies initially appeared to have been generally limited (with the exception of Uruguay), although they remained a potential risk. Directors noted that the recovery was likely to be strongest in Mexico and Central America, two regions that are closely linked economically to the United States, as well as in some Andean countries. In other countries the pace of recovery was likely to be more subdued.

Directors welcomed the analysis in the *World Economic Outlook* of debt crises in Latin America. They cautioned against generalizations across countries and across different stages of their reform processes. Nevertheless, they noted the extent to which the region's relative closure to external trade, higher macroeconomic volatility, relatively underdeveloped domestic financial markets, and low saving rates might help to explain the high incidence of debt crises in this region. Many countries had made progress in recent years in reducing vulnerability, mainly by adopting more flexible exchange rate regimes and developing domestic capital markets. The analysis had again underscored the benefits that countries in the region could reap from further progress in strengthening fiscal positions as well as from continuing reforms of their trade and financial systems.

Growth among most candidates in *central and eastern Europe* for membership in the European Union had been generally well sustained during the global slowdown. Robust domestic demand had offset weaker export performance, and growth was expected to pick up further as the global recovery took hold. While the high current account deficits in many of these countries had so far been readily financed by direct investment and other capital inflows, they nevertheless represented a source of vulnerability that, Directors agreed, underscored the importance of ongoing fiscal discipline and structural reforms to ensure a positive climate for investment and growth. Directors welcomed the recent improvements in economic indicators in Turkey. They expected that strengthening confidence and exports should underpin a sustained recovery in 2002, provided the strong implementation of sound macroeconomic and structural policies continued.

Growth in the countries of the *Commonwealth of Independent States* (CIS) had also remained remarkably resilient to the global slowdown, Directors observed, although they considered that the pace of activity in 2002 might weaken somewhat—mainly as a result of slowing demand in the region's oil-exporting countries. Board members welcomed the accelerated structural reforms in Russia, while noting that efforts to improve the investment climate remained a key priority. For the region as a whole, the central challenge continued to be to accelerate progress in structural reforms, notably in the areas of institution-building and governance, enterprise and financial sector restructuring, and in reducing the role of the state. The high level of external debt in a number of the poorest CIS countries continued to be a serious concern and would require ongoing close monitoring.

Directors were encouraged that growth in *Africa* had held up well in 2001 and was expected to remain relatively strong in 2002. The outlook for much of the region continued to depend heavily on commodity market developments, and on further progress in eradicating armed conflict and other sources of civil tension. It would also be important to contain the rise of famine in the southern African regions. Directors highlighted the central role that sound economic policies had played in raising significantly per capita income growth in strongly performing African countries in recent years. Sustained economic growth and diversification would require faster structural reforms, including improvements in public service delivery and infrastructure, trade liberalization, and strengthened regulatory institutions and more secure and stable property rights. Directors welcomed the New Partnership for African Development, endorsed in July 2001 by the leaders of the Organization for African Unity (OAU), which emphasized African ownership, leadership, and accountability in improving the foundations for growth and eradicating poverty. They stressed that these efforts would need to be supported by external assistance, including the further reduction of trade barriers, increased development aid—especially for HIV/AIDS—and support for capacity-building efforts (see Box 5.5).

Directors observed that growth in the *Middle East* was projected to weaken in 2002, although much would depend on oil market developments and the impact of the regional security situation. They noted that the adverse impact of lower oil prices in 2001 on oil-exporting countries had been limited by the prudent macroeconomic policies of recent years. Over the medium term, a key policy priority in many countries was to continue efforts to diversify production into nonenergy sectors and hence to reduce dependence on oil revenues.

Background Analysis. Directors welcomed the analysis of previous *recessions and recoveries* in industrial countries (Chapter 3 of the April 2002 *World Economic Outlook*). They noted that the synchronicity of the recent global slowdown had much in common with past downturns, whereas the relatively unsynchronized recessions of the early 1990s were an exception that reflected different shocks in different countries. In the recent downturn, the collapse in investment spending associated with the bursting of the technology bubble was also consistent with sharp drops in business fixed investment, which occurred typically in the lead-up to recessions in recent decades.

The mildness of the recent global slowdown was in line with the historical trend toward shallower recessions. However, the short duration and mildness of the recent downturn did not imply that the recovery would be slow or weak. Increases in interest rates prior to the recent downturns were smaller than before, which reflected relatively low inflation during the previous expansion. This helped to explain why the subsequent downturns had been relatively mild.

Regarding *monetary policies in a low-inflation environment*, Directors agreed that a major reason for the remarkable decline in inflation among industrial countries over recent decades had been the change in emphasis of central banks toward price stability and associated beneficial changes in private sector behavior. In discussing some of the policy challenges facing central banks, many Directors cautioned against drawing policy conclusions prematurely, noting that in several countries the low-inflation environment had not significantly hampered the effectiveness of monetary policy. More generally, in their view, the credibility of anti-inflationary monetary policy was an important asset that should be preserved.

International Capital Markets and Global Financial Stability

In June 2001, the Board held its last review of developments in the mature and emerging international capital markets in the context of an annual *International Capital Markets* report. Published since 1980, *International Capital Markets* has been combined with another report, *Emerging Market Financing*, in a new publication, the *Global Financial Stability Report* (see Box 2.2.). This report focuses on current conditions in global financial markets, and is intended to help the IMF look forward and draw policy implications to strengthen its role in promoting international financial stability and preventing crises. The frequency of the report—every quarter—and its focus on contemporary issues should enable the Board to keep up with fast-changing events in financial markets.

The new report is one element in a broad effort by the IMF to strengthen surveillance of international capital markets. Other elements include the *World Economic Outlook* reports, the Board's regular reviews of world economic and market developments, the ongoing work on private sector involvement in preventing and resolving financial crises, work on standards and codes, the Financial Sector Assessment Program (FSAP), and Special Data Dissemination Standards (SDDS).

International Capital Markets Report, June 2001

In their June 2001 discussion, Directors noted that the preceding year had been dominated by periods of increased asset price volatility, slowing growth in the global economy, and crises in key emerging markets. Adjustments in capital markets were evident in a repricing of risks in a wide range of equity and high-yield bond markets. Directors were of the view that the high correlation of asset price movements across countries reflected the globalization of finance and the increasing tendency of investors to invest on the basis of industrial sectors or credit ratings, rather than geographic location.

Slowing global economic growth had been both anticipated by, and reflected in, a sharp fall in global equity markets—particularly in technology stocks—and a dramatic rise in high-yield credit spreads, although financial markets had later recovered significantly after monetary policy was eased in the major countries. Directors noted that there had been a remarkable degree of co-movement in asset prices among the major advanced countries, particularly between European and U.S. stock markets. The key exception was Japan, which seemed somewhat delinked from global markets. This reflected the more important role of domestic than foreign investors and the remaining weakness in the country's corporate and financial sectors.

In discussing the risks facing international financial markets in the period ahead, Directors considered that—although the declines in equity markets had corrected part of the imbalances of recent years—there was still a risk that market sentiment might remain vulnerable to U.S. economic developments. Other sources of vulnerability could be concerns about the ability of monetary policy to offset economic weakness and about the sustainability of high productivity growth. In addition, if the sustainability of the current high U.S. household, corporate, and external imbalances came into question, a significant and potentially disorderly rebalancing of domestic and international portfolios might occur, which could affect key exchange rate relationships. The assessment of risks was complicated by a number of structural developments, including increasing concentration in the major financial systems, a growing reliance on over-the-counter (OTC) derivatives, and structural changes in major government securities markets. Those structural changes appeared to have reduced transparency about the distribution of financial risks in the international financial system; greater disclosure could help to enhance market discipline and official oversight. Board members noted, nonetheless, that U.S. banks appeared to be more robust than in previous downturns and were sufficiently well capitalized to weather a possible credit deterioration.

Directors reviewed the risks in Europe and Japan. Regarding Europe, Directors cautioned that, while banks remained strong, capital markets might be more vulnerable to spillovers and contagion from volatility in U.S. capital markets as well as to common shocks that appeared to affect these large economies simultaneously. Directors also expressed concern that loan provisioning in the Japanese banking sector might be inadequate and that this sector also had significant exposures to bond and equity prices in the Japanese market. At the same time, the Japanese banking sector seemed vulnerable to continued poor domestic macroeconomic performance, large unanticipated external economic and financial shocks, and volatility in Japanese financial markets.

While noting that domestic developments remained the key drivers of capital flows to emerging markets, Directors considered that, in the past year, emerging markets' access to international capital markets had been strongly affected both by events in the mature markets and by crises in emerging markets. As a result, many emerging markets had found it difficult to maintain continuous market access. While, in earlier periods, exchange rate and banking crises in emerging markets and the ensuing contagion had led to an abrupt loss of markets access, during the past year many emerging markets had lost market access mainly because of developments in mature markets, such as the collapse of equity prices on the Nasdaq exchange in the United States.

Directors agreed that a shift in the investor base for emerging market instruments had increased the vulnerability of capital-importing emerging market countries to shifts in investor sentiment or investment strategies. Because holdings of emerging market assets by "dedicated" investors remained limited, "crossover" investors—those who could place a small fraction of their assets in emerging market instruments, with large effects on these markets—had come to dominate the current investor base. Directors emphasized that those investors were likely to reduce or eliminate their holdings of emerging market assets if the outlook for emerging markets deteriorated, if more attractive investment opportunities in mature markets arose, or if managers became more risk averse. That could result in an abrupt loss of market access for emerging market borrowers that was not necessarily related to changes in emerging market fundamentals. Although Directors noted that emerging market borrowers had shown welcome adaptability—particularly through syndicated loans, prefunding of obligations, and the use of alternate currencies—to the "on-off" nature of market access, such adaptations could sharply increase the cost of access to international financial markets. It was difficult to assess whether that shift would be long lasting. In any event, emerging market economies should not be deterred from pursuing sound and transparent policies. Over time, that could help to restore the role of investors in providing financing for emerging markets and hence reducing volatility.

Against the background of data pointing to a further weakening of global economic prospects, Directors reviewed the outlook for capital flows to emerging markets. They acknowledged that, while those flows were influenced by developments in mature markets and prospects for the global economy, the domestic policies in capital-importing countries could also be a factor in their distribution. With lower interest rates and a relatively soft landing, the gross issuance of international bonds, equities, and syndicated loans could increase, and net flows to emerging markets—particularly non-oil-exporting emerging markets—recover in line with the global economic recovery. Nevertheless, Directors also recognized that if the global slowdown in economic growth were sharper than expected, the consequence could be a marked slowdown in capital flows to emerging markets, including in foreign direct investment (FDI). Directors were of the view that, since FDI flows remained the single largest source of capital in all regions, the staff should monitor them closely and assess the conditions and policies that would foster greater stability.

Major Government Securities Markets. Directors agreed that the structural changes under way in the major government securities markets had implications for financial markets and should be kept under review. They noted that the shrinking supply of U.S. treasury securities had already resulted in important changes in U.S. and international financial markets, as market participants had come increasingly to rely on other instruments, including swaps. Directors noted, however, that private financial instruments might not easily, or fully, substitute for treasury securities as domestic and international safe havens.

Some harmonization of regulation and convergence of issuance and trading practices had already occurred in government securities markets in the euro area. Over time, greater convergence and integration was likely to promote the emergence of a uniform euro-area benchmark yield curve and an increase in euro-area market liquidity. At the same time, the region's corporate bond market had become more integrated and had grown rapidly.

Directors discussed the situation in Japan, where lingering economic uncertainty and financial imbalances had impaired corporate financial activity and fuelled a rise in the supply of government debt. The combination of a low-interest-rate environment and technically driven changes in the supply of and demand for Japanese government bonds (JGB), along with shortcomings in the market infrastructure that had adversely affected market liquidity, had led to JGB market volatility while spreads in the corporate bond market had been significantly compressed. That situation presented financial institutions with challenges in managing risk, and also highlighted the challenges to the Japanese authorities of managing the costs and risks of a large and growing supply of government debt. Directors noted the steps taken to improve the JGB market infrastructure to enhance the efficiency and attractiveness of the JGB market to domestic and international investors.

Financial Sector Consolidation in Emerging Markets. Many emerging markets had undergone financial sector consolidation, although its extent and pace had varied in different regions. Directors saw this process as one facet of the continuing globalization of international financial activities, and akin to a "quiet" opening of capital accounts. While the migration of financial activities to low-cost financial centers was profoundly altering the financial systems of many emerging markets, it also linked them to international financial markets.

Directors pointed out that a number of aspects of the consolidation process differed from the experience of mature markets, including the role of cross-border mergers and acquisitions, which had been rare in mature markets. Furthermore, consolidation in emerging markets had frequently been a vehicle for restructuring the financial system following major financial crises, whereas, in mature markets, consolidation had more often been designed to reduce excess capacity. Also, the authorities had played a major role in fostering consolidation in emerging markets, whereas market forces had been the predominant force for consolidation in mature markets.

The process of financial sector consolidation in emerging markets raised a number of complex policy issues, Directors observed, including how to create sufficient market discipline and official supervision for institutions that were "too-big-to-fail." The experience of mature markets indicated that dealing with these problems would involve strengthening supervisory capacity to monitor the activities of large complex financial institutions, and establishing clear entry and exit rules and prompt corrective action for distressed institutions.

Directors noted that the emergence of financial conglomerates providing a wide range of products and services complicated prudential supervision and regulation. These conglomerates raised the issue of how the regulatory agencies overseeing banks, securities, and insurance companies should be structured. Directors considered that this would depend on the specific circumstances of each country or region.

On the topic of e–finance, Directors noted that, while its development was still at an early stage in most emerging markets, there had been steady growth in the application of the Internet to the production and delivery of financial services. This underscored the need for improved liquidity management at the level of financial institutions and better supervision.

Global Financial Stability Report, February–March 2002

In the Board's February inaugural discussion of the *Global Financial Stability Report* (published in March), Directors welcomed the recovery in global markets and the reduction in global risk aversion since the fourth quarter of 2001. They noted the remarkable turnaround in market sentiment regarding the strength and speed of a U.S.-led global economic recovery. Overall, financial markets had responded well to the uncertainties that arose during the slowdown and following the events of September 11, and had recovered quickly once it became clear that economic prospects were improving.

Mature equity markets in early 2002 had shown lackluster performance. Directors noted that this reflected widespread concerns about accounting problems that, among other things, reduced transparency on the true extent of the leveraging undertaken by corporations and financial institutions during the boom years.

Turning to the emerging markets, Directors agreed that contagion from the default and devaluation in Argentina had been subdued. More careful discrimination by investors across emerging markets, a variety of technical factors, and the adoption of sound economic policies geared toward more flexible exchange rates, higher official reserves, lower short-term debt, and stronger current account positions had contributed to the resilience of emerging markets during the fourth quarter of 2001 and beyond. However, risks remained, as events in Argentina were still unfolding and there was still significant uncertainty. Evidence of contagion might take the form of slower capital flows, including foreign direct investment, to some emerging markets. Furthermore, Directors observed that any unexpected changes in the global risk environment or the global economic outlook could adversely affect emerging market borrowers.

Stability Implications of Global Financial Market Conditions. While the international financial system had remained resilient in the face of serious disruptions, global financial conditions had worsened during 2001 across a broad range of markets, institutions, and sectors, Directors observed. Deteriorating credit quality and corporate earnings were reflected in higher corporate bond spreads and lower stock prices. These price adjustments had adversely affected the balance sheets of corporations and households. The slowdown had also affected financial institutions, although the major institutions in the United States and Europe seemed to be well capitalized. Directors acknowledged the heightened strains in Japan's financial system, and underscored the importance of decisive moves by the Japanese authorities to deal with long-standing weaknesses in the banking, insurance, and corporate sectors.

Turning to the outlook for global financial market conditions, Directors agreed that the main risks related to the potential for a subdued or delayed global recovery. With asset prices seemingly reflecting expectations of a near-term economic rebound, a subdued or delayed recovery could lead to market corrections. Directors noted that, under this scenario, Japan and emerging market borrowers could experience particularly adverse effects. The adjustment could also include a temporary and selective withdrawal from risk taking by financial institutions. At the same time, the resilience of the international financial system during financial disruptions in the 1990s was cause for optimism that the adjustments would be manageable.

Credit-Risk Transfer Market. Directors noted that credit-risk transfer markets had grown very rapidly, an indication of the useful role they played in spreading risk among economic agents and contributing to portfolio diversification, and in providing alternative sources of liquidity. Concerns about the activities of new and less-regulated participants in credit markets could be addressed by improved disclosure and transparency. Many Directors also called for strengthened oversight of nonbank and nonfinancial entities that were active in financial markets. They expressed concern that regulatory arbitrage might shift risks to institutions least capable of managing them, and that accounting and auditing standards and practices might be deficient in several major countries. These Directors suggested that a top priority in the period ahead should be to update the supervisory and regulatory frameworks to keep pace with the evolving credit-risk transfer markets.

Further Development of Early Warning System Models. Directors agreed that the development of models to provide advance warning of a country's vulnerability to crisis and of the buildup of systemic risk in financial markets was important for effective market surveillance and crisis prevention. Although such early warnings could be useful in helping the IMF to provide timely advice to prevent crises, given their current limited predictive power, early warning system (EWS) models should be used carefully and together with qualitative and other methods of vulnerability assessment. With this caveat in mind, Directors supported efforts to refine the EWS models currently being used in the IMF's work. Those efforts could also complement work at the national level on early warning systems. Noting that currency crises were not the only threat to financial stability, most Directors welcomed efforts to develop the basic building blocks of a more general early warning system able to predict other types of crises, including debt and banking crises.

Alternative Financing Instruments. Directors urged caution on the use of alternative debt instruments, other than "plain-vanilla" bonds and regular loan issues, to maintain access to global capital markets in times of financial difficulties. While acknowledging that some of those instruments might be useful under certain conditions, Directors stressed that they should not substitute for strong economic policies and sound debt management practices—the main foundation for sound and sustainable access by emerging market borrowers to international capital markets. They noted that where high bond yield spreads reflected investor concerns about a country's solvency, the use of some of those alternative instruments could make the problems worse.

Regional Surveillance

Central African Economic and Monetary Community

In May 2001, Executive Directors discussed developments and policy issues in the Central African Economic and Monetary Community (CEMAC), whose members include Cameroon, the Central African Republic, Chad, the Republic of Congo, Equatorial Guinea, and Gabon. They commended the authorities of the CEMAC countries for the progress made during 2000 in strengthening economic integration. The policy dialogue with the CEMAC regional institutions had served as a useful complement to bilateral surveillance, given the broadening range of policy issues dealt with at the regional level. They encouraged the authorities to continue to carry forward the process of integration at the next meeting of the Council of Ministers.

Directors noted that the sharp increase in oil-producing CEMAC countries' export earnings and government revenues in 2000 had led to a large reduction in the community's overall fiscal and external imbalances and to a strong recovery in the international reserves of the Bank of Central African States (BEAC). They viewed the competitive position of CEMAC as broadly adequate but noted that the economic situation remained fragile. The region was vulnerable to external shocks, especially to a drop in the price of crude oil and a weakening of the U.S. dollar against the euro, to which the CFA franc is pegged. In that context, Directors stressed the need for sustained implementation of structural reforms and efforts to diversify the economic base and produce a stable macroeconomic environment. They expressed concern about the sharp increase in domestic demand in 2001, which was expected to lead to a widening of the external current account deficit. Consequently, Directors also stressed the importance of further fiscal consolidation with a focus on strict control of government expenditure and saving of the oil revenue windfalls.

Notwithstanding progress made in 2000, an acceleration of the pace of economic integration would enhance CEMAC's credibility. Directors encouraged the authorities to strengthen regional institutions and establish a solid framework for close coordination of fiscal and structural policies, which would provide firm support to the common exchange rate regime. The success of efforts to strengthen integration would depend on the implementation of both coherent and comprehensive convergence programs by individual member countries and the implementation of an effective system of mutual regional surveillance of member countries' policies. Such a system should include binding rules and quantitative criteria, periodic reviews, and mechanisms to compel individual countries to take corrective measures in case of slippages.

Directors encouraged the authorities to improve the conduct of monetary policy and to take steps to strengthen the functioning of the regional interbank money market, which was essential for an efficient distribution of bank liquidity. They welcomed the decision to phase out the automatic granting of central bank credit to governments but urged member countries to proceed very cautiously on a proposal to have the central bank guarantee government security issues.

While acknowledging the recent progress made in rehabilitating the banking sector, Directors expressed concern at its continuing fragility. There was ample scope for a further strengthening of banks' management and supervision of the banking system. A large number of banks did not comply with the core prudential ratios. Directors stressed the importance of completing the programs of bank restructuring and privatizations. They also underscored the importance of strengthening the Central African Banking Commission (COBAC) and keeping it free of political interference, and of reforming judicial systems to ensure that they did not contribute to a weakening of national banking systems.

Directors welcomed the member countries' decision to further liberalize trade through a simplification of the present structure of the common external tariff, a reduction of average tariff rates, and the elimination of remaining intraregional barriers. To enable them to reap the benefits of economies of scale and strengthen domestic enterprises' competitiveness, Directors encouraged the authorities to work on common sectoral policies that are critical to regional integration, focusing on infrastructure, transportation, communication, and energy. They also stressed the importance of creating a favorable environment for private investment by implementing initiatives in business laws, investment charters, and competition policy.

Directors encouraged the authorities to seek technical assistance to enhance and harmonize the production of regional statistics, especially in national accounts, consumer price indices, trade, balance of payments, and government financial operations. They considered that the IMF should provide technical assistance for data improvement, as well as to promote macroeconomic convergence and enhance COBAC's capacity to carry out regional surveillance.

West African Economic and Monetary Union

In October 2001, the Board discussed recent economic developments and the main policy issues in the West African Economic and Monetary Union (WAEMU), whose members include Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo. The slowdown in the WAEMU region's overall growth performance that began in 1999 had continued. The negative effects of adverse external developments on the macroeconomic performance of the region had been compounded by a deterioration of the economic and financial situation in Côte d'Ivoire. There was a possibility that this economic slowdown could be prolonged beyond 2001 if the global environment and commodity prices weakened further. Against this background, Directors underlined the necessity of strengthening macroeconomic policies, deepening structural reforms, and improving competitiveness in the WAEMU countries to achieve the ultimate goals of economic integration in terms of growth and poverty reduction.

Directors commended the authorities of the WAEMU for the progress on the integration process in 2000, with the entry into force of the customs union and the steps taken to implement the Convergence, Stability, Growth and Solidarity Pact, which was adopted in December 1999. While welcoming adoption of the medium-term convergence programs by all countries, Directors noted that owing to weaknesses in policy implementation and the economic slowdown in the region, compliance with the regional convergence criteria by member countries had proved difficult, as indicated by the situation at the end of 2000. They believed that observing the convergence criteria by the end of 2002 would imply a more forceful political commitment, the implementation of corrective measures by member countries' governments, and a reinforcement of the institutional capacities at both the national level and on the part of the WAEMU Commission to oversee the convergence process. Directors attached particular importance to a stronger political commitment on the part of member governments to remove remaining obstacles to the creation of a single regional market and the establishment of a full-fledged customs union. They also emphasized the importance of external support in moving the integration process forward and, in particular, the role of technical assistance in strengthening the regional institutions and ensuring the effective implementation of the various regional policy initiatives.

A prudent monetary policy had resulted in a further accumulation of foreign assets of the Central Bank of West African States (BCEAO) and an inflation rate broadly in line with that of the euro zone, Directors noted. The BCEAO's key policy rates had not been adjusted since mid-2000, and they considered that there could be scope for greater flexibility in monetary management in light of the slowdown in economic activity. However, Directors emphasized the critical importance of sound fiscal policies and the associated containment of the governments' domestic financing needs in supporting an appropriate monetary policy. In this connection, they drew particular attention to the need to bring public debt down to sustainable levels and to avoid arrears.

Directors underscored the importance of deepening the regional interbank market and achieving greater integration of the WAEMU region's financial markets in facilitating private economic growth and fostering financial stability. They welcomed the decision to eliminate outstanding central bank credits to governments and to establish a regional securities market for member countries' governments, although they recommended a realistic implementation schedule. Directors encouraged the authorities to identify and eliminate the obstacles to the regional interbank market. Those reforms would facilitate the financing of fiscal deficits from nonbank sources, enhance the BCEAO's ability to manage liquidity in the banking system through market mechanisms, and promote the development of an efficient and competitive financial sector.

Despite the progress over the past ten years in rehabilitating the banking sector and conducting an effective supervision of banks, compliance with the recently revised prudential arrangements and regulations on internal controls appeared inadequate. Steps to strengthen banks' loan portfolios in the region should include measures to improve the observance of prudential ratios by banks, strengthen loan-recovery mechanisms, and improve the judicial environment. Directors noted that more effective banking supervision was essential for the successful development of a regional financial market.

Directors supported recent steps to harmonize indirect taxation in the WAEMU, formulate a draft common investment code, strengthen common sectoral policies, and establish structural funds, all of which should contribute to the reduction of regional disparities. They encouraged the authorities to move forcefully in addressing the remaining agenda, including harmonizing taxation of petroleum products, promoting common tax regulations and a concerted effort to control tax exemptions, and making necessary improvements in the taxation of small businesses.

The external competitiveness of the WAEMU economies was adequate on the basis of a number of traditional exchange rate indicators, Directors agreed. In view of the longer-term structural problems besetting the WAEMU economies, however, an overriding priority for the authorities should be to implement policies aimed at broadening the productive base, improving productivity, and enhancing cost efficiency in the provision of key public utilities and services. Directors encouraged the authorities to develop and monitor nontraditional competitiveness indicators, such as export market shares.

Directors noted the efforts under way to integrate the WAEMU into the regional arrangement of the Economic Community of West African States (ECOWAS)[1] with a view to creating a larger regional market and extending the common monetary framework to cover a broader group of countries in the region. To achieve this goal, it would be essential to further harmonize macroeconomic policies and trade policies between the WAEMU and non-WAEMU members of ECOWAS and to establish a credible surveillance mechanism to promote convergence among member states. Notwithstanding the desirability of such increased convergence and despite the strong political support underpinning the integration process within ECOWAS, the goal of achieving a single monetary union in West Africa by 2004 appeared very ambitious, owing to a range of economic reasons and institutional capacity constraints.

Directors believed that a strategy for regional integration would need to include the production of timely and reliable regional statistics, especially on national accounts, domestic debt, foreign trade, balance of payments, and the adoption of new indices to measure movements in prices and factor costs.

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

In October 2001, Executive Directors discussed the monetary and exchange rate policies of the euro-area countries and developments in trade policies of the European Union.

[1]Comprising Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, The Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, and Togo.

Policies of the Euro Area. Directors noted that in the face of large and global disturbances—including the earlier rise in energy prices, the downward correction in equity markets, and the marked slowdown in world trade growth—the euro area's economic expansion had proven less resilient than anticipated. Against this already sluggish background, the economic repercussions of the events of September 11 were likely to dampen near-term growth prospects further. Nonetheless, the area's macroeconomic fundamentals were sound, with low underlying inflation and much-strengthened fiscal positions, complemented by supportive policies that provide a base for a new cyclical upswing.

The area's cyclical setback should not detract from the considerable macroeconomic achievements of the last few years that were rooted in price stability, employment-friendly wage setting, fiscal consolidation, and a measure of structural reform. Those elements had provided the basis for faster income growth and job creation, especially in those countries that had implemented labor market reforms and sustained wage moderation. Structural rigidities remain pronounced, however, and Directors urged that reform efforts be stepped up across the area, especially in countries where labor market reforms had been lagging in recent years. More broadly, they highlighted the positive impact that growth-supporting macroeconomic and structural policies by the euro-area countries would have on global economic prospects.

As for monetary policy, Directors noted that risks to price stability were receding and that the European Central Bank (ECB) had properly reversed a significant portion of the monetary tightening it undertook in 2000. They commended the swift action by the ECB, in concert with the U.S. Federal Reserve and other central banks, to shore up confidence and provide sufficient liquidity to the banking system in the aftermath of the events of September 11.

Looking ahead, Directors expected risks to price stability to diminish further, particularly as weaker growth prospects and abating price pressures had increased the likelihood of continued wage moderation in 2002. The recent growth in M3 in excess of the ECB's reference value appeared to some extent to reflect temporary velocity shocks related, among other things, to portfolio shifts and should therefore not be given undue weight in policy assessments. Against this background, Directors saw room for further monetary policy easing, particularly if the euro appreciated. A number of Directors encouraged the authorities to continue their efforts to improve market understanding of the policy framework underlying the ECB's monetary decisions.

In discussing the factors responsible for the weakness of the euro's external value, many Directors noted the role played by the much steeper rise of stock market capitalization in the United States than in the euro area, the ongoing international diversification by euro-area investors, and the increased issuance by nonresidents of euro-denominated liabilities.

On fiscal policy, Directors strongly endorsed the objective, embedded in the Stability and Growth Pact (SGP),[2] that member countries reach and maintain budgetary positions either close to balance or in surplus over the medium term. This objective provided an anchor for assuring fiscal discipline while allowing for budget outcomes to vary over the cycle and across countries, as required for a well-functioning monetary union with a high degree of fiscal decentralization.

In considering how this objective might best be achieved, Directors discussed the merits of a framework that would combine the free play of automatic stabilizers with adherence to preannounced expenditure paths. In the view of a number of Directors, a key advantage of this approach would be to safeguard the medium-term orientation of the SGP while providing a stabilizing framework for monitoring each member state's position relative to its medium-term deficit objective. In contrast, focusing on meeting annual nominal deficit targets would, in the face of the global slowdown, require offsetting the operation of the automatic stabilizers, thus delaying the projected recovery. Other Directors, however, considered that reference to expenditure paths could usefully support the achievement of medium-term SGP objectives but should not replace nominal deficit targets.

Directors welcomed recent indications that, albeit with variations across countries, fiscal developments for the area as a whole broadly appeared to strike an appropriate balance between cyclical considerations and medium-term consolidation objectives. Most Directors agreed that, especially in light of the current generalized slowdown, the automatic stabilizers should be allowed to work. They generally did not see the need for significant discretionary fiscal policy actions to counteract the growth slowdown at that point, in view of the likely temporary nature of the adverse shocks and the effects such actions would have on fiscal positions.

Resolute and broad-based structural reforms would play a key role in raising the area's growth potential and rebuilding business and consumer confidence. Directors welcomed the recent progress made toward more competitive product markets. They looked forward to further steps being taken in areas such as public procurement, state aid, administrative reforms, and the reduction of the regulatory burden on business. They regretted that relatively little had been done to address

[2]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.

the work disincentives associated with tax and social benefits systems in many euro-area countries or to free up labor markets, including through more flexible wage-formation processes. Referring to the progress made by some countries on the basis of partial steps, Directors urged the authorities to aim for the major improvements in economic performance that should accrue from a more vigorous implementation of labor market reforms. Some Directors considered that a renewed effort toward structural reforms, aimed at enhancing the area's productivity growth rate, could also contribute to a stronger euro over time.

Directors expressed their appreciation for the intensive preparations that had been made to ensure a smooth changeover to euro banknotes and coins and welcomed assurances that the changeover would not lead to an increase in prices. They looked forward to a successful completion of this reform of unprecedented scope, which should result in greater price transparency and enhanced competition.

Referring to the integration of capital markets as one of the greatest potential benefits of European Economic and Monetary Union (EMU), Directors expressed the hope that the recommendations of the Lamfalussy Report[3] for streamlining the legislative process would soon come into play and encouraged the authorities to speed up implementation of the Financial Services Action Plan. Integrated capital markets posed new challenges to financial crisis prevention and management, and there was a need for significant strengthening of information exchanges among supervisors and of their decision-making processes.

Directors considered that further improvements in the availability, timeliness, and quality of euro-area statistics would be highly desirable, particularly for short-term cyclical indicators and balance of payments statistics, and they urged the authorities to continue their efforts to make improvements in these areas.

Directors welcomed the completion of three Reports on Standards and Codes (ROSCs) for the euro area (covering payment systems issues and the transparency of monetary policy and payments system oversight) and expressed broad agreement with their findings.

Recent Development in EU Trade Policies. Regarding the trade policies of the European Union (EU) as a whole, Directors expressed their conviction that the new Doha trade round would provide a much-needed boost to global growth prospects and urged the EU to continue to accord high priority to reaching agreement on the scope of such a round and to show leadership and flexibility to further the negotiations. They welcomed the EU's "Everything-but-Arms" initiative for the least-developed countries and the proposed steps to simplify the EU's Generalized System of Preferences. Directors emphasized that while those initiatives would be helpful in improving market access for eligible countries, more rapid progress in opening highly protected sectors to all trading partners would not only benefit developing countries but also entail significant gains for the EU itself. In this regard, they highlighted the essential contribution that a comprehensive reform of the EU's Common Agricultural Policy would make to both supporting trade liberalization and preparing for the EU's enlargement.

Trade and Market Access Issues

In September 2001, the Board discussed the role of the IMF in trade. Directors agreed that the IMF had a substantial role to play in supporting an open international trading system and trade liberalization. They saw four avenues through which the IMF could make an effective contribution. First, it should continue to highlight the need for the successful launch of the new Doha trade round (see Box 2.3) and the benefits it could bring, both by raising living standards in all countries and by ensuring a stable world trading system.

Second, Directors agreed, the IMF should continue to address trade issues and support trade liberalization in the context of surveillance and IMF-supported programs where appropriate. Some progress had been made in focusing on market access issues in Article IV consultations with industrial countries, but more needed to be done to identify practices that impeded the exports of developing countries. Developing countries should also be encouraged to continue trade liberalization efforts to improve efficiency and foster sustainable growth. Directors emphasized that trade reforms should be designed with appropriate sequencing and with due regard to their impact—particularly in the short term—on revenue and the current account. In the context of IMF-supported programs, any conditionality pertaining to trade measures should be consistent with the guidelines and evolving practice for streamlining conditionality.

Third, Directors considered that technical assistance from the IMF should continue to play a vital role in laying the groundwork for successful trade liberalization. Reforms by members in the areas of the IMF's particular expertise—namely, revenue systems and tax and customs administration—had often been essential in facilitating a smooth transition to more liberal trade regimes, with minimal impact on fiscal revenue.

[3]Alexandre Lamfalussy (Chairman) and others, 2001, *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets* (Brussels: European Union, Council of Economic and Finance Ministers [ECOFIN], February 15); available on the Internet at http://europa.eu.int/comm/internal_market/en/finances/general/lamfalussyen.pdf.

Fourth, the IMF should continue to cooperate closely with the World Trade Organization (WTO) and the World Bank to avoid duplication and to ensure that the work of the three institutions on trade was complementary. Noting the strategic importance of trade for sustainable growth and poverty reduction in the poorest countries, Directors welcomed the cooperative efforts of the IMF, the World Bank, the WTO, and others in revitalizing the Integrated Framework for Trade-Related Technical Assistance. They supported the efforts of the World Bank and the IMF to help poor countries "mainstream" trade into their overall development and poverty reduction strategies, and, within that framework, to better target and coordinate technical assistance to improve its effectiveness.

Directors agreed that the IMF's financing facilities were generally adequate to support members' efforts to liberalize trade. The IMF was well placed to assist members, given the importance of a stable macroeconomic environment, an appropriate exchange rate policy, and the overall incentive framework for the success of trade liberalization efforts. In addition to the revenue and balance of payments implications of trade reform, Directors identified other areas where they thought further work, in collaboration with the World Bank, was needed in the design of trade liberalization, including the appropriate sequencing of trade liberalization; the impact on the poor; the short-run adjustment costs in terms of output and employment, and measures to mitigate these costs; and the potential for export diversification in relevant cases.

In the communiqué issued following its meeting on April 20, 2002, the International Monetary and Financial Committee of the IMF's Board of Governors noted that enlarging market access for developing countries and phasing out trade-distorting subsidies would benefit both developed and developing countries. The Committee welcomed the commitment, reiterated at the United Nations Conference in Monterrey, Mexico in March 2002, to work toward the objective of duty- and quota-free market access for the exports of the least-developed countries. It also noted the potential for increased opportunities from lowering trade barriers among developing countries.

Box 2.3

Doha Development Agenda

The November 9–14, 2001, Fourth Ministerial Conference of the World Trade Organization (WTO), held in Doha, Qatar, launched a new round of multilateral trade negotiations—the Doha Development Agenda. The new round is the ninth since the signing of the General Agreement on Tariffs and Trade (GATT) in 1947 and the first since the conclusion of the Uruguay Round in Marrakech in 1994, which led to the establishment of the WTO.

The new round is comprehensive and aims to liberalize trade across a wide range of tradable goods and services and to update and strengthen the rules of the multilateral trading system. It also extends the work of the WTO into essentially new areas, such as investment, competition policy, and the environment. Rule-making constitutes a significant portion of the work program and is aimed at clarifying and improving disciplines on trade remedies (for example, antidumping measures), regional trade agreements, trade-related intellectual property rights, and the dispute settlement mechanism.

The fuller integration of developing countries into the trading system is a common theme of the Doha agenda. The Ministerial Declaration adopted at the Doha conference seeks to place the needs and interests of the developing countries at the heart of the work program. This is manifested by the importance it attaches to including the objective of duty- and quota-free market access for least-developed-country (LDC) producers, rules that take account of the special circumstances and implementation constraints of developing countries, and trade-related technical assistance and capacity-building programs. The development provisions in the declaration include commitments to make special and differential treatment more precise, effective, and operational and for special work programs for LDCs and small economies to promote their integration into the world trading system.

The launch of the new round sent a clear signal rejecting inward-looking policies and protectionism and provides a boost to market confidence and global prospects. For the new round to succeed, however, the intentions set out in the Doha agenda will need to be translated into actions including the opening up of markets, particularly for goods and services of greatest importance to developing countries.

CHAPTER 3

Strengthening the International Financial System

Discussions of how to reform the international financial system took center stage in 1998 in the aftermath of the crises in the Asian countries. Since then, much has been done to improve the IMF's capacity for crisis prevention and the architecture of the international financial system more generally. Specifically, initiatives have been launched to improve the IMF's analysis of countries' vulnerability; to increase the transparency of economic policymaking by member countries as well as of the IMF's own policies and operations; to promote timely and accurate reporting to the IMF and publication of economic data within a framework of internationally accepted standards; to strengthen financial sectors, including through prudential supervision; and to encourage the adoption of consistent monetary and exchange rate regimes less prone to crisis. As a result, policies have been strengthened in many countries. The resilience of the global economy and the international financial system in the face of the economic slowdown of 2001 and the events of September 11 suggests that these efforts are beginning to bear fruit.

Nevertheless, it would be unrealistic to suppose that all member countries will always be able to avoid crises. Thus the IMF has also been working to strengthen its capacity to assist members to resolve crises. During FY2002, the Board discussed two main aspects of this work. First, it examined how to help members cope with difficulties, when they arise, of maintaining their access to capital markets in a fashion that also maintains the stability of the international financial system. Second, in relation to extreme cases when a member needs to restructure its financial obligations, the Board investigated frameworks for sovereign debt restructuring that would lead members to be more inclined to approach their creditors at an early stage, before delay destroys value and increases the scale of economic disruption. At the same time, the Board recognized that care should be taken in the design of a new framework to avoid inducing countries to look to default as an easy way of avoiding needed adjustments.

Another key area of work to strengthen the international financial system—the international effort against money laundering—took on heightened importance in the wake of the events of September 11, 2001. Those events prompted a reexamination at national and international levels of mechanisms to promote and enforce laws combating not just money laundering but also the financing of terrorism. In this context, the IMF discussed how it should intensify its contribution to these international efforts, and work advanced on several fronts.

This chapter describes the progress made in the areas of crisis prevention (external vulnerability, transparency, standards and codes, and strengthening financial sectors), crisis resolution (including sovereign debt restructuring), and combating money laundering and the financing of terrorism up to April 2002. It also covers work done in the related areas of offshore financial center assessments and capital account liberalization. For IMF surveillance of international capital markets during the year, see Chapter 2. In addition, more detailed information on the initiatives that have been launched can be found on the IMF website.

Crisis Prevention

Assessing External Vulnerability

The crises of the late 1990s were in many ways different from earlier crises and prompted a reevaluation of traditional methods of assessing a member's vulnerability to changes in external circumstances. This reevaluation has reflected the increased role of private financing in emerging markets, the increased interconnectedness of markets across the globe, and the links between external financing difficulties and distress in the financial and corporate sectors—links formed partly by pressures on a country's exchange rate. With the prevention of crises and the promotion of financial stability among its top priorities, the IMF has strengthened its analysis of the vulnerability of member countries to changes in external circumstances and, in particular, to capital market conditions.

In October 2001, the Executive Board took stock of the progress in monitoring members' external vulnerability on a more continuous basis, especially for emerging market economies, whose access to international capital markets is often not certain. Directors welcomed the increased efforts to combine qualitative analysis reflecting individual country circumstances with vulnerability indicators and other quantitative tools, and the improved integration of bilateral and multilateral surveillance activities, as crises can emanate from either advanced or emerging market economies. They noted that the use of information on markets and market developments in vulnerability assessments was being further strengthened by the work of the new International Capital Markets Department.

Directors observed that the IMF was drawing systematically on a number of separate inputs:

- *The latest revisions to the World Economic Outlook.* These are the starting point for any assessment of vulnerabilities because a key objective is to capture influences from the global economy on emerging market countries, including through the explicit consideration of adverse scenarios.
- *Early warning system models.* These models estimate the likelihood of a balance of payments crisis based on a combination of vulnerability indicators. While work continues on improving their performance, these models still miss many crises and predict others that do not occur, and are likely to remain imperfect, somewhat mechanical, signaling tools; as such they need to be qualified by detailed country analysis and used cautiously.
- *Financing requirements.* Where there is a risk that a country's access to global financial markets may become difficult or be interrupted, detailed estimates of its external financing needs and prospective sources and uses of funds are important. The potential for liquidity problems is also reflected in the work on reserve adequacy, which takes into account indicators such as the ratio of reserves to short-term external debt, and stress testing of the balance of payments. This work on reserve adequacy and the work on assessing the determinants of spreads and ratings are useful to inform preventive policies.
- *Market information and contagion risks.* Besides the direct information content of foreign exchange spreads on borrowing costs for individual countries, the analysis of spreads serves to focus attention on changes in market perceptions and as such sharpens the discussion of contagion. The new International Capital Markets Department is responsible for systematically drawing on market information as well as refining tools to understand markets and market behavior.
- *Financial sector vulnerability assessments.* The IMF's specialized knowledge about the financial sectors of its members is a key input into the IMF's evaluation of vulnerabilities. Evaluations under the Financial Sector Assessment Program (FSAP)—jointly sponsored by the IMF and World Bank—help to assess the robustness of the financial sector through stress tests and alternative scenarios. For all countries, the staff remains actively involved in financial sector monitoring and advice.
- *Area department expertise.* The specialist knowledge of the IMF's area departments on their countries provides a broader perspective and judgment on the tools used for vulnerability assessments.

The increased focus on vulnerability and appropriate policy responses has further highlighted the significance of addressing gaps and deficiencies in the required data. The IMF's Special Data Dissemination Standard (SDDS) already provides an agreed framework for making available data on reserves and external debt. Other data needed for vulnerability assessments include those on foreign exchange exposures of the financial sector and the nonfinancial corporate sectors, and countries' financing needs—including their reliance on rollovers, trade finance, and bond finance. Directors encouraged staff to focus more intensively on these informational needs to ensure that data availability improves over time, and stressed that many countries would require technical assistance to achieve this.

Strengthened vulnerability assessments allow for timely policy adjustments to forestall external crises. Directors agreed that the IMF had an important role to play in involving national authorities in the discussion on vulnerabilities and in convincing them of the urgency of such measures, while information on possible future crises had to be kept strictly confidential. They underscored the role of the Board—through, for example, applying peer pressure and charging management explicitly to take action to express heightened concern on the part of the IMF. In this regard, it was all the more essential that the results of the staff work on vulnerability be communicated to Executive Directors in a timely fashion.

Work to reduce external vulnerabilities of member countries has continued to involve the development of policy guidelines. *Guidelines for Public Debt Management*, developed by the IMF and the World Bank, were published at the end of FY2001. *Guidelines for Foreign Exchange Reserve Management* were also developed in close collaboration with reserve management entities from a broad group of member countries and international institutions and published in September 2001 (see Box 3.1). In October 2001, the Executive Board considered a paper on issues related to reserve adequacy and management, including the implications of the capital account approach to assessing reserve adequacy for reserve management. The paper was also

Box 3.1
Board Discusses Guidelines for Foreign Exchange Reserve Management

During their September 2001 review of the Guidelines for Foreign Exchange Reserve Management, subsequently published by the IMF, the Board noted that the guidelines would serve as a set of basic principles for countries to draw upon in formulating sound reserve management policies and practices. Directors welcomed the voluntary nature of the guidelines and agreed that their scope and coverage were appropriate. The focus on a prudent risk management framework, and the emphasis on transparency and accountability frameworks, provided a basis for disseminating sound reserve management practices. Such practices complemented prudent macroeconomic policies and sound financial sectors, which were critical for building countries' resilience to shocks and preventing financial crises.

Directors also expressed appreciation for the feedback received from a broad group of member countries and international institutions in a comprehensive outreach process organized during the preparation of the guidelines. This process had strengthened members' sense of ownership of the guidelines and helped to ensure that the guidelines were in line with generally accepted sound practices. In particular, reserve managers had welcomed the focus of the guidelines on broadly applicable principles, while avoiding prescriptive practices, so as to ensure their relevance for members with a wide range of institutional structures at different stages of development.

Since there was no universally applicable set of practices for all countries, implementing the guidelines should be done in a way that took into account specific country circumstances. In discussing the potential use under surveillance, and in line with the voluntary nature of the guidelines, Directors agreed that the guidelines could be used to inform discussion between the authorities and the IMF on key areas requiring improvement in reserve management but should not be treated as rigid requirements or formal benchmarks for assessing reserve management.

meant to assist countries in formulating strategies for investing reserve assets and managing risk and to complement existing guidelines on reserve management. A next step will be to consider reserve adequacy in the context of a broader approach to external liquidity management, including external debt management.

The agenda for further work on vulnerability assessment is broad and evolving, and Directors have discussed a number of potential improvements to the various inputs into the assessments. The priorities ahead include work on national balance sheet approaches to crisis prevention and resolution, and on financial sector indicators. In addition, continuing efforts will be made to better understand market dynamics, to identify developments in individual countries that may have implications for other members, and to take careful account of the aggregated effects on the global economy of similar policies synchronized across a number of countries.

Transparency

Increased transparency, in both economic policy and in economic and financial data, can strengthen a market participant's ability to assess credit risks appropriately and so reduce the likelihood of crises and lessen their severity when they do occur. To this end, the IMF has promoted the transparency of its members' policies, undertaken a wide-reaching program to improve public understanding of its own policies and operations, and encouraged feedback from national authorities and from the public on transparency and other key policy initiatives. The IMF website has been a primary channel for these efforts.

There has been a dramatic change in the last few years in the IMF's publication policy and the availability of information about the IMF and members' policies. Before 1994, as far as country information was concerned, little more than research-oriented working papers and some background papers to Article IV staff reports were published by the IMF. The only publicly available information on an Article IV consultation was usually a brief summary in the IMF's *Annual Report.* Details of IMF-supported programs were considered confidential. Now the IMF publishes a wealth of information about its policy advice, lending arrangements, finances, and policies and assessments on key topics.

The IMF took an important step in bringing greater transparency to the IMF's bilateral surveillance when it launched Public (originally Press) Information Notices (PINs) in mid-1997. As of April 30, 2002, PINs summarizing the Executive Board's Article IV consultations on the economic situation of member countries had been published for 90 percent of the IMF membership, up from 56 percent at end-1998. But more notably, full Article IV staff reports are now published when the country concerned agrees. Between June 1999, when the Board decided to authorize the release of Article IV staff reports on a voluntary basis, and end-April 2002, 106 members have published 177 reports. Participation has been uneven, however, with publication rates highest for advanced, Western Hemisphere, and Central and Eastern European members.

The change in transparency with respect to IMF-supported programs has been as important. Chairman's statements, news briefs, and press releases following Executive Board discussion of the use of IMF resources are now released on a routine basis. There is a presumption that the documents setting out the authorities' intentions under their IMF-supported programs will be released to the public, and 96 percent of all such documents have been published since January 2001, when the Board approved the publication of all such documents. In January 2001, the Board agreed to the release of stand-alone staff reports on IMF-supported programs (Use of Fund Resources reports), subject to the member's consent. Through end-April 2002, 55 percent of stand-alone reports on IMF-supported programs had been released, with publication rates highest among the countries of Central and Eastern Europe.

The IMF is now more transparent in its policies and operations. Staff papers discussing key policy issues and summaries of Executive Board discussions of these papers are now released. In addition, the IMF has engaged in a dialogue with the public on some key policy issues. For example, public comment has been sought on the IMF's review of conditionality through the Internet and through seminars with wide participation of academics, policymakers, and nongovernmental organizations. A number of outside (as well as internal) evaluations of IMF activities and programs have been conducted in recent years, and the results of almost all of those studies have been published. Finally, an Independent Evaluation Office (IEO), which was established to complement the IMF's existing review and evaluation procedures, began operations in FY2002.

Standards and Codes

The spread of internationally accepted standards and codes of good practice in policymaking and institutional arrangements contributes to the better working of markets by allowing participants and policymakers to compare information on country practices against agreed benchmarks. Standards are also designed to improve transparency and good governance, and increase the accountability and credibility of policy.

Launched in response to the Asian crises, the IMF's standards and codes initiative has encouraged the development and improvement of internationally recognized standards in key areas; led to assessments of countries' observance of standards; and helped countries implement standards, including through the provision of technical assistance. Seeking and responding to feedback from authorities and the private sector have been important aspects of the initiative. During FY2002, progress was made on all these fronts.

Fourth Review of IMF's Data Standards Initiatives

In July 2001, the Executive Board concluded policy discussions on the IMF's Special Data Dissemination Standard (SDDS) and General Data Dissemination System (GDDS). This was the *Fourth Review of the IMF's Data Standards Initiatives*, in the course of which Directors discussed observance of the SDDS, the template for the dissemination of reserves data, the development of the external debt data category, and participation in the GDDS. In addition, the Board reviewed the staff's proposal to integrate an assessment methodology, called the Data Quality Assessment Framework, into the structure of the data module of the Reports on Observance of Standards and Codes (ROSCs), as a central element of a Data Quality Assessment Program. (See Box 3.2.)

Directors welcomed the opportunity to review the experience under the IMF's data standards initiatives and to consider proposals for their further refinement and consolidation. They expressed their strong appreciation to the staff for its work in this area. Directors supported the consultative approach applied in strengthening the design and implementation of these initiatives (see Box 3.3), and stressed that the voluntary nature of the initiatives as well as the cooperative approach to their implementation should remain important characteristics in moving forward. The substantial progress achieved in recent years under the IMF's data initiatives had further raised the IMF's standing as a center for dissemination of economic and financial statistics.

Directors highlighted the importance of members' data dissemination efforts for improved transparency and crisis prevention. They commended national authorities on the substantial progress achieved so far, as evidenced by the strong increase, since last year's review, in the number of countries meeting the specifications of the Special Data Dissemination Standard. They were also encouraged that participation in the General Data Dissemination System was increasing at a satisfactory pace and in line with the target set at the Third Review of Data Standards Initiatives.

The increased interest in the SDDS among users was evidenced by an increase in the usage of the Data Standards Bulletin Board (DSBB) and the feedback from the IMF's outreach efforts. Directors supported the staff's plans to strengthen further its outreach efforts through seminars on international standards and codes, as well as take advantage of the opportunities afforded by ROSC missions and surveys of the DSBB's users to solicit views.

Progress was also being made in the area of external debt statistics. Directors noted the work being done to finalize the *Debt Guide* as well as the positive response from the IMF membership to a series of seminars to raise awareness of the data dissemination standards for external debt and ascertain the extent to which countries were advancing toward meeting these requirements. The implementation of the new external debt data category would be discussed during the next review of the IMF's data standards initiatives.

Directors welcomed the development of the Data Quality Assessment Framework, and most supported its integration into the data module of the ROSC. Directors agreed to preserve the structure of the ROSC module, whereby the module would continue to provide a summary assessment of a member's observance with the data dissemination standards complemented with a summary assessment of data quality.

Looking ahead, Directors broadly agreed that the IMF's data standards would need to be updated to take into account the latest developments in statistical methodology. They also supported implementing an open exchange system for the distribution and exchange of statistical information on the Internet, which would enhance the functionality and user friendliness of the DSBB.

Most Directors agreed that the next review of the IMF's data standards initiatives should take place in the second half of 2003.

Assessing Members' Observance of Standards

The number of assessments summarized in ROSC modules increased by over 100 percent during FY2002. As of end-April, 228 ROSC modules for 76 economies had been completed and 165 for 59 economies had been published. Assessments are being carried out by the World Bank on countries' observance of standards in the areas of corporate governance, and accounting and auditing. Participation in ROSC modules—which is voluntary—has been led by member countries in Central and Eastern Europe.

Although members are responsible for implementing standards, the IMF and other international bodies are helping by providing technical assistance. (For further details, see Chapter 7.)

Feedback from Users of Reports on Observance of Standards and Codes

The IMF—in cooperation with other institutions, including the World Bank and the Financial Stability Forum—has undertaken a series of outreach missions designed to inform and solicit feedback from members and markets of the work on standards. In the last financial year, IMF staff has participated in seminars in France, Germany, Italy, Spain, Tunisia, and the United States, as well as at the World Trade Organization in Geneva and the OECD/Development Assistance Committee in Paris.

This outreach has elicited feedback that is helping to make ROSCs more accessible to users—for example, shorter in length, with a standardized format, and with more comprehensive country coverage. National authorities have also expressed concern that adequate technical assistance be made available to help them address weaknesses identified in standards assessments. Steps are being taken to respond to these concerns and the associated resource implications.

Box 3.2
IMF's Data Standards

The IMF's Data Standards Initiatives aim to enhance the availability of timely and comprehensive statistics and therefore contribute to the pursuit of sound macroeconomic policies and to the improved functioning of financial markets.

The **Special Data Dissemination Standard** (SDDS) was established in 1996 to guide countries that have or might seek access to international capital markets in the provision of data to the public. As of April 30, 2002, there were 50 subscribers to the SDDS—in November 2001, Costa Rica became the third new subscriber (the others were Brazil and Tunisia) since the end of the transition period in December 1998. Subscription is voluntary. Among other things, subscribers undertake to follow SDDS requirements on the coverage, periodicity, and timeliness of the data; to issue calendars identifying when data are to be released; and to pursue good practices with respect to the integrity and quality of the data. SDDS subscribers supply information about their data dissemination practices for posting on the Internet on the Dissemination Standards Bulletin Board (DSBB) at http://dsbb.imf.org. In addition, subscribers are required to maintain an Internet website, referred to as a National Summary Data Page (NSDP), which contains the actual data and to which the DSBB is electronically linked.

The **General Data Dissemination System** (GDDS) was established in 1997 as a framework for countries to improve their statistical systems to meet the evolving requirements of the user community. The GDDS fosters the application of sound methodological principles, the adoption of rigorous compilation practices, and the observance of procedures that ensure professionalism and objectivity. Countries that participate in the GDDS provide metadata describing their data dissemination practices and detailed plans for improvement for posting on the DSBB.

In July 2001 the Executive Board approved an important enhancement to the IMF's data standards. The **Data Quality Assessment Framework**—and its integration into the data module of the Report on the Observance of Standards and Codes[1] (ROSC)—addresses the concern that standards assessments should examine not only the periodicity, timeliness, and coverage of data releases but also the quality of the data being released. The framework for assessing data quality was developed by the IMF in consultation with national statistical offices, international organizations, and data users outside the IMF. It brings together best practices and internationally accepted concepts and definitions in statistics and covers such dimensions of data quality as integrity, methodological soundness, accuracy and reliability, serviceability, and accessibility, as well as the related institutional prerequisites.

[1]Reports on the Observance of Standards and Codes, a joint endeavor of the IMF and World Bank carried out in consultation with the relevant authorities of the respective countries, summarize the extent to which countries observe certain internationally recognized standards.

Strengthening Financial Sectors

Along with the Asian crises, the banking sector problems faced by a large number of IMF members have highlighted the critical importance of concerted action to strengthen financial systems. During FY2002, as part of its intensified financial sector surveillance activities launched in recent years, the IMF continued to carry out a number of financial "health checkups" under the Joint IMF–World Bank Financial Sector Assessment Program (FSAP), examined the use of summary financial soundness indicators, and gave greater focus to assessments of offshore financial centers.

Box 3.3
Collaborating on Standards

IMF staff members have collaborated with a number of other groups to revise and develop standards. Staff members are working with

- the Basel Committee on the New Basel Capital Accord—a crucial complement to the Basel Core Principles, the internationally recognized standard for banking supervision;
- relevant international agencies to develop assessment methodology and guidance on international standards for securities regulation (International Organization for Securities Commissions, IOSCO), insurance supervision (International Association of Insurance Supervisors, IAIS), and systemically important payment systems (Committee on Payment and Settlement Systems, CPSS);
- the Bank and the International Accounting Standards Board on developing more detailed standards and standards assessment methodologies for accounting and auditing;
- other agencies to complete their work on the *External Debt Guide* and are assisting countries to compile data on external debt consistent with the Special Data Dissemination Standard (SDDS) requirements and the General Data Dissemination System (GDDS) recommendations.[1] In this regard, the IMF posted the second draft of the *Debt Guide* on its external website seeking another round of comments before finalizing it; and
- the Financial Action Task Force (FATF) and the World Bank to develop a methodology for enhancing the assessment of legal, institutional, and financial supervisory standards relevant for countering money laundering and terrorist financing (see text).

[1]The Inter-Agency Task Force on Finance Statistics, formed under the aegis of the United Nations Statistical Commission and chaired by the IMF, is the coordinating body for this work.

Financial Sector Assessment Program

The FSAP, participation in which is voluntary, aims at strengthening the monitoring of countries' financial systems in the context of the IMF's bilateral surveillance and the World Bank's financial sector development work. Following the pilot, the IMF and the Bank Executive Boards agreed that the FSAP should be undertaken in the future at a rate of up to 24 country assessments a year. At the IMF, Financial System Stability Assessment (FSSA) reports, which are derived from the discussion of FSAP findings, were endorsed as the preferred instrument for strengthened monitoring of financial systems as part of IMF surveillance. By April 2002, 27 countries had completed their FSAP participation.[1] An additional 50 countries had committed to participate in the program, and the work was already under way for 27 of these countries. In January 2001, publication of the FSSAs was authorized to allow sharing an integrated assessment of the strengths and vulnerabilities of these financial sectors with markets; 11 countries had published their FSSAs by April 2002. The program of assessments in financial year 2002 placed greater emphasis on systemically important countries in line with the views of the two Boards.

As a complement to the work on assessing external vulnerability and the Financial Sector Assessment Program, the IMF has developed a set of Financial Soundness Indicators (FSIs) and methods of macroprudential analysis designed to improve the assessment and monitoring of vulnerabilities in financial systems. (Macroprudential analysis includes stress testing of financial systems' sensitivity to a variety of shocks.) In June 2001, the Board endorsed a core and an "encouraged" set of FSIs. The core set focuses on the banking sector and was selected because of its analytical relevance, usefulness, and availability. The encouraged set includes additional indicators of the banking sector as well as indicators for the nonbank financial sector, the corporate and household sectors, and real estate markets. Directors agreed that a more general compilation and greater use of soundness indicators, with a focus on the core set, would pave the way for a significant strengthening of surveillance. They supported more systematic compilation of data on FSIs in the Financial Sector Assessment Program and in Article IV reports with in-depth financial sector assessments.

In July 2001, during their Fourth Review of the IMF's Data Standards Initiatives, Directors discussed the possible inclusion of FSIs in the SDDS. While a number of Directors believed this would be a useful development, others considered that such indicators should not be included even at a later stage, so as not to discourage new subscriptions and not to overburden

[1]An FSAP is considered complete once the FSSA has been discussed by the Executive Board and the FSAP report has been sent to the authorities.

existing subscribers. It was decided to return to the issue at a future date.

The work ahead on FSI-related issues includes activities in four areas: support of compilation efforts by national authorities; analytical and empirical work on measuring and analyzing FSIs; strengthened monitoring of FSIs, in cooperation with country authorities, as a key component of the FSAP/FSSA process; and encouraging national authorities to release the indicators to the public on a regular basis.

Offshore Financial Center Assessments

The IMF has extended its financial sector work to include offshore financial centers (OFCs). The program involves voluntary assessments of OFCs at three possible levels of intensity.[2] As of end-April 2002, IMF staff have undertaken missions to 19 offshore financial centers for the purpose of gathering information, providing technical assistance, and assisting self-assessments; staff completed 9 OFC assessments and three (Cyprus, Gibraltar, and Panama) were published during the period. The Coordinated Portfolio Investment Survey (CPIS) organized by the IMF, which includes the participation of several important OFCs, will support this work by helping national statisticians to compile more comprehensive data on cross-border investment positions.

Capital Account Liberalization

The IMF has strengthened its work on capital account issues, including by undertaking more analysis, giving more prominence to capital account issues in Article IV consultations, and expanding discussions with the private sector. The benefits of capital account opening include a more efficient international allocation of savings and improved productivity (for example, through technology transfer in foreign direct investment flows), enlarged opportunities for portfolio diversification, risk sharing, deeper financial markets, and a greater international division of labor. On the other hand, volatile international capital flows have played a role in a number of recent crises, pointing to the importance of appropriate sequencing of capital account liberalization.

In July 2001, in response to a request from the International Monetary and Financial Committee of the IMF, the Board held a preliminary discussion on financial sector stability and sequencing of capital account liberalization. Bearing in mind that there is no simple rule applicable to all countries, Directors discussed some general principles that could be helpful to countries in sequencing and coordinating capital account liberalization. These principles emphasize

- the importance of macroeconomic stability and of giving priority to financial sector reforms that support such stability;
- coordinating different financial sector policies to ensure mutually reinforcing reforms;
- taking into account the initial condition of financial and nonfinancial entities and the effectiveness of existing capital controls;
- implementing early, key measures that may have a long lead time;
- considering the sustainability of the reform process; and
- ensuring the transparency of the liberalization process.

The principles point to the desirability, in most cases, of liberalizing long-term flows (in particular foreign direct investment) ahead of short-term flows with suggestions of specific policy measures that should be put in place before different types of flows are liberalized. In many cases a gradual approach to liberalization may be required, but would not in itself guarantee orderly liberalization.

A workshop to discuss advanced country experiences with capital account liberalization took place in December 2001. Discussions will continue both within the IMF and with the private sector, including through the Capital Markets Consultative Group.[3]

Crisis Resolution

While the IMF's efforts at crisis prevention should reduce the number of crises over time, it would be unrealistic to expect that all member countries will always be able to avoid crises. During FY2002, the Executive Board held continuing and informal discussions on a range of issues related to the resolution of financial crises and the role of the private sector.

In August 2001, the Board had a preliminary, informal discussion on a staff paper that reviewed the *treatment of the claims of private sector and Paris Club creditors.* The Board had requested staff to prepare a paper on issues relating to comparability of treatment

[2]Module I is an assisted self-assessment with technical assistance from experts, as needed, to help offshore financial centers assess their compliance with particular standards. Module 2 is a stand-alone IMF-led assessment of standards, and Module 3 (or FSAP) is a comprehensive assessment of risks and vulnerabilities, institutional preconditions, and standards observance prepared by the IMF.

[3]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. 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.

between Paris Club and private sector claims in the exceptional cases in which a rescheduling by Paris Club and other official bilateral creditors is required. Directors felt that many of the questions raised by the paper were of a technical nature, but that the staff paper nevertheless provided a useful background to help advance the discussions between the staff and the Paris Club, and between the Paris Club and the private sector, on ways to address comparability of treatment and private sector involvement.

In September 2001, the Board assessed the determinants and prospects for the *pace of capital market access by countries emerging from crises,* a critical element of the framework for private sector involvement. Directors had a broad-ranging discussion but concluded that more theoretical and empirical work was needed before they could reach firm opinions on this complex subject. They also agreed with the staff that these assessments could not be made in a mechanical way, and that judgment and monitoring would continue to be required in each specific case.

Directors considered that improved understanding of the reasons behind the loss of market access could also provide useful indications on how countries might reaccess markets. Three determinants of market access stood out: namely, changes in global financial conditions; market contagion; and domestic economic policies. Past experience suggested that countries that lose market access as a result of adverse developments in global financial markets, or minor spillover from crises elsewhere, generally regain market access quickly as the effects of such developments pass. Some Directors stressed that domestic economic policies were often a major cause of loss of market access.

The Board considered the determinants of the restoration of market access identified in the staff paper to be a useful starting point, but stressed that the sample was limited. While noting the importance of favorable conditions in international capital markets for restoring access, Directors agreed that the single most important determinant of a country's prospects was adopting credible corrective policies—especially corrective macroeconomic and structural policies that improved a country's external accounts and debt sustainability. Other determinants were also considered.

Finally, many Directors stressed the need to seek greater input from market participants themselves and a better understanding of the rationale underlying their lending decisions as the IMF continued to refine its work in this area.

Work Program for Crisis Resolution

The Managing Director's April 2002 Report to the IMFC laid out a four-point work program to strengthen the framework for crisis resolution:

- Increasing the IMF's capacity to assess the sustainability of a country's debt;
- Clarifying the IMF's access policy;
- Strengthening the tools available for securing the private sector's involvement in the resolution of financial crises; and
- Examining a more orderly and transparent legal framework for sovereign debt restructurings, as well as identifying with more clarity the considerations that should guide the availability of IMF financing during and after a restructuring.

Improving the analytical framework that the IMF uses to judge *debt sustainability* is essential to the IMF's ability to respond appropriately to different crises. As outlined in the Prague framework, the IMF must strive to distinguish between those cases where a major debt restructuring, possibly involving a substantial write-down of claims, is called for; those cases where the official sector will need to encourage creditors to reach voluntary agreements to maintain their exposure to help overcome coordination problems; and cases in which it is appropriate for the IMF, in conjunction with others, to provide financing in support of the member's adjustment program to help restore confidence and catalyze the resumption of private capital inflows. This distinction should be based solidly on an assessment of the member's debt sustainability.

In assessing the sustainability of a member's external and fiscal position, the focus is on a member's ability to sustain financial and economic viability, and whether some form of debt reprofiling or restructuring is necessary to achieve that objective in the context of a well-designed program of adjustment. Sustainability analysis may not always yield unequivocal results, but the IMF is working to strengthen the analytic basis used to make an inherently difficult judgment. It is envisaged that staff would bring together in a more systematic fashion the elements that go into such a judgment, including the initial stock of actual and contingent liabilities, expected external and internal developments that will affect the debt-servicing burden, the likelihood of more adverse scenarios occurring, and the member's capacity—including its political and institutional capacity—to adjust policies in response to shocks.

A second strand in the work program will be to clarify the policy on access to IMF resources for members facing capital account crises. In this context, it will be important to recognize that a policy on access limits in such cases must be based on the reality that the IMF's resources are inherently limited, while the potential financing needs of a country integrated into global markets can be very large indeed, and, in some cases, are not adequately reflected in members' quotas. The policy would specify the circumstances under which the IMF would be prepared to support a member's policies in the event it was facing difficulties. The general direction would be that larger levels of access require stronger justification. A clearer policy on access limits should allow the IMF to provide the scale of financing needed to support members addressing their problems, while at the same time reinforcing incentives for responsible policies and prudent assessment of risk.

A third strand of the work program aims to *strengthen the tools* available for securing the private sector's involvement in the resolution of financial crises within the context of the existing legal framework. One aspect of the work explores the use, in cases in which a member's debt burden is judged to be sustainable, of financing options to help resolve financial crises and to complement the catalytic approach. The broad conclusion is that although the use of alternative financing tools under certain circumstances may help to manage crises, they need to be carefully assessed on a case-by-case basis. In each case, the benefits of these financing techniques need to be weighed against potential dangers of unsettling markets that they may affect, as well as their impact on transferring risk from sovereigns to the domestic financial system.

To contain the harmful impact of sovereign debt restructuring, efforts will be needed to limit the erosion of confidence and keep the restructuring process orderly, including through the prompt announcement of corrective policy measures and the formulation of a fair restructuring offer.

Sovereign Debt Restructuring

In the infrequent cases when countries run up unsustainable debt burdens, they need to seek a restructuring of their obligations. A shortcoming in the international financial system is the absence of a framework for the predictable and orderly restructuring of sovereign debts. There is no comprehensive mechanism for majority decision making by private creditors—a problem that is compounded when the debt includes numerous different debt instruments issued in different jurisdictions. The upshot of this collective action problem is that debt restructuring is often delayed, prolonged, and disorderly, depleting asset values of creditors and imposing severe hardship on the debtor country. This is not only damaging to the debtor and its creditors, it is also disruptive to international capital markets and to the trading partners of the debtor country.

In a February 2002 Executive Board seminar to discuss staff papers that examined *complementary tools for the catalytic approach and further considerations in the restructuring of international sovereign bonds*, Directors made progress on their discussion of issues relating to the involvement of the private sector in the resolution of financial crises. Directors noted that even though the recent experience with the catalytic approach had been uneven, it was useful to give early consideration to the use of such complementary tools as rollover agreements with domestic investors aimed at helping meet financing needs while policies took hold and confidence was rebuilt. Directors stressed, however, that such policies could not substitute for sound economic policies, efficient public debt management, strengthened transparency, and active debtor-creditor relations. The use of alternative financing tools to help to manage crises would have to be examined on a case-by-case basis, carefully weighing the benefits and potential costs of these techniques in the specific context of each country.

Directors noted that, notwithstanding the principle that contractual obligations should be honored, in those exceptional circumstances in which financing requirements were large and prospects for an early return to spontaneous capital market access were poor, a broad spectrum of actions might be warranted. Bondholders along with other creditors may need to contribute to the resolution of the crisis. In cases in which a member's debt situation is not sustainable, these actions might need to include a restructuring that brought about debt and debt-service reduction so as to provide an adequately financed program.

On March 6 and March 8, 2002, the Executive Board held an informal seminar to discuss approaches to improving the legal framework for sovereign debt restructuring. They discussed two staff papers. The first—issued in November 2001—followed closely the speech by First Deputy Managing Director Anne Krueger (see Box 3.4) setting out a possible new statutory regime governing debt restructuring. The second staff paper—issued in February 2002—elaborated further on such statutory approaches and developed an approach in which the IMF played a less central role in decision making. The second paper also assessed the extent to which the use of collective action clauses in debt instruments could achieve the desired improvements in the sovereign debt restructuring process. There are pros and cons to all the options being considered, and it was recognized that substantial further consideration would be necessary before coming to concrete proposals.

The seminar highlighted a common belief among many Directors, a belief shared by management, that the existing process for restructuring sovereign debt was more prolonged, more damaging to the country and its creditors, and more unpredictable than was desirable. Both countries and their creditors would gain if stronger incentives were created for countries with unsustainable debts to address their problems rapidly, and if there were a more predictable process, in such exceptional cases, for reaching rapid agreement on a restructuring that paved the way toward the restoration of sustainability. This needed to be done without introducing incentives that might result in unnecessary defaults or broadly increasing the perceived risk of default.

The twin challenges were to develop an improved framework that could facilitate the sovereign debt restructuring process and to improve the IMF's analytical basis for making judgments about debt sustainability. These efforts should be integrated into broader efforts to improve the effectiveness of crisis prevention and resolution. Recourse to a comprehensive debt restructuring would remain appropriate in only very limited and exceptional circumstances, consistent with the private sector involvement framework.

The staff paper for the discussion outlined broad statutory and contractual approaches for achieving these objectives: a statutory approach with enhanced IMF authority, a statutory approach based on majority action across the aggregated debts of the sovereign, and a contractual approach based on collective action clauses. The second statutory option envisages a restructuring mechanism with limited IMF involvement in the operations of the mechanism itself and where decisions on whether to give legal protection for the sovereign and provide seniority for new private financing would be left to the debtor and a qualified majority of its creditors. Although an amendment of the IMF's Articles of Agreement could provide the statutory basis for this power, the IMF would not be empowered to make decisions that limited the enforcement of creditor rights. Rather, it would give the qualified majority of creditors the ability to accord the debtor temporary protection against legal action, strengthen the hand of the debtor and a qualified majority of its creditors against a dissident group of creditors, and perhaps most crucially, allow the entire creditor body to vote as a whole rather than instrument by instrument (which is the case with existing collective action clauses). At the same time, safeguards would be established to protect the seniority of certain claims, and procedures would need to be put in place to verify claims and ensure the integrity of the voting process.

Box 3.4

FDMD Krueger Proposes a Sovereign Debt Restructuring Mechanism

Proposals for a new sovereign debt restructuring mechanism were spelled out by IMF First Deputy Managing Director Anne O. Krueger initially in a speech to the National Economists' Club in November 2001 and then in a more developed version at the Institute for International Economics in April 2002. The proposal was also described by Ms. Krueger in a pamphlet entitled "A New Approach to Sovereign Debt Restructuring," published in April 2002.

The First Deputy Managing Director took as her premise the growing international realization that the absence of a strong legal framework for sovereign debt restructuring generates considerable costs. First, sovereigns wait too long before seeking a restructuring, leaving both their citizens and creditors worse off. Second, when they finally do opt for restructuring, the process takes longer than needed and is less predictable than debtors and creditors would like. Ms. Krueger observed that the current international financial system lacks an established framework for an equitable debt restructuring that returns the country to sustainability.

In advancing her proposal, Ms. Krueger outlined the objective of a Sovereign Debt Restructuring Mechanism (SDRM) as being "to facilitate the orderly, predictable, and rapid restructuring of unsustainable sovereign debt." Use of the mechanism would be for the debtor country to decide and not for the IMF or a country's creditors to impose. The mechanism would only be invoked in very limited circumstances—specifically, when a country's debt had become unsustainable.

Two key challenges, she said, were, first, to create incentives for debtors to address their problems promptly and, second, to create incentives for all parties to reach rapid agreement on restructuring terms. The policies of the IMF regarding the availability of its resources before, during, and after the restructuring process would play a critical role in shaping these incentives.

Under the terms of the approach outlined by Ms. Krueger, an international legal framework would be created that would allow a qualified majority of a sovereign's creditors to approve a restructuring agreement, which would then be binding on a dissenting minority. This provision would be supported by three other features: a temporary stay on creditor litigation after a suspension of payments but before a restructuring agreement is reached; safeguards to protect creditor interests during the stay; and a mechanism to induce new financing by giving it seniority over preexisting private indebtedness during the period of the stay.

As envisaged by Ms. Krueger, an international judicial panel would be set up to arbitrate disputes and oversee voting. An amendment to the IMF's Articles of Agreement would provide the legal basis to make an agreement binding on all creditors. Significant legal authority would not, however, be transferred to the IMF itself; the IMF would not be in the position of imposing an agreement and the essential decision-making authority would rest with the debtor and a majority of its creditors.

Inevitably, it would take time to sort through the complex issues associated with the design of a restructuring mechanism, and then, if so agreed and if there was broad-based support for the steps that it would require, to put a statutory approach in place. Contractual improvements could help before then, and, as was emphasized by several Directors, such improvements should be pursued vigorously on their own merits. The IMF will continue to explore ways in which contractual approaches to debt restructuring can be made more effective. Future work in this area would include steps that could be taken to create stronger incentives for the use of appropriate majority restructuring and majority enforcement provisions in international debt contracts. It would also include an assessment of the feasibility and market acceptability of collective action clauses that aggregate claims across instruments for voting purposes.

Finally, the Board agreed that efforts to improve the existing framework for debt restructuring should not displace other aspects of the work program on the resolution of financial crises. Improving the assessment of debt sustainability was crucial. The Board's discussion also confirmed that an early review of access limits would be a key element in IMF efforts to improve the effectiveness of the private sector involvement framework.

In its April 2002 Communiqué, the IMFC endorsed the IMF's work program to strengthen the existing Prague framework for crisis resolution, and in particular to provide members and markets with greater clarity and predictability about the decisions the IMF will take in a crisis.

The Committee also welcomed the consideration of innovative proposals to improve the restructuring of sovereign debt to help close a gap in the current framework. It encouraged the IMF to continue to examine the legal, institutional, and procedural aspects of two approaches, which could be complementary and self-reinforcing: a statutory approach, which would enable a sovereign debtor and a supermajority of its creditors to reach an agreement binding all creditors; and an approach, based on contract, which would incorporate comprehensive restructuring clauses in debt instruments. The Committee looked forward to reviewing progress in this area at its next meeting in fall 2002.

Combating Money Laundering and the Financing of Terrorism

Money laundering and the financing of terrorism are issues that concern countries at every stage of development, and involve both onshore and offshore financial centers. These are global problems that not only affect security, but also potentially harm economic prosperity and the international financial system.

Background

At the end of the last financial year, the Executive Boards of the IMF and the Bank considered how the two institutions might enhance their contributions to global efforts to fight money laundering. Directors recognized that more vigorous national and international efforts to counter money laundering were needed. Directors emphasized that the IMF's involvement in this area should be confined to its core areas of competence, and confirmed that it would not be appropriate for the IMF to become involved in law enforcement activities. The Board generally agreed that the IMF should take a number of steps to enhance the international efforts to counter money laundering, including:

- developing a methodology that would enhance the assessment of financial standards relevant for countering money laundering that could be used in reports under the Financial Sector Assessment Program;
- working more closely with major international anti-money-laundering groups;
- increasing the provision of technical assistance in this area;
- including anti-money-laundering concerns in its surveillance and other operational activities when macroeconomically relevant; and
- undertaking additional studies and publicizing the importance of countries acting to protect themselves against money laundering.

A set of similar steps was agreed to by the Bank.

Directors also generally agreed that the 40 Recommendations on anti-money laundering (AML) made by the Financial Action Task Force on Money Laundering (FATF) should be recognized as the appropriate standard for combating money laundering.[4] Directors agreed that work should go forward to determine how the recommendations could be adapted and made operational to the IMF's work, with a view toward eventually preparing related ROSCs. They noted that the FATF process needed to be made consistent with the ROSC process and once this was done, the FATF could be invited to participate in the preparation of a ROSC module on money laundering. The Board asked staff to contribute to the ongoing revisions to the FATF 40, discuss with the FATF principles underlying the ROSC procedures, and come back to the Board with a report and proposals.

Post–September 11 Board Discussion

At a November 12, 2001, Board discussion, Executive Directors welcomed the opportunity to review progress in the IMF's work on anti-money-laundering issues and to consider the IMF's role in combating terrorism financing in the aftermath of the attacks of September 11. They stressed that the IMF had a key role to play in combating money laundering and terrorism financing as part of international efforts to prevent the abuse of

[4]The FATF's 40 Recommendations are widely recognized as the key set of AML standards. These recommendations cover law enforcement, financial system regulation, and international cooperation. In October 2001, the FATF issued new international standards to combat terrorist financing, in the form of eight Special Recommendations. The "FATF 40+8" is the shorthand reference used by the FATF to cover all the Recommendations.

financial systems and to protect and enhance the integrity of the international financial system.

Directors acknowledged the progress achieved in implementing the measures contained in the Board's summing up of April 13, 2001, to enhance the role of the IMF in the area of anti–money laundering. In particular, Directors noted that:

- an AML Methodology Document had been prepared, circulated for comment, and was being piloted;
- work was under way with FATF to adapt the FATF 40 Recommendations to the IMF's Report on Observations of Standards and Codes process and to review and update the Recommendations; and
- technical assistance for anti–money laundering had been intensified and in some cases extended to include, for example, the creation of financial intelligence units.

In considering how the IMF could extend its activities to limit the use of financial systems for terrorism financing, and to make its anti-money-laundering work more effective, Directors stressed that the IMF's involvement in these areas should be consistent with its mandate and core areas of expertise. Recognizing that no single agency can resolve the problems independently, they emphasized that the IMF should adopt a disciplined and collaborative approach that respected the expertise, scope, and mandate of other institutions, and that the roles of the various institutions involved should be clarified. Directors reaffirmed that the IMF's primary efforts should be in assessing compliance with financial supervisory principles and providing corresponding technical assistance. They confirmed, in particular, that it would be inappropriate for the IMF to become involved in law enforcement issues.

Directors generally agreed on a set of measures (later known as the IMF's action plan) in response to the challenges facing the institution. In particular, Directors supported:

- Expanding the IMF's involvement beyond anti–money laundering to efforts aimed at countering terrorism financing.
- Expanding the joint IMF/World Bank AML Methodology Document and IMF technical assistance to include aspects relating to anti-terrorism financing. In addition, Directors noted that effective implementation of financial supervisory principles depends on a sound legal framework and on other institutional structures. Thus, most Directors considered it appropriate to expand coverage to legal and institutional issues in the anti-money-laundering methodology. Some Directors considered that the methodology document should eventually cover all the FATF recommendations, both the original 40 (as revised) and the additional 8 on anti–terrorist financing. Several other Directors, however, supported an evolutionary approach whereby the staff would work on expanding coverage of the assessment methodology to these issues while experience in the implementation of the current Methodology Document accumulated.
- Applying the expanded methodology in Offshore Financial Center (OFC) assessments (the pace of which would be speeded up), as well as onshore assessments in the context of Financial Sector Assessment Programs, though they stressed that these assessments should be done on a voluntary basis.
- Circulating to all IMF members over time in the context of Article IV consultations a voluntary questionnaire (based on the expanded AML methodology). This exercise should be seen as a complement to and not as a substitute for FSAPs and OFC assessments, and should inform the Article IV discussions and help set priorities for technical assistance. The results of the exercise could, with the agreement of the member, be made available to the Board.
- Enhancing the IMF's collaboration with the Financial Action Task Force, including by working closely and rapidly with the task force on a suitable assessment process compatible with the uniform, voluntary, and cooperative nature of the ROSC exercise and by contributing to the revision of the FATF 40 Recommendations.
- Increasing relevant IMF technical assistance—but avoiding diversion of assistance resources from their traditional uses—to correct deficiencies in countries' anti-money-laundering and anti-terrorism-financing regimes identified in the course of FSAPs and OFC assessments; and to develop an IMF role in the coordination of such technical assistance.
- Undertaking further research and analysis on relevant issues, including alternative remittance and payment systems, and corporate vehicles.

Directors further agreed that a key element in combating money laundering and terrorist financing was more effective information sharing and cooperation among national authorities and international agencies. They called upon governments to create mechanisms to enable collection and sharing, including cross-border sharing of financial information with appropriate supervisory and law enforcement authorities. Directors stressed that primary responsibility for enforcement of anti-money-laundering and anti-terrorism-financing measures would continue to rest with national authorities.

Directors noted the preliminary estimates of additional resources needed to undertake these tasks. They generally agreed that these estimates could be used as a basis for moving forward. Refining these

Box 3.5

Progress on Anti–Money Laundering and Combating the Financing of Terrorism During FY2002

In a joint progress report to the IMFC in April 2002 on the implementation of their intensified work on Anti–Money Laundering and Combating the Financing of Terrorism (AML/CFT), the IMF and the World Bank reviewed progress in developing assessment methodologies, in intensifying the assessment of members' AML/CFT regimes and offshore financial centers, in research on informal funds transfer systems, in analysis of AML/CFT legal and institutional frameworks, and in building capacity among members (for the last, see Chapter 7 on technical assistance).

Development of AML/CFT Methodologies

Convergence on a single comprehensive AML/CFT methodology. The November 17, 2001, IMFC Communiqué called for enhancing "collaboration with the FATF on developing a global standard covering the FATF recommendations, and working to apply the standard on a uniform, cooperative, and voluntary basis." In response to this call, and to earlier guidance, IMF and Bank staffs have intensified their consultations with the FATF. A single comprehensive methodology for assessing the FATF 40+8 Recommendations has not yet been agreed, although there is substantial convergence at the staff level.

Expanded Methodology Document. A preliminary redraft of the expanded methodology was sent for information to the Boards of the IMF and the Bank in February 2002. It extended an earlier draft: (1) combating the financing-of-terrorism elements were integrated into the assessments along with anti-money-laundering elements; (2) a separate new section was developed to address the adequacy of the legal and institutional AML/CFT framework; and (3) a section covering nonprudentially regulated financial service providers was introduced.

Simultaneously with circulating this expanded methodology to the IMF and Bank Boards, the draft was sent for comments to the standard setters (Basel Committee, IOSCO, IAIS, FATF, and the Egmont Group). As a result of consultations with standard setters, a revised version of the expanded methodology, including additional material from the FATF, was circulated to the Boards of the IMF and Bank before the Spring 2002 Meetings of the IMFC.

Intensification of AML/CFT Assessments

In FSAPs and OFC Assessments. AML/CFT issues are now being addressed in all FSAPs and OFC assessments. FSAP and OFC missions have provided the framework for raising issues and making concrete recommendations to national authorities for action to strengthen their AML/CFT regimes. Among the concerns identified in these assessments have been weak legal and regulatory frameworks for AML/CFT; ineffective implementation of AML/CFT regimes including poor industry awareness; narrow coverage of institutions; limited definition of violations under AML/CFT laws and regulations; and inadequate reporting and evaluation of suspicious activities.

Several countries have already taken actions to strengthen their AML/CFT regimes in response to IMF and Bank recommendations and the assessments conducted in FSAPs and the OFC assessment program. For example, a large offshore financial center conducted a comprehensive review of its AML/CFT policies and implemented a strong action plan to address weaknesses identi-

estimates and including the resource impact of the extra work, together with any possible offsets, would be examined in the budget discussions for the financial year 2003.

Directors believed that this package of further actions by the IMF, taken together, constituted a substantive and measured response to the global challenges by enabling the IMF to make a more useful contribution to combating money laundering and terrorist financing. They requested the staff to keep the Board informed on progress in this area, including on efforts to converge toward a single and comprehensive assessment methodology that was operational for the IMF's work, and to prepare a progress report for the Board by the Spring 2002 Meeting of the International Monetary and Financial Committee (see Box 3.5) as well as a paper on the outcome of the enhanced work program before the 2002 Annual Meetings.

IMFC April 2002 Communiqué

At its April 2002 meeting, the IMFC underscored that international efforts to counter abuse of the international financial system to finance terrorism and launder the proceeds of illegal activities remained a priority. It was encouraged by the response by many countries to its call in November 2001 for all countries to ratify and implement fully the UN instruments to counter terrorism financing, to freeze terrorist assets, and to establish financial intelligence units and ensure the sharing of information. The Committee urged countries that had not as yet done so to fully implement and comply with these instruments. It also welcomed the substantial progress made by the IMF, in close collaboration with the World Bank, in implementing all elements of its action plan to intensify the work on anti–money laundering and combating the financing of terrorism. The Committee noted in particular the good start made in assessing gaps in national AML/CFT regimes, and fully supported the provision of technical assistance to help countries identify and address such gaps.

While reiterating the responsibility of national authorities for combating money laundering and the financing of terrorism, the Committee stressed that success will critically depend on continued vigilance and timely action at the global level. It called on the fied by the assessment; a major developing country enacted new AML/CFT legislation; another major developing country established a Financial Intelligence Unit and is joining the Egmont Group; and another is upgrading its supervisory capacity on AML/CFT. Further actions are being taken by a number of countries with technical assistance from the IMF and the Bank (see Chapter 7).

The OFC assessment program has been accelerated: IMF staff has agreed with jurisdictions to schedule double the number of Module 2 or Module 3 OFC assessments initiated in 2002 to 20 from the 10 assessments begun in 2001.

AML/CFT in the Context of Article IV Surveillance. Consistent with the call in the IMF Action Plan for expanded attention to AML/CFT issues in Article IV consultations, a specific questionnaire—covering legal, regulatory, supervisory, and institutional aspects of AML/CFT—has been distributed to an initial group of 38 members. Responses are voluntary. The initial group of 38 countries was selected so as to achieve representative geographical coverage, to complement assessments under FSAPs and the OFC assessment program, and to feed into the schedule of Article IV consultations.

Progress on Other Research and Analysis

Informal Funds Transfer Systems. The IMF and the Bank are conducting a study of these systems among various developed, transitional, and developing countries. The goal of the research is to study the technical details and functioning mechanisms of the systems with particular regard to their macroeconomic, financial, and regulatory implications, including their potential use for money laundering and the financing of terrorism.

The first informal funds transfer network examined was the Hawala system. The IMF-Bank fact-finding mission visited six countries (Germany, Pakistan, the Philippines, Saudi Arabia, the United Arab Emirates, and the United Kingdom). The mission examined the factors underlying the development of the Hawala system and the extent of its use as well as its economic and regulatory impact. It found that the system is largely driven by legitimate remittance activity of expatriate communities.

However, its characteristics—mainly anonymity and lack of traceability—have made it vulnerable to criminal activities. Regulation varies considerably from country to country. Although the system is prohibited in some countries (Saudi Arabia), it is permitted by other government authorities even though not necessarily supervised. Some countries (the United Kingdom) require registration. Others (Germany) license system dealers. Further research will be conducted, including on the best way to monitor these systems and constrain their use by criminals. A final report will be prepared in time for the Fall 2002 Annual Meetings.

AML/CFT Legal and Institutional Framework. The IMF's Legal Department has conducted a survey of the AML/CFT legal and institutional frameworks of a broad cross-section of countries using the criteria defined in the draft expanded methodology. The survey relies on publicly available documents and will form the basis for an analytical report, to be completed before the Fall 2002 Annual Meetings.

IMF to make further progress on all elements of its work program, consistent with its mandate and expertise. In particular, efforts should now focus on completing the comprehensive AML/CFT methodology, based on a global standard covering the Financial Action Task Force recommendations, and the development of assessment procedures compatible with the uniform, voluntary, and cooperative nature of the ROSC process. Enhancing the delivery of technical assistance on AML/CFT would also be crucial. The Committee urged the IMF, in cooperating with other international organizations and donor countries, to identify and respond to needs for technical assistance. It looked forward to receiving a full report on progress in this area at its next meeting in September 2002. The Committee called on members to share information on their own actions in this field.

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 recipient country's adopting policy reforms to correct the underlying problems that gave rise to the request for support. During FY2002, the Executive Board continued the review of conditionality it had begun the previous year, working to focus and streamline the conditions attached to IMF financing and to enhance country ownership of reforms.

Besides periodic reexamination of its policies on conditionality, the Board regularly reviews its policy on access to its financial resources. The amount of financing to which a country has access is linked both to its quota in the IMF (a reflection of the country's economic size, openness to the global economy, and other factors) and to the terms of the particular lending window. In FY2002, the Board reviewed the access policy limits under the credit tranches and the Extended Fund Facility.

(For more details of developments in IMF financial operations and policies during the financial year, see Chapter 6.)

Review of Conditionality

The policy conditions under which the IMF extends financing to its member countries are designed to ensure that the country has adopted the reforms needed to address its external balance of payments problems. This practice, known as "conditionality," assures a country that it will continue to receive financing as long as it carries out a reform program's policies or achieves the intended outcome. Conditionality also protects the revolving character of the IMF's resources by extending financing only when the country concerned is committed to policies that will enable it to improve its external position and, hence, repay the IMF.

Conditionality has evolved considerably during the history of the IMF, reflecting the changing circumstances and challenges faced by its members. Over time, IMF-supported programs have increasingly emphasized the importance of economic growth as a policy goal. Programs have also stressed the need to tackle structural economic problems where these hamper a country's efforts to achieve a sustainable balance of payments position. More recently, the IMF has supported programs to deal with capital account crises, with an added emphasis on restoring market confidence; these cases have often called for large access and comprehensive policy packages. Because of this evolution, the IMF has regularly reviewed developments in conditionality.

The latest review began in the fall of 2000 (see *Annual Report 2001,* page 41) and was still in progress at the end of April 2002. A central concern is that if policy conditions are excessively broad and detailed they can undermine a country's "ownership" of its policy program—a key success factor. Thus, the review aims to ensure that conditionality in IMF-supported programs is designed and applied in a way that reinforces national ownership and a country's sustained implementation of its economic reform program. To this end, the review emphasizes that conditionality should focus on those policies that are critical to the macroeconomic goals and set a clearer division of labor between the IMF and other international institutions, especially the World Bank.

During FY2002, the Board made good progress on the review and met to discuss it on four separate occasions—in July and November 2001 and in January and April 2002. In addition, a comprehensive report was delivered to the International Monetary and Financial Committee (IMFC) in April 2002 summarizing the progress made to date in streamlining and focusing conditionality and enhancing the ownership of IMF-supported programs.

Streamlining Structural Conditionality—Initial Experience

In July 2001, the Board reviewed the initial experience with streamlining structural conditionality and considered issues related to coordinating program conditionality with the World Bank. The Board also took the opportunity to consider comments on conditionality from outside the IMF, which had been solicited through the IMF's website (see Box 4.1) and under a program of seminars held in several major cities.

Board members reviewed the experience in applying an "Interim Guidance Note on Conditionality" that was issued to the staff by the Managing Director in September 2000. (For the text of the guidance note, see *Annual Report 2001,* pp. 42–43.) While noting that the shortness of the period and the limited number of cases precluded drawing firm conclusions, the Directors considered the review useful in highlighting the factors that would shape further progress in streamlining.

The purpose of streamlining and focusing conditionality, Directors affirmed, was to enhance the success and effectiveness of programs by concentrating on those conditions that were critical to achieving a program's macroeconomic objectives, while taking adequate account of national decision-making processes and the administrative capacity to carry out reforms.

Directors agreed that the discussion and feedback from the real-time assessments of new IMF-supported programs brought to the Executive Board would continue to be a key instrument for refining the balance in the scope and detail of IMF conditionality, and they agreed to discuss the role played by the World Bank in each case. They welcomed the focus on the case-by-case coverage of conditionality, and looked forward to its continuation, including the more detailed explanations for including or excluding particular reform measures.

Directors observed that the experience under arrangements supported by the Poverty Reduction and Growth Facility (PRGF) and those supported by other financial policies and facilities had differed, which to some extent reflected the corresponding different arrangements for coordination with the World Bank. For PRGF-supported programs, a division of labor had been established that had permitted a noticeable reduction in the number of conditions in PRGF-supported programs, and a concentration on measures critical to the success of a program and within the IMF's core areas. Under Stand-By Arrangements, where the framework was less formal, the experience was more mixed. However, the small number of cases made it difficult to draw conclusions from the observed differences.

The Board also reviewed IMF and World Bank collaboration on country programs and conditionality. Directors agreed that, to clarify the delineation of responsibilities, it would be useful to identify one institution as the "lead agency" for each policy area. That agency would be responsible for designing and monitoring conditionality. They noted the importance of strengthened and more systematic coordination between the IMF and the World Bank to secure the benefit of the complementary expertise of the two institutions.

Box 4.1

IMF Requests Public Comment

In September 2001, the IMF issued a News Brief inviting public comment on a number of papers related to streamlining and focusing IMF conditionality. The papers were posted on the IMF's website and interested parties were invited to send in comments. All comments received by October 15 were conveyed to the IMF Executive Board as background information for its discussion in November 2001 and were taken into account in further work by IMF staff. They were also made public on the IMF website.

Directors stressed that the policy advice, program design, and conditionality supported by the Bank and IMF needed to be consistent, and most Directors agreed that, wherever possible, these should be integrated within a coherent country-led framework. They also agreed that the application of the proposed approach would need to take account of the circumstances of individual countries.

Directors welcomed the extensive comments and suggestions on conditionality received from outside the IMF, including the comments on the papers posted on the IMF's website and those from seminars held in Berlin, Tokyo, and London. Points stressed in those comments included the benefits of national ownership of reform programs, the need to pay attention to the sequence and pace of policy implementation, and the importance of a clear and coherent strategy for assistance from the international community, including the IMF and multilateral development banks.

Strengthening Country Ownership of Programs

In November 2001, the Board informally reviewed the status of the ongoing efforts related to strengthening country ownership of IMF-supported programs. Directors agreed that, while ownership remained a difficult concept to define for operational purposes, ideally it should reflect a shared vision and an active support of program objectives by the country authorities and the IMF. Directors considered that ownership was present when a country's authorities willingly assumed responsibility for their policies, based on an understanding that the policy program was achievable and was in the country's own interest. At the same time, broader rather than narrower ownership—involving not only the executive branch of a country's government, but also its parliament and other major stakeholders—was desirable.

Table 4.1
IMF Financial Facilities

Credit Facility	Purpose	Conditions	Phasing and Monitoring[1]
Credit Tranches and Extended Fund Facility[4]			
Stand-By Arrangements (1952)	Medium-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
Extended Fund Facility (1974) (Extended Arrangements)	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
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 Stand-By or Extended Arrangements 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)
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 percent of quota) available on approval but not expected to be drawn. Presumption that one-third of resources are released on activation, with the phasing of the remainder determined by a postactivation review
Compensatory Financing Facility (1963)	Medium-term assistance for temporary export shortfalls or cereal import excesses	Available only when the shortfall/excess is largely beyond the control of the authorities and a member has an arrangement with upper credit tranche conditionality, or when its balance of payments position excluding the shortfall/excess is satisfactory	Typically disbursed over a minimum of six months in accordance with the phasing provisions of the arrangement
Emergency Assistance	Quick, medium-term assistance for balance of payments difficulties related to:		None, although post-conflict assistance can be segmented into two or more purchases
(1) Natural disasters (1962)	(1) natural disasters	(1) Reasonable efforts to overcome balance of payments difficulties	
(2) Post-conflict (1995)	(2) 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) Note: 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 participatory process, and integrating macroeconomic, structural, and poverty reduction policies	Adopt 3-year PRGF program. PRGF-supported programs are based on a Poverty Reduction Strategy Paper (PRSP) prepared by the country in a	Semiannual (or occasionally quarterly) disbursements contingent on observance of performance criteria and reviews

[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 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.

Access Limit[1]	Charges[2]	Repurchase (Repayment) Terms[3]: Obligation schedule (years)	Expectation schedule (years)	Installments
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
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
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
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
45% of quota each for export and cereal components. Combined limit of 55% of quota for both components	Basic rate	3¼–5	2¼–4	Quarterly
Generally limited to 25% of quota, though larger amounts can be made available in exceptional cases	Basic rate	3¼–5	Not applicable	Quarterly
140% of quota; 185% of quota in exceptional circumstances	0.5%	5½–10	Not applicable	Semiannual

[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.

One theme that emerged from the Board discussion was that the relationship between ownership and conditionality was complex, interactive, and dynamic. While strong conditionality could not compensate for weak ownership, conditionality and ownership could be complementary and mutually supportive. The IMF's experience suggested that conditionality could promote and strengthen ownership, in particular by demonstrating the authorities' commitment to a course of action. Directors agreed that the IMF would need to pay careful attention to each element and the ways in which they interacted. In that regard, early involvement of country authorities in the design of a program, and emphasis on the contribution of surveillance as a platform and foundation for program design, would be important for building and sustaining ownership over the long run. There was general agreement among Board members that the IMF should be open to programs that differed from the staff's preferred options, as long as the core objectives of the program were not compromised.

Directors noted that a key policy dilemma for the IMF was how to respond to requests for financial assistance by members in need whose commitment to reforms might be weak. Because the IMF was a cooperative institution, it would be hard to withhold financial support from members simply because of doubts about program ownership. In such cases, the IMF might need to rely on prior actions and a strengthening of conditionality to assure program implementation. Directors broadly supported the action plan set out by the staff for further improving relations with members applying to use IMF resources. That plan had five principal elements.

- The IMF had to strengthen its analysis of political economy issues to better understand the forces that might block or weaken implementation of programs, develop a more effective dialogue on feasible policy options, and avoid agreeing to programs that had a low probability of success.
- In cases where a country faced long-term structural problems and where the IMF was likely to remain engaged for a considerable period, a country-led process of consensus building was a promising way to strengthen national ownership of effective policies.
- Directors gave broad support to the idea that IMF technical assistance should be given more of a medium- and longer-term focus aimed at capacity building (including program design). Such a shift could make technical assistance a more effective instrument in helping countries take ownership of economic policies.
- The primary responsibility for communicating policy intentions and program content to the public rested with the authorities themselves, but the IMF could play an important supporting role.
- The establishment of the Independent Evaluation Office (IEO) already provided an intensive ex post evaluation of programs. Directors felt that, as the IEO's work unfolded, it should shed light on how ownership affected success rates.

Making Improvements

The Board had a further discussion on the modalities of conditionality in January 2002. Directors considered proposals for greater use of outcomes-based conditionality and floating-tranche disbursements, and reviewed the use of various tools of conditionality, including performance criteria, prior actions, and program reviews guided by indicative targets and structural benchmarks. Directors stressed the need to apply the modalities of conditionality flexibly and to take into account country- and program-specific circumstances, consistent with the objective of enhancing the effectiveness of IMF conditionality through streamlining, focusing, and enhanced ownership. Directors broadly welcomed proposals to base conditionality more on outcomes than on specific actions by the authorities. They noted that providing some financing in floating tranches could enhance flexibility and ownership, while cautioning that the scope for this could be limited. Along with an overall streamlining and focusing of conditionality, Directors agreed that some tools—notably agreeing to waivers and requiring prior actions—should be used more sparingly. As a result, Directors envisaged that program reviews could become even more important, and they noted that this should be accompanied by a clear delineation of the scope of reviews. In some cases, Directors noted, greater selectivity in approving financial arrangements would be preferable to requiring extensive prior actions as a way to address instances of poor performance and limited ownership.

To improve clarity and transparency, Directors stressed the importance of ensuring that the nature and boundaries of the IMF's conditionality be presented clearly in all IMF documents. In this connection, they welcomed the proposal to include in all staff reports on the use of IMF resources a single standardized table showing all the elements of conditionality that would be applied in a given case.

Review of Progress

In its final meeting before the Spring 2002 IMFC Meeting, the Board in early April 2002 took stock of the ongoing review of conditionality. It reviewed experience in implementing the Interim Guidance Note that had been in effect since September 2000. Directors welcomed the increased focus on the core areas of fiscal, financial, and exchange rate policies, and stressed that it was important to retain structural conditions in the fiscal domain. They also noted that the nature and extent of conditionality continued to vary across countries and that, to a large extent, such differences were appropriate in view of variations in country circumstances and in the nature of IMF support.

While there had been progress in clarifying the scope and rationale for IMF conditionality in program documents, Directors stressed that more could be done to lay out both the macroeconomic goals of programs and the criteria for determining whether particular measures were critical for reaching these goals. In this connection, Board members stressed the importance of the enhanced framework for collaboration with the World Bank. IMF-supported programs should be consistent with an overall country framework, which would often require support from the World Bank and other agencies. The nature and extent of this collaboration would necessarily be more extensive in PRGF countries, where collaboration with the World Bank was closest.

A number of Directors were concerned that the IMF's initiative in streamlining and focusing conditionality might not result in an overall reduction of policy conditions when all international financial institutions were considered and asked that this aspect be monitored. At the same time, other Directors expressed concern that areas no longer covered by IMF conditionality might not be adequately covered by other agencies, particularly the World Bank.

The Managing Director then reported to the International Monetary and Financial Committee on the progress of the review of conditionality, noting that there was a broad consensus on how to streamline and focus conditionality and enhance ownership. This report indicated that the IMF was strengthening collaboration with the World Bank and establishing a track record of well-focused programs.

The report emphasized that successful and lasting implementation of policy reforms was not merely a function of conditionality. More fundamentally, it required a commitment on the part of a country's economic and financial authorities, its political leaders, and other domestic groups, based on their understanding that reforms were in their country's interest.

In the coming months the IMF would bring the review to closure. To this end, the Board would consider new guidelines that would incorporate the conclusions of the conditionality review with the aim of reaching agreement before the Committee's September 2002 meeting. Periodic reviews of conditionality should include assessments of consistency with the guidelines, interaction with the World Bank and other agencies, and transparent presentation and documentation of conditionality. The aim would be to ensure that the IMF remained focused and responsive to its members' needs and that IMF-supported programs had a strong chance of success.

Review of Access Policy

The IMF regularly reviews its policy governing access to its financial resources. This access policy is applied in individual cases based on certain agreed criteria, described below, and on a system of access limits. These limits, which are set on the annual and cumulative use of IMF resources by members, are expressed as a percentage of a member's quota and are generally reviewed annually. The limit on annual access to IMF resources under the credit tranches (typically in the form of Stand-By Arrangements) and the Extended Fund Facility is currently 100 percent of quota, and the limit on the cumulative use of IMF resources is 300 percent of quota. The Board may decide to exceed these limits in exceptional circumstances. In August 2001, the Board completed its review of access policy in the credit tranches and under the Extended Fund Facility.

The review covered both the limits on access and the criteria used to determine access within the limits in individual cases. Directors decided that the current annual and cumulative access limits should be maintained through the end of 2002, and agreed that the criteria for access to IMF resources agreed upon by the Board in 1983 remained appropriate. Directors further agreed that emergency assistance and the Compensatory Financing Facility should remain subject to their own access policies outside the access limits for the credit tranches and Extended Fund Facility.

The Board determined that it should later review its policy involving high access to IMF resources. Most Directors requested that this review consider financing under all facilities—including the Supplemental Reserve Facility—and that it be pursued in tandem with the continuing discussions by the Board on a framework for private sector involvement in the prevention and resolution of balance of payments crises.

Directors discussed a proposal to supplement access limits with an annual access norm, which would serve as an operational benchmark against which access criteria would be applied. They agreed that the proposal should not be pursued, since such a norm could lead to unintended bunching of access levels or be considered an entitlement.

Directors emphasized that proposals for access to IMF resources should be based on careful and explicit justification in staff papers. They encouraged the staff to base access proposals on the agreed access criteria, and to be prepared to propose substantial variation in access within the agreed access limits based on the criteria. Directors noted that the access criteria should also be applied in precautionary arrangements.