3 ADAPTING TO A RAPIDLY CHANGING WORLD

ADAPTING TO A RAPIDLY CHANGING WORLD

MONITORING GLOBAL INTERCONNECTIONS

As recent experiences in world economic and financial markets have underscored, countries have become more interconnected. Developments in one country or region can quickly spill across borders. In reviewing economic trends and developments that affect the health of the international monetary and financial system, the IMF has focused increasingly on the regional and international consequences of member countries' economic and financial policies.

Spillover Report

The IMF first prepared pilot Spillover Reports in 2011, to assess the impact of economic policies in the world's five largest systemic economies—China, the euro area, Japan, the United Kingdom, and the United States—on economic partners. A second pilot Spillover Report, now consolidated in one document, but covering the same five systemic economies, was considered by the Executive Board in an informal meeting in July 2012 and published later that month.[2]

The consolidated report provides an added perspective to the policy assessments developed in the Article IV discussions for each of the five economies (see Web Box 3.1) and serves as input to the IMF's broader multilateral surveillance. The topics covered in the report reflect consultations with policymakers from the five economies and from selected economic partners (Brazil, the Czech Republic, India, Korea, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, and Turkey). Rather than capturing all possible spillovers, the 2012 report builds on the previous year's findings, focusing on forward-looking issues.

Pilot External Sector Report

The Managing Director's 2011 Statement on Strengthening Surveillance included a plan covering a range of efforts,[3] including on external stability issues. In that context, the Executive Board discussed a Pilot External Sector Report in an informal meeting in July 2012.[4]

The pilot report analyzes the external positions of 28 systemic economies and the euro area. It combines multilateral and bilateral perspectives in a single report and points to potential policy responses. The analysis incorporates a new External Balance Assessment developed by the IMF staff to assess external imbalances, acknowledging the uncertainties inherent in such exercises.

By applying the same methodologies to all countries, the report ensures that assessments for individual countries are multilaterally consistent, promoting candor and evenhandedness. At the same time, country teams provide in-depth knowledge of country-specific factors, and an element of judgment, to identify elements not captured by models.

With a view to refining these approaches to the IMF's external sector surveillance, the IMF staff consulted with officials, academics, the private sector, civil society, and others in mid-2013, and another Pilot External Sector Report was published in August 2013.

POLICY ADVICE

In the course of supporting programs in member countries, helping countries strengthen their institutions and capacities, monitoring member countries' economies, and overseeing the international monetary system, the IMF provides policy advice to member countries on a variety of issues pertaining to economic stability.

Surveillance architecture

The IMF is mandated by its Articles of Agreement to oversee the international monetary system and monitor the economic and financial policies of its 188 member countries, an activity

Box 3.1

IMF engagement in Europe

The IMF's work in Europe—providing policy advice, technical assistance, and when necessary, financing—is conducted in close cooperation with European Union countries, as well as European institutions, such as the European Commission and the European Central Bank (see "Engagement with Other Organizations" in Chapter 4).[a]

Since the start of the crisis, a number of European countries have requested IMF financial support to help address fiscal and external imbalances. This includes continued support to three members of the euro area—Greece, Ireland, and Portugal—during the most recent financial year. Cyprus also requested an arrangement under the Extended Financing Facility during the year which was approved by the Executive Board in May 2013. As of April 30, 2013, the IMF had financial arrangements with eight countries in Europe;[b] commitments totaled about €107 billion (US$140 billion). This means that of the IMF's total disbursing and precautionary commitments, as of the end of the financial year, about 62 percent were to Europe as a whole.

Most of the first wave of IMF-supported programs early in the crisis were with countries in emerging Europe. The IMF provided front-loaded, flexible, and high levels of financing for many small European advanced and emerging market economies, including Hungary, Iceland, Latvia, and Romania. Strengthening conditions in Iceland and Latvia enabled both countries to make early repayments of parts of their financing arrangements during the year.[c]

The IMF tailors its policy advice to individual members, and program design in individual European countries varies accordingly. At the same time, its engagement at the regional level in Europe has focused on structural reforms to boost economic growth, such as product and services market reforms, as well as labor market and pension reforms. It has also underscored the importance of adequate safety nets to protect those most vulnerable during these difficult adjustments. In addition, at an area-wide level, the IMF has consistently called for more determined steps toward a complete monetary union, including a unified banking system and deeper fiscal integration. In the 2012 Article IV consultation on euro area policies, for example, the Executive Board stressed the importance of policymakers' continuing to demonstrate shared and unequivocal commitment—with a clear, credible road map—to deeper integration. In addition to structural reforms in both deficit and surplus countries, this requires action on two broad pillars: first, steps toward a banking union, comprising a pan-European deposit guarantee scheme and a pan-European bank resolution scheme—both backed with common resources—together with a common supervisory framework; second, greater fiscal integration, with stronger governance arrangements and risk sharing, balanced by appropriate safeguards.[d]

Efforts in recent years to strengthen the international financial system, including in Europe, have triggered additional demands for IMF technical assistance. This year, the IMF agreed to monitor European financial assistance for Spain's bank recapitalization program. Under the agreement, the IMF provided independent advice in support of the efforts of the Spanish and European authorities to restore the health of Spain's financial sector.[e]

Given the importance of Europe to global economic health and financial stability, and given the depth of IMF engagement within the region, the Executive Board is kept informed about matters relating to Europe. No fewer than seven Board briefings and updates on Europe were provided during the year, in June, August, September, October, November, and December 2012 and February 2013.

a The IMF website provides extensive information about the IMF's work in all regions of the world. For its engagement in Europe in particular, see "Tackling Current Challenges" in the "About the IMF" tab of the IMF's home page (www.imf.org/external/about/onagenda.htm), "The IMF and Europe" (www.imf.org/external/region/eur/index.aspx), and "Factsheet: The IMF and Europe" (www.imf.org/external/np/exr/facts/europe.htm), as well as the various links on each of these pages.

b Bosnia and Herzegovina, Kosovo, and Romania (Stand-By Arrangements), Greece, Ireland, Moldova, and Portugal (Extended Fund Facility), and Poland (Flexible Credit Line).

c See Press Release Nos. 12/235, "Iceland Repays Early Some Outstanding Obligations to the IMF" (www.imf.org/external/np/sec/pr/2012/pr12235.htm), and 12/314, "Latvia Makes Early Repayment to the IMF" (www.imf.org/external/np/sec/pr/2012/pr12314.htm).

d See Public Information Notice No. 12/80, "IMF Executive Board Concludes Article IV Consultation on Euro Area Policies" (www.imf.org/external/np/sec/pn/2012/pn1280.htm).

e See Press Release Nos. 12/400, "Statement on the First Financial Sector Monitoring Mission to Spain" (www.imf.org/external/np/sec/pr/2012/pr12400.htm), and 13/34, "Statement on the Second Financial Sector Monitoring Mission to Spain" (www.imf.org/external/np/sec/pr/2013/pr1334.htm).

Box 3.2

Policy advice and assistance to Arab countries in transition

The Arab countries in transition—Egypt, Jordan, Libya, Morocco, Tunisia, and Yemen—continue to face difficult internal transitions.[a] A weak global economic environment, together with limited exchange rate flexibility, has been eroding international reserves, while substantial increases in public wages and subsidies, in response to high social pressures, have diminished fiscal buffers sharply. This underscores the urgent need to maintain macroeconomic stability. Continued political uncertainty is also holding back growth. The moderate economic recovery expected for these countries in 2013 will not be sufficient to generate the jobs needed to tackle the region's substantial unemployment. These problems are considerably aggravated by the tragic conflict in Syria, which has deteriorated into a major humanitarian crisis with growing economic and social spillovers to neighboring countries.

Persistent global, regional, and domestic risk—in particular, from lower global growth or reintensification of global financial risk aversion, higher global food and fuel prices, escalation of the conflict in Syria, and setbacks in political transitions—could undermine this already challenging outlook. On the other hand, a more benign global environment and successful political transitions could influence the outlook more positively.

In view of low fiscal and reserve buffers, fiscal consolidation and greater exchange rate flexibility, while finding more efficient ways to protect the poor, are short-term policy challenges. In this context, greater transparency and accountability in the use of public resources could reinforce the credibility and durability of measures. It is also important for policymakers to move quickly on designing and implementing effective structural reforms to build dynamic and inclusive economies that generate more jobs. Promoting private sector growth and international trade, as well as attracting foreign direct investment inflows, will be key components of success. The international community can support positive change by providing better trade access for the region's products and services, financing, and policy advice.

Energy subsidy reform (discussed later in this chapter) combined with measures to protect the poor is a particular concern for these countries. Some countries have already started to implement this reform agenda and are making inroads in reducing fiscal and reserves pressures.

The IMF has committed more than US$8.6 billion in financing arrangements with Jordan, Morocco, and Yemen. As the financial year drew to a close, the IMF was in discussions on a possible arrangement with Egypt and a second program with Yemen, as well as discussions with Tunisia that led to the Executive Board's approving an SDR 1.15 billion (US$1.74 billion) Stand-By Arrangement shortly thereafter. More generally, the institution has been closely engaged with all the Arab countries in transition, providing policy analysis and capacity development support.

The Executive Board was kept informed of developments in Arab countries in transition during the year, with informal Board briefings in September 2012 and January and April 2013.

a See "Arab Countries in Transition: Economic Outlook and Key Challenges," IMF staff report prepared for the Deauville Partnership Ministerial Meeting (www.imf.org/external/np/pp/eng/2013/041613.pdf).

known as surveillance. Surveillance takes place at both the regional and global levels (multilateral surveillance) and for individual countries (bilateral surveillance), enabling the IMF to highlight risks to stability and growth and advise on needed policy actions.

The IMF's key instruments of multilateral surveillance are the *World Economic Outlook*, *Global Financial Stability Report*, and *Fiscal Monitor*. These twice-yearly publications, along with *Regional Economic Outlook* reports (see "Accountability" in Chapter 5), constitute the IMF's examination of economic and financial developments among the broader membership. Updates for the *World Economic Outlook* are issued twice a year.

The centerpiece of the IMF's bilateral surveillance is the Article IV consultation (see Web Box 3.1), usually held every year to assess economic and financial developments, prospects, and policies for each member country.[5] A total of 114 Article IV consultations were completed during the year (see Web Table 3.1). In the majority of cases (for this year, 100, or 87.7 percent), the staff report and other accompanying analysis are published on the IMF's website (unless the member objects).

The Executive Board reviews the implementation and effectiveness of surveillance periodically, including via a Triennial Surveillance Review. The most recent of these triennial reviews, concluded in October 2011,[6] emphasized five operational priorities: interconnectedness, risk assessments, financial stability, external stability, and traction. In addition, the review suggested a change in the IMF's legal framework for surveillance to facilitate an integrated and balanced approach to global economic and financial stability. The Managing Director's action plan for addressing these key issues was endorsed by the Board and published together with the review.

Decision on Bilateral and Multilateral Surveillance

In July 2012, the Executive Board took a significant step toward modernizing IMF surveillance and addressing the priorities of the 2011 Triennial Surveillance Review, adopting a Decision on Bilateral and Multilateral Surveillance—known as the Integrated Surveillance Decision. The decision provides a basis for the IMF to engage more effectively with members, strengthening IMF surveillance in a number of ways:

- It provides a conceptual link between the IMF's assessment of individual economies and global stability and clarifies that surveillance should focus on economic and financial stability both at the individual country and global levels.

- It makes Article IV consultations a vehicle not only for bilateral but also for multilateral surveillance, thus allowing for more comprehensive, integrated, and consistent spillover analysis. In particular, it allows the IMF to discuss with a member country the full range of spillovers from its policies when they may have a significant impact on global stability. Although members have no obligation to change policies as long as they promote their own stability, the decision encourages countries to be mindful of the impact of their policies on global stability.

- It promotes a more balanced treatment of domestic and exchange rate policies by adding guidance on the conduct of member countries' domestic policies, while maintaining the existing principles for exchange rate policies. It also stresses the contribution of the overall mix of policies to a country's domestic and balance of payments stability.

- It defines, for the first time, the scope and modalities of multilateral surveillance, including by laying out a framework for potential multilateral consultations.

In reaching the decision,[7] Executive Directors agreed that the integration of bilateral and multilateral surveillance would help fill important gaps in surveillance. In particular, they considered that clarifying the scope of multilateral surveillance would help improve the quality, effectiveness, and evenhandedness of IMF surveillance. At the same time, the decision maintains adequate flexibility to adapt surveillance as circumstances may require. Importantly, it does not, and cannot be construed or used to, expand or change the nature of members' obligations.

Executive Directors underscored that increased attention to multilateral surveillance should not come at the expense of the focus on issues relevant for the stability of individual economies. They welcomed the clarification in the decision that, to the extent that a member is promoting its own stability, it cannot be required to change its policies to better support the effective operation of the international monetary system. They emphasized that the framework for multilateral surveillance set out in the decision should not be exercised in a manner that leads to an excessive examination of a member's domestic policies.

Executive Directors considered it important to ensure the smooth implementation of the decision and agreed that leaving six months between its adoption and entry into force would allow sufficient time for both the IMF staff and country authorities to become fully familiar with the new framework. The decision took effect in January 2013.

Progress implementing the priorities of the 2011 Triennial Surveillance Review

In a November 2012 discussion,[8] Executive Directors welcomed progress made on the priorities set at the time of the 2011 Triennial Surveillance Review. They noted that many of the initiatives undertaken in the preceding year had already brought significant improvements in the focus of surveillance on interconnections, risks, financial stability, and external stability.

Interconnections. Executive Directors welcomed progress on the analysis of interconnections. They agreed that further strengthening of this work was necessary to improve the identification of risk transmission channels and to further leverage spillover analysis and cross-country work in surveillance.

Risks. Executive Directors agreed that the focus of surveillance on risks had sharpened (for example, see "Joint IMF–Financial Stability Board Early Warning Exercise" later in this section) and that the use of risk assessment matrices in staff reports had contributed to this effect, helping to ensure consistency of messages across various surveillance products. They agreed that a candid discussion of risks should be included in all country reports. Most supported further progress on the quantification of global risks, which would provide a basis for country teams to identify the impact of global risks on individual economies.

Financial stability. Executive Directors stressed the need to continue efforts to integrate financial surveillance into Article IV consultations and multilateral surveillance, as highlighted in the IMF's financial surveillance strategy (discussed later in this section). They noted the progress on following up on Financial Sector Assessment Program (FSAP) recommendations in Article IV staff reports, but suggested more could be done to integrate assessments of macro-financial linkages in surveillance.

External stability. Executive Directors noted that the pilot External Balance Assessment and the Pilot External Sector Report (see previous section) may have contributed to a stronger focus on external stability for a limited number of countries and recommended that the new approaches be extended to the wider membership. To strengthen the credibility of these efforts, assessment methods should be refined further, it was noted, including by taking full account of country-specific factors, and the external assessment for countries not covered under the new methodology should also be improved.

Traction. Executive Directors emphasized the importance of the relevance and quality of IMF surveillance in generating traction. They called for systematic follow-up on issues raised in previous Article IV consultations and noted that enhanced communication to policymakers on key messages and risks, including through the Managing Director's *Global Policy Agenda*, could help.

Resources. Executive Directors noted that implementing the IMF staff's proposed recommendations was unlikely to be cost neutral, although some argued that resources should be provided through cost savings. Many stressed the importance of closer cooperation across departments to enhance both efficiency and quality of surveillance.

Review of progress in members' provision of data for surveillance purposes

Also in November 2012, the Executive Board considered a policy paper on the provision of data to the IMF for surveillance purposes. In addition to reviewing recent trends in data provision, the paper discussed how initiatives to close data gaps could help address the priority areas identified in the 2011 Triennial Surveillance Review. It also proposed improving reporting of data deficiencies and strengthening the focus on financial sector data. Finally, it discussed ensuring greater consistency among plans to improve data in the context of the General Data Dissemination System (GDDS; see "Data and Data Standards Initiatives" in Chapter 4), technical assistance, and data deficiencies identified in Article IV consultations.

In discussing the paper,[9] Executive Directors considered that the data provision framework in place remained adequate. Nevertheless, they agreed that there remained scope for strengthening implementation of the framework within the existing resource envelope, drawing on the conclusions of the 2011 Triennial Surveillance Review and the data gaps revealed by the global crisis.

Executive Directors saw merit in improving clarity and candor in assessing and communicating the adequacy, quality, and timeliness of data provision to the IMF, along the lines proposed in the paper. They supported the paper's proposals to identify more prominently in Article IV staff reports the main data deficiencies that hamper surveillance, progress in implementing past recommendations, and data sources.

Executive Directors stressed the importance of financial sector data for both the IMF and member countries, noting that data limitations may impede financial and external stability assessments. They supported modifying the Statistical Issues Appendix in Article IV staff reports to focus more on data for financial sector surveillance and, where relevant, progress on the Group of Twenty (G-20)/IMFC Data Gaps Initiative and on adherence to the recently approved Special Data Dissemination Standard Plus (SDDS Plus; see "Data and Data Standards Initiatives" in Chapter 4) for countries that have indicated their intention to adhere to the initiative, while also making further progress in areas in which the conceptual statistical framework needs development.

Executive Directors broadly supported further efforts to improve key data sets: International Investment Position, Currency Composition of Foreign Exchange Reserves (COFER), financial soundness indica-

Left Vendors on a floating market on the Mekong River in Vietnam
Right Spices for sale at a market in Jerusalem

tors, general government debt, and monetary and financial data, including through the adoption of standardized reporting forms.

Executive Directors stressed the importance of working closely with other international agencies to fill data gaps while minimizing the reporting burden for countries. In particular, they encouraged the staff to continue to cooperate closely with the Financial Stability Board (FSB) in developing a data set for global systemically important financial institutions, with appropriate data-sharing procedures among official institutions on a strictly confidential basis.

Executive Directors agreed that the next review of data provision should take place in 2017.

Strategy for financial sector surveillance

Although financial deepening and globalization have brought important benefits, the increased size and complexity of financial systems, coupled with the significant scale and pace of capital flows, now inextricably link national economies to one another and expose them to financial shocks. In September 2012 the Executive Board adopted a strategy for financial surveillance, a key recommendation of the 2011 Triennial Surveillance Review and the Managing Director's action plan for surveillance.[10]

Executive Directors noted that the strategy is appropriately ambitious, but focused, to ensure effective use of scarce resources, and they welcomed its prioritized activities and specific time frames for further strengthening financial surveillance. They broadly endorsed its three pillars: (1) improving risk identification and macro-financial policy analysis, (2) upgrading the instruments and products of financial surveillance to foster an integrated policy response to risks, and (3) increasing the traction and impact of financial surveillance by engaging more actively with stakeholders.

Executive Directors underlined the importance of strengthening the analytical underpinnings of macro-financial risk assessments and policy advice and broadly concurred with the policy areas identified for analysis in the strategy. In particular, with shocks that propagate rapidly through highly interconnected financial systems across countries, they stressed the importance of deepening the understanding of the nature and implications of cross-border linkages, vulnerabilities, and spillovers. They generally welcomed the IMF staff's work on developing a unified macro-financial framework, which would explore the interdependencies of real-financial sectors and improve understanding of linkages and interactions between macroeconomic and macro-prudential policies.

Executive Directors considered it a priority to strengthen and mainstream financial surveillance in Article IV consultations. They also underscored the importance of follow-up of FSAP recommendations in those consultations. Most could support the strategy's proposal for higher-frequency FSAP assessments for those countries that request them, prioritized according to clear criteria in line with existing policies.

Executive Directors noted the intention expressed in the strategy to have the IMF, with its universal membership, serve as a global facilitator on macro-prudential policy. They looked forward to further collaboration between the IMF and FSB in line with their respective mandates. They also supported deepening the collaboration with the World Bank on financial sector work.

Executive Directors acknowledged the challenges in implementing the strategy, including analytical roadblocks, information and data gaps, resource constraints, and limits to traction. They looked forward to the opportunity to review progress in implementation, including in the context of the 2014 Triennial Surveillance Review.

Guidance Note for Surveillance under Article IV Consultations

In October 2012, the IMF issued a Guidance Note for Surveillance under Article IV Consultations to assist IMF staff in conducting bilateral and multilateral surveillance in the context of those consultations.[11] The note emphasizes the operational priorities from the 2011 Triennial Surveillance Review and the Integrated Surveillance Decision. With regard to the latter, it confirmed the continued focus of surveillance on members' exchange rate policies while clarifying how the IMF can engage more effectively with members on their domestic economic and financial policies. The note also reflected the IMF's efforts to follow up on the 2011 Independent Evaluation Office (IEO) report on performance in the run-up to the global crisis.[12] The Executive Board was briefed on the guidance note in an informal meeting in September 2012.

Joint IMF–Financial Stability Board Early Warning Exercise

In 2009, the IMF introduced the Early Warning Exercise—to identify and assess low-probability but high-impact risks to the global economy—and has also developed analytic frameworks to assess vulnerabilities and emerging risks in advanced economies, emerging market economies, and low-income countries. The exercise is typically conducted (in collaboration with the FSB) twice each year, and the Executive Board was briefed on the results of the exercise in October 2012 and April 2013. Following discussions at the Board and with the FSB, the exercise's findings are presented to senior officials during the Spring and Annual Meetings.

Fiscal sustainability and structural reforms

Fiscal transparency, accountability, and risk

The last decade and a half has seen a concerted effort to develop a set of internationally accepted standards for fiscal transparency and to monitor and promote their implementation. This period has also witnessed a steady improvement in the comprehensiveness, quality, and timeliness of countries' public financial reporting. Nevertheless, understanding of governments' underlying fiscal positions and the risks to those positions remains inadequate.

In August 2012, the Executive Board met informally to consider a policy paper on fiscal transparency, accountability, and risk.[13] The paper argues for a revitalized fiscal transparency effort to address the shortcomings in standards and practices revealed by the crisis and guard against a resurgence of fiscal opacity in the face of growing pressures on government finances. It identifies required actions on three fronts. First, fiscal transparency standards need to be updated to address gaps in and inconsistencies among standards. Second, the IMF needs to adopt a more modular, analytical, and calibrated approach to evaluating country compliance with fiscal transparency standards. Third, national, regional, and international institutions need to strengthen incentives to improve fiscal transparency practices. Since the Board's meeting, work has been undertaken to update the IMF's fiscal transparency code and manual (expected to be completed by the 2013 Annual Meetings), including public consultations on the code revision and pilot transparency assessments for three countries, based on the revised framework.

Macroeconomic and fiscal policy in resource-rich developing countries

Natural resource revenues have important implications for macroeconomic and fiscal policy frameworks in resource-rich developing countries owing to the exhaustibility and volatility of resource revenues. These countries face the challenge of transforming resource wealth into other assets that support sustained development, while maintaining mechanisms to avoid the boom-bust cycles that stem from revenue volatility. Also, their distinct characteristics—low per capita incomes, scarce domestic capital, and limited access to international capital markets—make advice based on traditional consumption-savings/investment theories inadequate. In this context, increasing the revenue potential of extractive industries in resource-rich countries has become an increasingly important element of IMF policy advice and technical assistance.

In an informal meeting in September 2012, the Executive Board considered two policy papers addressing issues for resource-rich developing countries. The first paper concerns macro-fiscal frameworks and policy analysis tools for these countries that could enhance IMF policy advice.[14] It puts forward five key innovations: (1) a fiscal sustainability framework that accounts for the growth- and revenue-enhancing impact of public investment, (2) a tool to support sustainable investment by analyzing the fiscal and macroeconomic implications of saving/investment scaling-up scenarios, (3) a set of proposed fiscal indicators to measure savings from and use (consumption or investment) of resource flows, (4) a new toolkit to design fiscal rules that smooth revenue volatility and assess long-term fiscal sustainability, and (5) a framework that generates current account benchmarks to analyze external sustainability in these countries.

The second paper focuses on the design and implementation of fiscal regimes for extractive industries.[15] It sets out the analytical framework underpinning, and key elements of, country-specific advice given and suggests ways of better realizing the revenue potential, particularly in developing countries. It observes that designing fiscal regimes for extractive industries involves complex trade-offs among employment, environmental impacts, and revenue objectives.

Lessons and implications of energy subsidy reform

Energy subsidies impose substantial fiscal and economic costs in most regions, with a commensurate adverse impact on fiscal balances and public debt. For many low- and middle-income countries, the fiscal costs have been substantial and pose even greater fiscal risks if international prices continue to increase.

In February 2013, the Executive Board was briefed informally on a policy paper reviewing country experience with energy subsidies and exploring implications of subsidy reform.[16] Drawing on countries' experiences, the paper outlines key elements of subsidy reform:

- a comprehensive energy reform plan with clear long-term objectives, analysis of the impact of reforms, and consultations with stakeholders;
- an extensive communications strategy, supported by improvements in transparency;
- appropriately phased price increases, which can be sequenced differently across energy products;
- improving the efficiency of state-owned enterprises to reduce reliance on subsidies;
- targeted measures to protect the poor; and
- institutional reforms that depoliticize energy pricing.

Capital flow management and macro-prudential policy

Executive Board discussions in the area of monetary policy during the year dealt with capital flows and the interactions of monetary and macro-prudential policy.

Capital flows

Capital flows have important benefits for individual countries and for the global economy, including by enhancing financial

Left IMF Economic Counsellor Olivier Blanchard (left), Bank of Israel Governor Stanley Fischer (center), and Economist Ted Truman (right) at "Liberalization and Management of Capital Flows" seminar at the 2013 Spring Meetings **Right** Oil refinery in Vienna, Austria

sector competitiveness, facilitating productive investment, and easing the adjustment of imbalances. However, the size and volatility of flows, as witnessed in recent years, also pose policy challenges. It is therefore important that the IMF be in a position to provide clear and consistent advice to members with respect to capital flows and policies related to them. In this regard, in 2011 the IMFC requested work on a "comprehensive, flexible, and balanced approach for the management of capital flows, drawing on country experiences."

Liberalization and management of capital flows

In two meetings in November 2012, the Executive Board concluded its discussions regarding the liberalization and management of capital flows.[17] In the policy paper that formed the basis for the Board's discussion, the IMF staff proposed an institutional view that builds on countries' experience in recent years, previous IMF policy papers and Board discussions on capital flows,[18] and recent analytical research.

Most Executive Directors agreed that the institutional view proposed in the paper provided a good basis for IMF policy advice and, where relevant for bilateral and multilateral surveillance, assessments on issues of liberalization and management of capital flows. Many Executive Directors emphasized that the role of source countries in capital flows should be adequately integrated into the institutional view. Executive Directors underscored that the institutional view in no way alters members' rights and obligations under any international agreements, including the Articles of Agreement.

Executive Directors observed that a country's net benefits from liberalization, and therefore its appropriate degree of liberalization, would depend on its specific circumstances, notably the stage of its institutional and financial development. They agreed that there should be no presumption that full liberalization is an appropriate goal for all countries at all times, although a number of them viewed capital account liberalization as a worthy long-term goal for all countries.

Executive Directors emphasized that capital flow liberalization needs to be well planned, timed, and sequenced, to minimize possible adverse domestic and multilateral consequences. Most viewed the "integrated approach" to liberalization as appropriate,[19] consistent with countries' individual circumstances, particularly their institutional and financial development, and taking into account macroeconomic and financial sector prudential policies.

Executive Directors emphasized that macroeconomic policies—monetary, fiscal, and exchange rate management—have to play a key role in managing inflow surges or disruptive outflows, supported by sound financial supervision and regulation and strong institutions. They agreed that, in certain circumstances, capital flow management measures, that is, measures designed to limit capital flows, can be useful and appropriate. They stressed that such measures should not substitute for warranted macroeconomic adjustment.

Executive Directors generally agreed that capital flow management measures should seek to be targeted, transparent, and temporary, and should be lifted once inflow surges abate or disruptive outflow pressures subside; that such measures should seek to avoid discriminating on the basis of residency; and that the least-discriminatory measure that is effective should be preferred. They concurred that certain capital flow management measures can continue to be useful over the longer term for safeguarding financial stability.

Most Executive Directors concurred that policies in source countries play an important role in promoting the stability of the international monetary system, and that accordingly policymakers should seek to better internalize the risks associated with their policies. Executive Directors stressed that better cross-border coordination of relevant policies, including at the regional level, would help mitigate the riskiness of capital flows.

Executive Directors noted that the IMF's legal framework for surveillance had long recognized the importance of capital flows and policies to manage them, even though the institution's mandate with respect to international capital movements is more limited than that on payments and transfers for current international transactions. With this in mind, most Executive Directors noted that the IMF is well placed to provide policy advice and, where relevant and in accordance with the Integrated Surveillance Decision (see discussion earlier in the chapter), assessments on issues related to capital flows, in close cooperation with country authorities. Specifically, most Executive Directors endorsed the proposal set forth in the policy paper for use of the institutional view in policy advice and in bilateral and multilateral surveillance. Moreover, many Executive Directors stressed the need for surveillance in important source countries to assess properly the potential impact of policies on cross-border capital flows.

Guidance Note on Liberalization and Management of Capital Flows

Given the importance of providing operational clarity on the institutional view, a Guidance Note on Liberalization and Management of Capital Flows was developed, and the Executive Board was briefed on it in April 2013.[20] The guidance note explains that the institutional view provides a basis for consistent advice and assessments when relevant for surveillance, but there are no mandatory implications for IMF-supported programs.

The guidance note advises that application of the institutional view will need to reflect country circumstances. It encourages the IMF staff to incorporate in staff reports, and find ways to disseminate among the staff, policy lessons from country cases, interactions with authorities, and new analysis on capital flow liberalization and management.

Interaction of monetary and macro-prudential policies

The global crisis showed that price stability does not guarantee macroeconomic stability. Including financial stability as an additional objective thus requires macro-prudential tools that can target specific sources of financial imbalances. Effective macro-prudential policies (which include a range of constraints on leverage and the composition of balance sheets) can then potentially limit risks ex ante and help build buffers to absorb shocks ex post.

In January 2013, the Executive Board held an informal discussion on the interaction between monetary and macro-prudential policies. The policy paper provided to the Board for discussion finds that ideally, with macro-prudential policies perfectly targeting the sources of threats to financial stability, monetary policy should remain primarily focused on price and output—but that the conduct of both policies would need to take into account the effects they have on one another's main objectives.[21]

Additionally, the paper observes that interaction between monetary and macro-prudential policies has implications for institutional design, while acknowledging that the policy interactions are not fully known, institutions are imperfect, and political economy and other constraints can arise. Nevertheless, policy coordination can improve outcomes, making it advantageous to assign both policies to the central bank. However, concentrating multiple objectives in one institution can muddy its mandate, complicate accountability, and reduce credibility. Thus, safeguards are needed to distinguish between the two policy functions through separate decision making, accountability, and communication structures.

LOW-INCOME COUNTRIES

Throughout the global crisis, the IMF has remained committed to meeting the changing needs of low-income countries. In addition to increasing the financial support available to these countries, other reforms have included overhauling the institution's lending framework, streamlining loan conditionality, and reducing to zero the interest charges on concessional IMF loans for low-income countries through the end of 2014.[22]

The following subsections discuss the IMF's continuing efforts in support of these countries during the year. However, a March 2013 Executive Board meeting on debt limits in IMF-supported programs with low-income countries is discussed in Chapter 4.

Review of facilities for low-income countries and eligibility for concessional financing

When the IMF reformed its facilities for low-income countries in 2009, the Executive Board requested that experience with the new architecture be reviewed after three years. Two Board discussions during the year provided an opportunity to conduct such an assessment.

Review of facilities

At the first stage of the review, in September 2012,[23] Executive Directors considered that the 2009 reforms had been broadly successful in creating a streamlined architecture of facilities better tailored to low-income countries' needs. They noted that the central challenge ahead would be to preserve the IMF's ability to provide financial support to these countries in the face of a sharp prospective drop in its concessional financing capacity after 2014.[24]

Noting that access levels at the time of the discussion appeared broadly appropriate on average, most Executive Directors saw merit in keeping access unchanged in special drawing right (SDR) terms when the Fourteenth General Review of Quotas becomes effective, which would imply a corresponding decrease in access in percentage of quota.[25] Executive Directors recognized that access would need to be raised in the future as financing needs increased, based on a careful assessment of projected financing needs and available resources. Although the terms of financing arrangements through the PRGT appeared on average to strike the right balance between concessionality and financing capacity, most Executive Directors saw merit in greater differentiation of financing terms, particularly through greater use of blending of nonconcessional and concessional financing.

Executive Directors generally saw merit in exploring refinements to increase the flexibility of existing instruments to provide contingent financing and policy support to low-income countries, rather than creating a new instrument. They also generally saw room for improvements to certain design aspects of the facilities—including proposed refinements aimed at refocusing the Poverty Reduction Strategy on substance rather than process, in consultation with the World Bank.

In the second stage of the review, in April 2013,[26] the Board considered specific refinements in the areas of blending and access, precautionary support, the Policy Support Instrument framework,[27] and arrangements under the Standby Credit Facility and Extended Credit Facility. Most Executive Directors supported enhancing the blending policy along the lines of the first approach set out in the related policy paper, which enhances blending incrementally while maintaining broadly the existing rules to determine which countries are presumed to blend.[28] Most considered that access norms and limits, which had doubled in 2009, were broadly appropriate in nominal terms. Accordingly, and also taking into account the nature and scarcity of the IMF's concessional resources, these Executive Directors agreed that, once the quota increase under the Fourteenth General Review of Quotas becomes effective, access norms and limits as a percentage of quota and the quota levels that determine the application of the procedural safeguards should be reduced by half. Executive Directors saw a need to review these limits regularly in light of low-income countries' evolving financing needs. They supported the proposed increase in the cumulative access limit under the Rapid Credit Facility.

Executive Directors generally welcomed the proposals to augment access between scheduled reviews for on-track arrangements under the Extended Credit Facility and Standby Credit Facility in case of an acute increase in the member's underlying balance of payments problems that cannot await the next scheduled review. They supported relaxing rules under the Standby Credit Facility to encourage its use as precautionary, including permitting greater front-loading of support and easing time limitations on repeated use of arrangements treated as precautionary. It was felt that easing of requirements on documentation, timing of staff report issuance, and review schedules, as well as extension of the initial duration, would help enhance the Policy Support Instrument's attractiveness.

Executive Directors endorsed proposed refinements to Extended Credit Facility arrangements to allow longer duration and greater flexibility in setting their review schedules. They also welcomed other proposals for operational streamlining. They noted that timely termination of defunct Extended Credit Facility arrangements would help unlock PRGT resources that would otherwise remain committed.[29] Most Executive Directors also favored easing procedural requirements related to the Poverty Reduction Strategy.

Box 3.3

Call for greater coordination on global development

The UN Millennium Development Goals aim to end poverty and hunger, increase access to education and health care, improve gender equality, and ensure environmental sustainability. Emphasizing the need for coordinated efforts to achieve these goals by 2015, the leaders of the IMF, African Development Bank, European Bank for Reconstruction and Development, Inter-American Development Bank, and World Bank Group released a statement in February 2013, pledging close collaboration to support development and growth.[a] The statement coincided with the launch of the 2013 Millennium Development Goals conference in Bogotá, Colombia.

The leaders also pledged strong support for and collaboration with the UN-led process of defining the Post-2015 Development Framework, supporting an approach that integrates economic, social, and environmental sustainability. They pledged to work together to develop options for long-term investment to strengthen the foundations of growth and called for a renewed focus on financing for development, with greater leveraging of official development assistance and private sector investment, as well as better domestic resource mobilization and management and stronger institutions. They committed to harnessing their institutions' analytical and convening power to identify solutions to issues of inclusive growth, environmental sustainability, and long-term financing.

a See Press Release No. 13/60, "International Financial Institutions Call for More Coordination on Global Development" (www.imf.org/external/np/sec/pr/2013/pr1360.htm)

Executive Directors agreed to conduct the next review of the facilities for low-income countries on the standard five-year cycle, noting that the review could be brought forward if warranted, while access norms and limits would be reviewed as warranted, in light of regular updates on the use of PRGT resources and projected needs, and future quota increases.

Review of eligibility for concessional financing

In April 2013, the Executive Board also reviewed the IMF's framework for determining eligibility to use its concessional resources, including the criteria for determining PRGT eligibility and the list of PRGT-eligible countries. Executive Directors broadly supported the proposals, including transitional arrangements.

Executive Directors highlighted the need to maintain a transparent and rules-based framework for PRGT eligibility that ensures uniformity of treatment among members in similar circumstances. They also reiterated the importance of preserving the IMF's scarce concessional resources for members with a low income level and vulnerabilities, and closely aligning eligibility with the objectives of the PRGT and with practices in the International Development Association. They broadly welcomed the proposed special provisions for very small states (microstates) in the PRGT eligibility framework,[30] in view of the unique challenges these states face.

Executive Directors agreed to conduct the next review of PRGT eligibility in 2015, noting that the framework allows for interim updates where warranted by the existing criteria and requirements.

Vulnerability Exercise for Low-Income Countries

In 2011 the IMF developed an analytical framework to assess vulnerabilities and emerging risks in low-income countries. Using this framework, the IMF conducts an annual Vulnerability Exercise for Low-Income Countries.

In November 2012, the Executive Board met to discuss a report on the results of the 2012 exercise.[31] Executive Directors considered appropriate and timely the report's focus on risks to low-income countries from a sharp downturn in global growth, a more protracted slowdown in growth, and a spike in food and fuel prices. They concurred with the IMF staff's policy recommendations, while emphasizing the importance of a more discriminating analysis based on individual country or regional differences. They called on the staff to take concrete steps to incorporate these recommendations into IMF surveillance, financing programs, and technical assistance.

Executive Directors encouraged low-income countries to continue to rebuild policy buffers, while balancing adjustment against the need to maintain or raise growth and preserve priority spending. They highlighted several broad priorities for stoking domestic engines of growth to substitute for weaker global demand and reduce the impact of external shocks: deepening financial sector development, developing domestic debt markets, strengthening financial regulation and supervision, improving the business climate, and better targeting investments in infrastructure to increase productivity and long-term inclusive growth.

Executive Directors agreed that, to avoid aggravating the negative economic and social impact of a sharp slowdown of global growth, countries with sufficient fiscal room should seek to maintain growth-friendly spending, particularly on infrastructure. They noted, however, that with donors facing severe budget constraints, some low-income countries might find it difficult to finance increasing deficits and that some adjustment would be appropriate and inevitable. Executive Directors emphasized that the impact of a protracted global growth slowdown would be more substantial over the medium term, given the potential permanent output losses that accumulate over time.

Executive Directors noted that many low-income countries remained highly vulnerable to global commodity price shocks. They observed that the fiscal exposure to commodity price shocks could be significantly reduced by eliminating domestic food and fuel price controls while building effective social safety nets. They also noted that monetary policy should respond quickly to such shocks to curb second-round inflationary pressures.

Executive Directors noted the potential increased demand on IMF resources if these risks materialized. In this regard, they reiterated the importance of the institution's having adequate concessional resources (see "Poverty Reduction and Growth Trust" in Chapter 4).

Enhanced financial sector surveillance in low-income countries

The Executive Board considered a policy paper on enhanced financial sector surveillance in low-income countries in an informal meeting in May 2012. The paper advocates taking better account of the interplay between financial deepening and macro-financial stability in IMF surveillance, as called for in the 2011 Triennial Surveillance Review.[32] The analysis identifies policy and institutional impediments in low-income countries that have a bearing on the effectiveness of macroeconomic policies, macro-financial stability, and growth, focusing on the role of policies in facilitating sustainable financial deepening.

The paper points to a balance between market-friendly actions, appropriate macro-prudential oversight to avoid creating new sources of instability, and carefully calibrated public policy interventions. By highlighting aspects of financial systems that need to be taken into account in formulating macroeconomic policy advice, the paper takes a first step toward an approach to financial surveillance in low-income countries that goes beyond a focus on institutional solvency and effective market infrastructure to consider dimensions of financial deepening.

Heavily Indebted Poor Countries Initiative/ Multilateral Debt Relief Initiative

The IMF and World Bank launched the Heavily Indebted Poor Countries (HIPC) Initiative in 1996, as part of a comprehensive approach to debt reduction designed to ensure that no poor country faces a debt burden it cannot manage. To be considered for assistance under the initiative, a country must meet certain criteria.[33] Debt relief is provided in a two-step process: interim debt relief in the initial stage, referred to as the *decision point*, and when a country meets its commitments, full debt relief at the *completion point*. No additional countries reached their decision points during the year, and three countries—Comoros, Côte d'Ivoire, and Guinea—reached their completion points under the initiative.

As of April 30, 2013, of the 39 countries eligible or potentially eligible for HIPC Initiative assistance, 36 had reached their decision points; of these, 35 countries had reached their completion points. In total, debt relief of SDR 2.6 billion has been provided under the HIPC Initiative for these countries.[34]

In 2005, to help accelerate progress toward the UN Millennium Development Goals, the HIPC Initiative was supplemented with the Multilateral Debt Relief Initiative (MDRI). MDRI relief covers the full stock of debt owed to the IMF at the end of 2004 that remains outstanding at the time a country qualifies for such relief. The IMF has provided debt relief of SDR 2.3 billion (US$3.4 billion) under the MDRI, including debt relief to two non–heavily indebted poor countries. Although they reached the completion point under the HIPC Initiative, Afghanistan, Comoros, Haiti, and Togo had no MDRI-eligible debt with the IMF and therefore did not receive debt relief from the IMF under this initiative. Additionally, Côte d'Ivoire and Guinea had fully repaid their MDRI-eligible debt by the time they reached the completion point and also did not receive debt relief from the IMF under the MDRI.[35]

SMALL STATES

The IMF's smallest member countries share a number of intrinsic characteristics that translate into a common set of development challenges. Because of their small size, they have higher fixed and variable costs, with little scope to exploit economies of scale. In the public sector, this results in higher costs and reduced volumes of services provided; in the private sector, in concentrated market structure and a lack of diversification; and in trade, in high transport costs (which are exacerbated for the most remote small states). Small size also influences the financial sector and how small states manage their exposure to natural disasters. The Executive Board considered issues related to small states—the first comprehensive examination since 2000—in an informal briefing in December 2012 as well as a formal discussion in March 2013.

Macroeconomic issues in small states and implications for IMF engagement

At its March 2013 meeting, the Executive Board discussed a policy paper on macroeconomic issues in small states and implications for IMF engagement.[36] The paper examines the macroeconomic challenges unique to microstates, reviews the IMF's engagement in small states, and presents proposals to strengthen its effectiveness.

Left Deputy Managing Director Min Zhu addresses the Pacific Islands Seminar, "Global Shocks, Near-Term Challenges and Sustainable Growth," at the 2012 Annual Meetings **Right** A farmer rides a tractor while tilling the soil outside of Port-au-Prince, Haiti

Executive Directors recognized that small states had not matched the improved economic performance of larger countries since the late 1990s. With slower and more volatile growth than larger peers and higher public spending during this period, it was observed, a number of small states faced high debt burdens and reduced policy buffers. The ability of small states to manage economic shocks had also been hampered by their weak financial systems. Microstates faced particular challenges, marked by more volatile growth and external accounts and more costly banking services.

Executive Directors noted that the evidence suggests that small states are generally well served by the IMF's surveillance, technical assistance, and financing facilities, especially since the 2009 reforms to the institution's low-income facilities. They concurred that IMF policy advice should help small states rebuild policy buffers to the extent possible and strengthen institutions and governance. Many Executive Directors suggested that consideration be given to more frequent staff contacts between Article IV consultations, as well as the possibility of increasing the frequency of these consultations. Executive Directors suggested the possible preparation of a staff guidance note for IMF engagement with small states or an annex to the existing guidance note for Article IV consultations.

Executive Directors concurred that a strong analytical agenda, as well as an active dialogue with small-states communities, should inform the IMF's policy advice to small states and help strengthen the design and traction of economic adjustment programs. They encouraged the IMF staff to discuss its analysis with small states and associated development partners. Following this outreach, Executive Directors looked forward to discussing a more refined set of operational conclusions with resource implications.

PROGRAM DESIGN

An IMF-supported program is a package of policy measures that, combined with approved financing, is intended to accomplish specific objectives, such as orderly external adjustment, broad-based inclusive growth, and poverty reduction. Programs are formulated by countries in consultation with the IMF and in most cases are supported by an Executive Board–approved financing arrangement.

The Executive Board considered aspects of IMF program design on several occasions during the year. In addition to the review of conditionality in IMF programs, covered in the next subsection, the Board informally discussed crisis-related IMF programs in July 2012 and also discussed the IMF's policy on debt limits in IMF-supported programs (see Chapter 4).

2011 review of conditionality

Conditionality covers both the design of IMF-supported programs—that is, the underlying macroeconomic and structural policies—and the specific methods used to monitor progress toward the goals outlined by program countries. In addition, it helps create safeguards for the temporary use of IMF resources. The IMF reviews conditionality regularly as part of its effort to assess policies and adapt to a changing environment. The last review took place in 2004–05.

In September 2012, the Executive Board discussed a package of policy papers reviewing the conditionality, design, and effects of IMF-supported programs during the period 2002–September 2011.[37] Executive Directors generally agreed that the Guidelines on Conditionality remained broadly appropriate, although their implementation could be improved in several areas. They broadly endorsed the specific proposals put forward in the papers and welcomed the intention to modify the Operational Guidance Note on Conditionality in light of the conclusions reached at the meeting, complemented by ongoing efforts to improve debt sustainability analysis.

Executive Directors underscored the need to adhere strictly to the macro-criticality criterion for setting conditionality, with close scrutiny for conditionality outside the IMF's core areas of responsibility. They supported developing an approach for better risk diagnostics across a range of dimensions and tailoring robustness tests according to this assessment. They also saw room for further strengthening the discussion of systemic and contagion risks in programs involving exceptional access, especially where these risks have an impact on the robustness of debt sustainability.

Executive Directors encouraged more analysis of the social impact of policy measures in programs, in close cooperation with country authorities and institutional partners. They also supported, where feasible and appropriate, inclusion of policy measures to mitigate adverse short-term impacts on the most vulnerable, particularly in programs with high risks and large fiscal adjustment.

Executive Directors highlighted the importance of coordination and collaboration with other international institutions, and donors where relevant, to ensure adequate financing and coherent conditionality while avoiding duplication.

Executive Directors noted that implementing the recommendations made in the review would likely have some budgetary implications. They looked forward to a fully costed proposal in the context of budget discussions, taking into account the Board's discussion and the findings of the IMF staff's Working Group on Jobs and Inclusive Growth.[38]