CHAPTER 1

The Setting: World Economic Developments in FY2000

Global economic and financial conditions improved during the financial year,[1] as the world economy proved more resilient to the financial crises that erupted in 1997–98 than initially believed (Table 1.1 and Figure 1.1). On average, output growth picked up or remained strong in the advanced economies, the developing countries in Asia, and the countries in transition, but slowed in Africa, the Middle East, and the Western Hemisphere. Core inflation was broadly stable or fell in most regions, but fiscal and external imbalances remained problematic in some countries. Financial flows to emerging markets picked up in 1999 and the cost of finance eased somewhat, but the situation was fragile and impeded recovery in many countries. At the same time, buoyant demand in North America and growing demand in Europe and parts of Asia provided needed export markets for countries emerging from recession.

Other key developments during 1999 and early 2000 included the rise in world oil prices to their highest levels since 1991, with a bottoming out of many other commodity prices; a firming of interest rates in advanced economies, except in Japan; and gains in most equity markets, driven especially by share prices of technology-related firms. Systemic economic or financial problems related to the year 2000 ("Y2K") computer bug failed to materialize, in part because of the planning and remediation efforts undertaken by the private sector, governments, and international institutions.

The pace of economic activity rebounded in the developing countries as a group in 1999/2000, largely because of the gains made in the crisis-affected countries in Asia, and to a lesser extent in Russia. In Latin America, by contrast, economic output was unchanged on average, but did not decline sharply as was initially feared when a financial crisis struck the region in late 1998 and early 1999. Indeed, industrial production began to recover in the larger countries in the region by mid-1999. Among the advanced economies, divergent output trends remained evident. The expansion continued apace in North America, the United Kingdom, Australia, and some smaller European countries, but slowed modestly in Europe for the year as a whole. The largest countries in the euro area, however, showed increasing momentum in the second half of 1999 and into 2000. The Japanese economy remained weak in 1999, with wide demand fluctuations through the year. This global environment of strong demand and recovery in some areas but weak conditions in others helped to set the stage for developments in commodity and financial markets and a pickup in world trade.

[1]This chapter generally covers developments during the IMF's financial year (May 1999 through April 2000). References to calendar years are necessary in many instances because of data limitations.

Global Environment

In *commodity markets*, world oil prices nearly tripled from low levels of about $10 a barrel in late 1998 and early 1999; prices remained in the $25–$30 range through the end of the financial year. This price rise was attributed in part to voluntary supply restraints by some of the major oil producers and to the unexpectedly robust economic recovery in Asia. The increase in oil prices put upward pressure on inflation in 1999 and early 2000 in many countries, but not to the same extent as the oil price increases of the 1970s, and core inflation measures were largely unaffected through early 2000. Higher oil prices helped ease financial conditions in the oil-exporting countries. Other commodity prices staged a modest rebound, and the IMF's index of nonfuel commodity prices rose by about 3 percent through the financial year, ending a trend decline of some 30 percent since the previous peak in 1996. Price developments varied by product, however, and not all exporters saw their terms of trade improve.

World trade volumes picked up in 1999 and helped improve the external environment for many countries. Imports into the advanced economies grew robustly; this largely reflected the continued strength of domestic demand growth in the United States and the recovery in Europe that began in the second half of 1999.

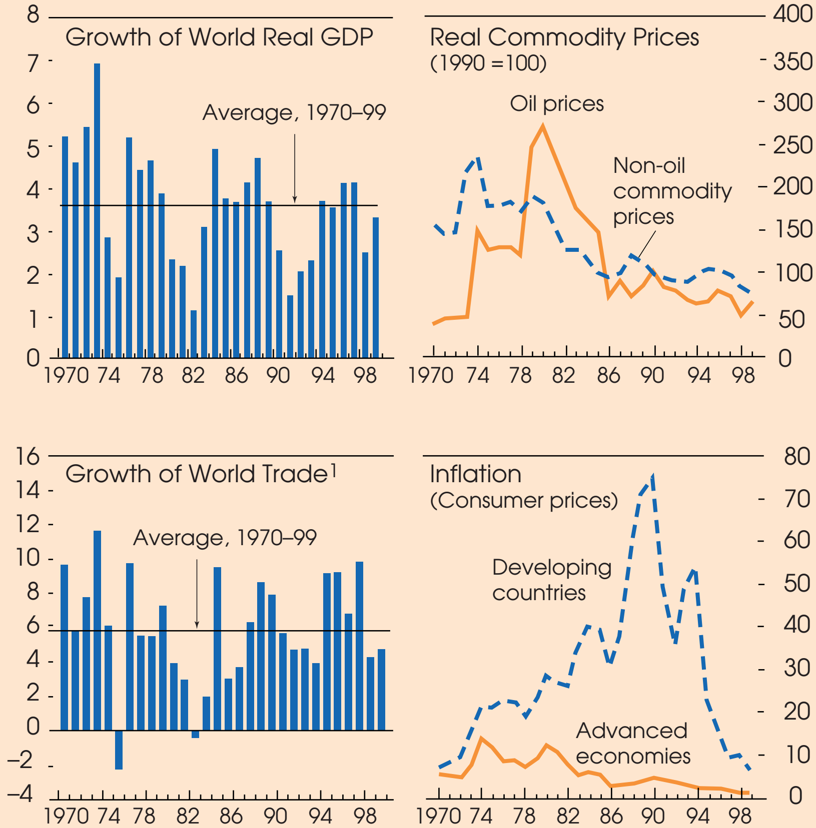
Table 1.1
Overview of the World Economy
(Annual percent change unless otherwise noted)

	1992	1993	1994	1995	1996	1997	1998	1999
World output	**2.0**	**2.3**	**3.7**	**3.6**	**4.1**	**4.1**	**2.5**	**3.3**
Advanced economies	2.1	1.4	3.3	2.7	3.2	3.3	2.4	3.1
Major industrial countries	2.0	1.3	3.0	2.3	3.0	3.1	2.5	2.8
United States	3.1	2.7	4.0	2.7	3.6	4.2	4.3	4.2
Japan	1.0	0.3	0.6	1.5	5.0	1.6	–2.5	0.3
Germany	2.2	–1.1	2.3	1.7	0.8	1.5	2.2	1.5
France	1.5	–0.9	2.1	1.8	1.1	2.0	3.4	2.7
Italy	0.8	–0.9	2.2	2.9	1.1	1.8	1.5	1.4
United Kingdom	0.1	2.3	4.4	2.8	2.6	3.5	2.2	2.0
Canada	0.9	2.3	4.7	2.8	1.7	4.0	3.1	4.2
Other advanced economies	2.5	1.9	4.5	4.3	3.8	4.2	2.0	4.6
Memorandum								
Industrial countries	1.9	1.1	3.1	2.4	3.0	3.2	2.7	2.9
Euro area	1.5	–0.8	2.4	2.3	1.5	2.4	2.8	2.3
Newly industrialized Asian economies	6.0	6.3	7.6	7.3	6.2	5.8	–2.3	7.7
Developing countries	6.4	6.4	6.7	6.1	6.5	5.8	3.2	3.8
Africa	–0.7	0.4	2.3	3.2	5.6	2.9	3.1	2.3
Asia	9.4	9.4	9.6	9.0	8.3	6.7	3.8	6.0
China	14.2	13.5	12.6	10.5	9.6	8.8	7.8	7.1
India	4.2	5.0	6.7	7.6	7.1	5.8	4.7	6.8
ASEAN-4[1]	6.3	6.9	7.6	8.0	7.3	3.3	–9.5	2.5
Middle East and Europe	6.2	3.5	0.5	3.8	4.6	4.7	2.7	0.7
Western Hemisphere	3.6	4.1	5.0	1.7	3.6	5.4	2.1	0.1
Brazil	–0.5	4.9	5.9	4.2	2.7	3.6	–0.1	0.5
Countries in transition	–14.4	–7.6	–7.6	–1.4	–0.6	1.7	–0.7	2.4
Central and eastern Europe	–8.8	–3.8	–2.9	1.7	1.6	2.3	1.8	1.4
Excluding Belarus and Ukraine	–5.3	0.2	3.2	5.6	3.7	2.7	2.0	1.5
Russia	–19.4	–10.4	–11.6	–4.2	–3.4	0.9	–4.5	3.2
Transcaucasus and central Asia	–14.1	–11.0	–11.5	–5.0	1.3	2.6	2.3	4.4
World trade volume (goods and services)	**4.7**	**3.8**	**9.0**	**9.1**	**6.7**	**9.7**	**4.2**	**4.6**
Imports								
Advanced economies	4.7	1.5	9.6	8.9	6.2	9.1	5.5	7.4
Developing countries	11.2	11.0	7.1	11.1	8.3	10.5	0.4	–0.3
Countries in transition	–24.7	9.3	4.5	12.3	8.3	7.1	2.9	–5.4
Exports								
Advanced economies	5.2	3.3	8.9	8.8	5.9	10.3	3.7	4.4
Developing countries	11.5	8.0	12.2	8.3	11.2	10.9	4.5	1.7
Countries in transition	–21.3	9.0	1.3	10.3	5.3	4.9	6.3	3.9
Commodity prices								
Oil[2]								
In SDRs	–4.5	–11.1	–7.3	1.8	23.7	–0.2	–31.2	37.6
In U.S. dollars	–1.7	–11.8	–5.0	7.9	18.4	–5.4	–32.1	38.7
Nonfuel (average based on world commodity export weights)								
In SDRs	–2.8	2.7	10.6	2.3	3.3	2.0	–13.5	–7.7
In U.S. dollars	0.1	1.8	13.4	8.4	–1.2	–3.3	–14.7	–6.9
Consumer prices								
Advanced economies	3.5	3.1	2.6	2.6	2.4	2.1	1.5	1.4
Developing countries	36.1	49.8	55.1	22.9	15.1	9.5	10.1	6.5
Countries in transition	788.9	634.3	273.3	133.5	42.4	27.3	21.8	43.7
Six-month London interbank offered rate (LIBOR, percent)								
On U.S. dollar deposits	3.9	3.4	5.1	6.1	5.6	5.9	5.6	5.5
On Japanese yen deposits	4.3	3.0	2.4	1.3	0.7	0.7	0.7	0.2
On euro deposits	9.8	7.4	5.7	5.7	3.7	3.5	3.7	3.0

Source: IMF, *World Economic Outlook* (May 2000).
[1]Indonesia, Malaysia, the Philippines, and Thailand.
[2]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil.

Imports of the advanced economies in the Asia and Pacific region were also strong, except for Japan, where domestic demand was largely stagnant. Among developing countries, for which data are preliminary, imports rose in Asia, driven in large part by a postcrisis rebound in Thailand and other countries. Demand in China for foreign goods and services also increased robustly, although the reported increase in imports in part reflected a vigorous antismuggling campaign. In contrast, import volumes fell in other regions. In the Western Hemisphere, needed macroeconomic adjustment led to a fall in imports in all the larger developing countries, except for Mexico. Significant import compression also occurred in Russia and spilled over to dampen export demand in neighboring countries, especially in the first part of the year.

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



Source: IMF, *World Economic Outlook* (May 2000).
[1]Volume of goods and services.

Capital flows to emerging markets remained subdued in 1999. They showed only a slight improvement from the crisis-affected levels in 1998, and remained below decade-average levels. In addition, private financing shifted away from bank lending toward bond and equity finance. The largest increase in financial flows came from equity issues, with almost all of the proceeds going to Asia, where recovery was most advanced. Indeed, the recovery in emerging Asia led to a near doubling of gross private financial flows to this region. Flows into developing countries in the Middle East and Africa also rose, but were about unchanged in the Western Hemisphere, and flows into Europe fell.

Financing costs for emerging markets fluctuated during 1999 and into 2000, but remained high compared with the period before the Asia crisis, reflecting both wide interest rate spreads and a modest upward trend in advanced country interest rates. Early in 1999, the financial crisis in some countries in Latin America caused a spike in bond spreads in some countries (and reduced availability of funds), but the impact dissipated quickly as those affected took corrective policy actions. More generally, interest rate spreads appear to have been more differentiated across emerging markets as lenders took greater account of country-specific risks; this made contagion less of a force than in past episodes of financial market volatility. The failure of some countries to meet their external payment obligations later in the year and into 2000 did not appear to put systemic pressure on secondary market spreads. In the early fall of 1999, debt markets rallied (and emerging market spreads fell) as investors became more confident that Y2K computer problems would be avoided. The rally, greater differentiation, and a broadly more stable financing environment benefited from increasing confidence and had mutually reinforcing effects on the recovery in Asia in 1999 and other regions later in the year.

Dollar- and euro-denominated interest rates generally rose over the period for short-term and longer-term maturities, although yield curves tended to flatten in early 2000. Central banks in North America and Europe tightened monetary policies to head off future inflation. In the United States, the Federal Reserve raised interest rates from the middle of 1999 through the end of April 2000. Over the period, the Federal Reserve more than reversed the interest rate cuts made in 1998 when it provided liquidity to markets in the wake of the Russian financial crisis and the near collapse of a major hedge fund that threatened the smooth operation of financial markets. In the euro area—where the economic recovery was on track—policy interest rates were raised in late 1999. In Japan, in contrast, the Bank of Japan has followed a "near zero" interest rate policy since early 1999 as one of the measures undertaken to revive the economy.

In *exchange rate markets*, the three major world currencies moved significantly. The euro—introduced as the common currency of 11 European countries on January 1, 1999—depreciated through the year against the yen and the U.S. dollar, with the yen appreciating against the dollar in the second half of the year (see Chapter 2). The currencies of the larger emerging market countries were broadly stable in 1999—especially compared with the previous few years—but with a few exceptions. Currencies of the crisis countries in Asia appreciated or remained broadly stable during 1999 and into early 2000, reflecting the economic and financial turnaround in these countries. In Latin America, the Brazilian real depreciated against the U.S. dollar and neighboring currencies when Brazil adopted a floating exchange rate regime in early 1999, but the currency stabilized later in the year; Chile moved to a freely floating exchange rate regime after years of a sliding band system, without a major impact on the currency's trend value. Other major currencies in the region were broadly stable against the U.S. dollar. Similarly, the Russian ruble became much less volatile, especially later in 1999.

Key Developments in Emerging Market and Advanced Economies

In *Asia*, the recovery from the 1997–98 financial crisis and subsequent recession was impressive. The recoveries in Korea, Malaysia, and Thailand were supported by expansionary fiscal and monetary policies, which contributed to a turnaround in domestic demand. Buoyant exports within the region and to North America were also a source of growth and allowed imports to rise without a return to the external account deficits seen before the crisis. Thus, the region was a net supplier of financial resources to global capital markets in 1999. A recovery in economic output also began to take hold in Indonesia, which registered positive real GDP growth in 1999, after a severe output contraction in 1998. The expansion in *China* slowed slightly in 1999, while that in *India* picked up. The expansion in both countries remained robust enough to continue significant growth in per capita income and to reduce poverty. In China, economic growth was supported and reinforced by improved conditions in other economies in the region—which led to a strong export performance—and by the early effects of a fiscal stimulus package adopted in the second half of 1999. The decline in prices, which had become an increasing policy concern, began to abate from the middle of 1999, but unemployment remained a concern. In India, a pickup in industrial production in 1999 helped offset a slowing in agricultural output in the latter half of the year.

In *Latin America*, the macroeconomic impact of the 1998–99 financial crisis was less severe than in the earlier crisis in Asia, and activity in most economies in the region was expanding by the end of 1999. The recovery in *Brazil* started early in the year, led by increases in agricultural and industrial output, with the latter supported by improved competitiveness. In *Argentina*, domestic demand was weak in 1999, but industrial production began to rise at midyear, pointing to a turnaround in the economy. Similarly, a pickup in industrial production signaled a solid recovery in *Chile*. *Mexico* avoided an economic downturn in 1999, owing to the strength of import demand from its largest trading partner, the United States; rising oil prices and related revenue; and gains in domestic demand. Quick recoveries were helped in most of these countries by relatively low rates of inflation, which boosted confidence and allowed scope for some policy response to the weak economies. *Colombia, Ecuador*, and *Venezuela*, however, experienced sharper economic contractions.

In *Africa*, economic growth slowed in 1999, mainly reflecting weakness in several large countries. *South Africa* was affected directly by the global financial crisis and spillovers into its markets, while the pickup in oil prices during the year helped *Nigeria* and other oil exporters in the second half of 1999, but had little impact on annual economic indicators. *Kenya* and several other countries were hurt by weak nonfuel commodity prices, which with higher oil import costs, added to the recent downward trend in their terms of trade. Activity in many sub-Saharan countries was also affected by poor rainfall in 1999, as well as policy slippages in some countries in the region. Encouragingly, average economic growth picked up in the countries in the region with IMF-supported reform programs. Debt relief was provided to some of these countries as part of the first phase of the Initiative for Heavily Indebted Poor Countries (see Chapter 5).

Oil exporters in the *Middle East* received a boost to national incomes from higher oil prices and the terms of trade effect. The higher oil prices also relieved pressures on external and fiscal accounts brought on by low prices in past years. Output growth was weak in these countries, however, because the rise in global oil prices was caused in part by reduced oil production, which is a large part of economic output. The *Egyptian* economy benefited from a low inflation environment and was among the strongest in the region. Elsewhere, the *Turkish* economy contracted sharply in 1999, and an adjustment program was put in place late in the year.

Macroeconomic developments in the *transition countries* reflected both higher oil prices and the external market for exports. *Russia*'s economic performance was better than initially expected after its financial crisis in 1998, although in contrast to countries in Asia and Latin America, export volumes did not pick up as sharply and quickly after the exchange rate depreciation. The fiscal and external trade balances in Russia also benefited from higher world oil prices. Countries in central Europe and the Baltic region weathered the recent economic slowdown in the European Union, although output growth slowed for the year.

Divergences in economic performance among the *advanced economies* continued into 1999. Output and demand growth was robust in the United States during the past year and into 2000, while Japan's economy was almost stagnant for 1999 as a whole, expanding in the first half of the year and contracting in the second half. In early 2000, however, some signs of recovery became evident, including a pickup in industrial production, a marked rise in machine orders, and a rebound in exports. The recovery remained fragile, however, as demonstrated by the weakness in consumer demand through the year. Economic activity in Europe gained momentum, especially in the second half of 1999. This overall picture masks some differences among countries in Europe, with France growing fastest among the major continental countries, and with vigorous expansions in many of the smaller countries in Europe's new monetary union.

The *current account balance* of the industrial countries as a group deteriorated by $170 billion in 1999, but the deterioration was uneven across countries. The increase in the U.S. deficit, to record levels as a percent of GDP, accounted for much of the deterioration, and came at a time when the U.S. dollar was strong and when a rise in national saving was outpaced by a rise in investment spending. Current account surpluses narrowed modestly in Japan and the euro area, partly the result of higher oil prices. In sum, the industrial countries provided a needed demand stimulus to emerging market economies, but at the same time the amount of financing measured by net capital flows to them increased only slightly.

CHAPTER 2

IMF Country, Global, and Regional Surveillance

Central to the IMF's mandate of improving the operation of the international monetary system is its oversight (or "surveillance") of the economic and financial policies of its member countries. IMF surveillance has taken on even more importance in the wake of the Mexican crisis of 1994 and the later financial crises in Asia and other emerging market economies, and the IMF has adapted its oversight to its members' changing needs in an increasingly integrated global economy. As a result, IMF surveillance is also the mechanism through which most of the initiatives being pursued—or planned—as part of the international community's efforts to strengthen the architecture of the international monetary and financial system will come together (see Chapter 4). The IMF has also acted to ensure that the process of surveillance is a continuous one through informal and supplemental discussions and mechanisms.

The IMF carries out surveillance in several ways:

- *Country surveillance* takes the form of regular (usually annual) consultations with member countries over their policies. (The consultations are referred to as "Article IV consultations" as they are mandated in Article IV of the IMF's Articles of Agreement, or charter.)
- *Global surveillance* entails periodic reviews by the IMF's Executive Board of global economic developments, based on World Economic Outlook reports prepared by IMF staff, and periodic discussion of developments, prospects, and policy issues in international capital markets.
- *Regional surveillance* over monetary unions has recently intensified—for example, in FY2000, the Board discussed developments in the European Economic and Monetary Union and in the Central African Economic and Monetary Community.[1] Stepped-up discussions between staff and regional authorities serve to supplement country consultations with member countries.

[1]One of the two monetary unions in the CFA franc zone (the other being the West African Economic and Monetary Union).

To achieve more continuous and effective surveillance, the Board supplements its scheduled, systematic monitoring with regular informal sessions—sometimes monthly, or more frequently—on significant developments in selected countries and regions. The Board also meets regularly to discuss world economic and financial market developments. These continuing assessments by the Board inform and guide the work of IMF staff on member countries and are communicated to national authorities by Executive Directors.

In all these ways, the IMF seeks to signal dangers on the horizon and anticipate the need for policy action among its members.

The critical importance of effective and timely IMF surveillance has crystallized in recent years, owing to the rapid growth of private capital markets, increased economic and financial integration, higher risks of domestic policy errors spilling over to other countries, and the implications of current account convertibility and market-oriented reforms in most member countries.

Effective IMF surveillance increasingly depends on the following:

- *Provision of Information.* The IMF encourages countries to introduce greater transparency and fuller disclosure of timely, reliable, and comprehensive data. Surveillance activities have thus paid more attention to the gaps or deficiencies in data that could hamper analysis and have emphasized the importance of candid information on the quality of the data available.
- *Continuity of Surveillance.* The IMF has supplemented annual consultations with interim staff visits to member countries, and with frequent, informal Board meetings to review major developments in selected member countries.
- *Focus of Surveillance.* Surveillance at the country level focuses on the core areas of surveillance over exchange rate, macroeconomic, and related structural policies. It examines whether, in the light of the country's situation, these policies are conducive to achieving reasonable price stability, sustainable external positions, and economic growth. With the rapid integration of international financial markets,

capital account developments, financial sector issues, and the assessment of external vulnerability—in particular for emerging market countries—have been added to the set of core surveillance issues in recent years. The set of core issues is likely to keep evolving given continuing changes in the global economy, although issues related to external sustainability and vulnerability to balance of payments or currency crises will continue to remain central. Surveillance also covers, albeit on a selective basis, such noncore issues as poverty, health and education, the environment, governance, and military spending when these have a direct and sizable influence on macroeconomic developments.

- *Vulnerability Assessment.* Vulnerability analysis in country surveillance has been deepened, particularly for emerging market economies. Such analysis is supported by the collection of more comprehensive and timely data relevant for the assessment of vulnerabilities—including debt- and reserve-related indicators of vulnerability, and capital account development. Related work is under way on structural and institutional elements in foreign exchange reserve management, high-frequency monitoring of external liabilities of domestic banking systems, macroprudential indicators of financial sector vulnerability, and early warning systems.
- *Transparency.* Efforts to increase the transparency of members' policies and IMF policy advice have progressed considerably. About a third of member countries participate in a pilot program for the voluntary release of Article IV staff reports, and the vast majority of members now release Public Information Notices (PINs)[2] after Article IV consultation discussions.
- *Surveillance and Standards.* Adherence to international standards and codes of good practice, which is voluntary, is increasingly seen as important for improving the policy environment and for reducing countries' macroeconomic and financial vulnerability. Progress has been made in developing and strengthening standards, including the Special Data Dissemination Standard (SDDS), the Code of Good Practices on Transparency in Monetary and Financial Policies, and the Basel Core Principles (BCP) of banking. Progress has also been made in preparing assessments of members' observance of standards through the experimental Financial Sector Assessment Program (FSAP) and Reports on the Observance of Standards and Codes (ROSCs). IMF surveillance provides a framework within which to organize and discuss with national authorities the implications of assessments of adherence to standards and codes.

Country Surveillance

The IMF holds consultations with its member countries generally every year to review each member's economic developments and policies. Consultations are not limited to macroeconomic policies, but touch on other policies affecting the macroeconomic performance of a country, including, for example, where relevant those relating to the labor market, governance, and the environment. With the intensified global integration of financial markets, the IMF is also taking into account more explicitly capital account and financial and banking sector issues (see Chapter 4 for discussion of mechanisms for strengthened surveillance of members' financial sectors).

To conduct country surveillance, an IMF staff team visits the country, collects economic and financial information, and discusses with the authorities the economic developments that have occurred since the last such visit, and the monetary, fiscal, and relevant structural policies that the country is pursuing. The Executive Director for the member country usually participates. The IMF staff normally prepares a concluding statement, or memorandum, summarizing the discussions with the member country and leaves this statement with the government. If a country decides to release the staff's concluding statement to the public, the IMF publishes the statement on its website. Back at IMF headquarters, the staff prepares a written report describing the economic situation in the country and the substance of the policy discussions with the government, and evaluating the country's policy stance. The Executive Board then discusses this report. The country is represented at the Board meeting by its Executive Director. The views expressed by the Board members during the meeting are summarized by the Chairman of the Board (the Managing Director), or the Acting Chairman, and a summary text ("summing up") is produced. If the Executive Director representing the member agrees, the summary text is released to the public, together with introductory background material, as a Public Information Notice. In FY2000, the Board conducted 127 Article IV consultations with member countries, 106 of which resulted in the issuance of a PIN (see Table 2.1); PINs also appear on the IMF website.

In addition to Article IV consultations, the Board carries out surveillance in its discussions of ongoing IMF financial arrangements in support of members' economic programs, of financial arrangements intended as precautionary, and through staff-monitored programs.

[2]Public Information Notices (PINs) are issued, at the option of a member country, following the conclusion of its Article IV consultation. Such releases are aimed at strengthening IMF surveillance over the economic policies of members by increasing the transparency of the IMF's assessment of these policies.

Table 2.1
Article IV Consultations Concluded in FY2000

Country	Board Date	PIN Issued
Albania	June 14, 1999	June 22, 1999
Antigua and Barbuda	November 10, 1999	November 22, 1999
Armenia	October 8, 1999	November 5, 1999
Aruba	May 7, 1999	May 26, 1999
Australia	January 28, 2000	February 15, 2000
Austria	June 9, 1999	June 21, 1999
Azerbaijan	June 30, 1999	August 9, 1999
Bahamas, The	August 3, 1999	August 27, 1999
Bangladesh	January 24, 2000	—
Barbados	November 5, 1999	December 10, 1999
Belarus	July 27, 1999	—
Belgium	February 25, 2000	March 3, 2000
Benin	August 23, 1999	—
Bhutan	June 7, 1999	June 17, 1999
Bolivia	February 7, 2000	February 25, 2000
Bosnia and Herzegovina	March 8, 2000	March 16, 2000
Botswana	October 6, 1999	November 17, 1999
Brazil	July 28, 1999	August 23, 1999
Bulgaria	March 31, 2000	April 19, 2000
Burkina Faso	May 21, 1999	June 28, 1999
Burundi	March 15, 2000	April 7, 2000
Canada	February 2, 2000	February 18, 2000
Cape Verde	May 24, 1999	June 14, 1999
China, P.R. of	July 23, 1999	—
Colombia	December 20, 1999	December 29, 1999
Costa Rica	October 6, 1999	October 26, 1999
Côte d'Ivoire	June 15, 1999	July 16, 1999
Croatia	January 7, 2000	January 31, 2000
Czech Republic	July 21, 1999	July 29, 1999
Denmark	August 5, 1999	August 26, 1999
Djibouti	October 18, 1999	—
Dominica	January 10, 2000	February 16, 2000
Dominican Republic	August 6, 1999	August 25, 1999
El Salvador	November 5, 1999	November 15, 1999
Equatorial Guinea	August 23, 1999	August 30, 1999
Eritrea	March 8, 2000	—
Estonia	June 24, 1999	July 1, 1999
Ethiopia	July 27, 1999	August 16, 1999
Finland	October 8, 1999	October 18, 1999
France	October 22, 1999	October 28, 1999
Gambia, The	June 18, 1999	July 12, 1999
Georgia	April 21, 2000	May 18, 2000
Germany	October 20, 1999	November 3, 1999
Ghana	November 19, 1999	December 7, 1999
Greece	October 20, 1999	November 8, 1999
Guatemala	December 16, 1999	December 29, 1999
Guinea	December 21, 1999	March 8, 2000
Guinea-Bissau	September 13, 1999	October 8, 1999
Guyana	May 12, 1999	May 21, 1999
Haiti	September 3, 1999	September 24, 1999
Honduras	December 8, 1999	December 21, 1999
Hong Kong	February 18, 2000	March 6, 2000
Hungary	March 8, 2000	March 17, 2000
Iceland	May 5, 1999	May 14, 1999
Ireland	August 4, 1999	August 20, 1999
Israel	March 23, 2000	April 24, 2000
Italy	June 3, 1999	June 23, 1999
Jamaica	January 10, 2000	January 27, 2000
Japan	August 4, 1999	August 13, 1999
Kazakhstan	July 26, 1999	August 9, 1999
Kenya	December 16, 1999	January 5, 2000
Kiribati	July 16, 1999	September 22, 1999
Korea	December 17, 1999	December 29, 1999
Kuwait	March 13, 2000	April 4, 2000
Lao P.D.R.	November 22, 1999	December 2, 1999
Latvia	July 28, 1999	August 10, 1999
Lebanon	September 8, 1999	—
Lesotho	July 12, 1999	—
Liberia	February 28, 2000	April 11, 2000
Lithuania	July 26, 1999	August 3, 1999
Malaysia	July 7, 1999	September 8, 1999
Maldives	October 27, 1999	—
Malta	June 18, 1999	July 13, 1999
Mauritius	August 3, 1999	August 18, 1999
Mexico	March 17, 2000	March 22, 2000
Moldova	August 6, 1999	August 23, 1999
Mongolia	January 24, 2000	February 17, 2000
Morocco	June 9, 1999	June 25, 1999
Mozambique	June 28, 1999	July 14, 1999
Myanmar	October 13, 1999	—
Nepal	February 18, 2000	March 14, 2000
Netherlands	October 15, 1999	October 25, 1999
Netherlands Antilles	June 7, 1999	July 13, 1999
New Zealand	August 30, 1999	September 15, 1999
Nicaragua	September 15, 1999	September 27, 1999
Nigeria	December 8, 1999	—
Norway	January 28, 2000	February 15, 2000
Oman	June 30, 1999	July 16, 1999
Palau	November 10, 1999	November 24, 1999
Panama	February 16, 2000	February 28, 2000
Papua New Guinea	June 8, 1999	—
Paraguay	March 1, 2000	—
Peru	June 24, 1999	July 6, 1999
Philippines	July 22, 1999	August 10, 1999
Poland	March 15, 2000	March 31, 2000
Portugal	October 8, 1999	October 22, 1999
Qatar	January 24, 2000	—
Russia	July 28, 1999	August 2, 1999
Rwanda	November 19, 1999	December 6, 1999
São Tomé and Príncipe	April 28, 2000	May 16, 2000
Saudi Arabia	October 6, 1999	—
Slovak Republic	July 21, 1999	August 4, 1999
Slovenia	March 3, 2000	March 16, 2000
South Africa	February 14, 2000	March 10, 2000
Spain	June 30, 1999	July 30, 1999
Sri Lanka	October 13, 1999	October 22, 1999
St. Vincent	November 10, 1999	December 10, 1999
Sudan	May 12, 1999	June 3, 1999
Suriname	June 30, 1999	August 19, 1999
Sweden	August 25, 1999	September 2, 1999
Switzerland	February 14, 2000	March 2, 2000
Syrian Arab Republic	July 2, 1999	—
Tajikistan	January 27, 2000	February 14, 2000
Thailand	January 12, 2000	February 10, 2000
Togo	May 21, 1999	July 7, 1999
Trinidad and Tobago	June 9, 1999	June 21, 1999
Tunisia	September 2, 1999	September 17, 1999
Turkey	December 22, 1999	January 3, 2000
Turkmenistan	November 1, 1999	—
Uganda	August 26, 1999	—
United Kingdom	March 1, 2000	March 6, 2000
United States	July 30, 1999	August 5, 1999
Uruguay	July 27, 1999	July 30, 1999
Uzbekistan	January 31, 2000	—
Venezuela	August 6, 1999	—
Vietnam	May 21, 1999	June 8, 1999
Zimbabwe	May 5, 1999	—

- *Precautionary Arrangements.* Member countries agree with the IMF on a Stand-By or Extended Arrangement but do not intend to use the financial resources committed unless circumstances warrant. The country has the right, however, to draw on the resources provided it has met the conditions agreed upon in the arrangement. Such arrangements help members by providing a framework for economic policy and highlighting the IMF's endorsement of its policies, which boosts confidence in them. They also assure the country that IMF financing will be available if needed and if the agreed conditions are met.
- *Staff-Monitored Programs.* The IMF staff monitors a country's economic program and meets regularly with the country's government to discuss the policies undertaken. Staff monitoring does not constitute formal IMF endorsement of the member's policies, nor is financing provided.

Global Surveillance

World Economic Outlook

The Executive Board's conduct of global surveillance is based on staff reports on the World Economic Outlook, which feature a comprehensive analysis of prospects for the world economy, individual countries, and regions, and an examination of topical issues. Although these reports are usually prepared (and published) twice a year, they may be produced more frequently if rapid changes in world economic conditions warrant.

During FY2000, the Board met on two occasions to discuss the World Economic Outlook: in September 1999 and in March 2000. These discussions focused on the strengthening global economic recovery.

At their World Economic Outlook discussion in September 1999, Directors welcomed the strengthening of the global economy during 1999 to date, led by rapid recoveries in most of the crisis-hit Asian economies and, to a lesser extent, in Russia; preliminary indications of a long-awaited turnaround in Japan; a better-than-expected outcome in Brazil; a firming of activity in much of western Europe; and ongoing growth in the U.S. economy. Reduced tension in financial markets was supporting growth in many emerging market economies, a number of which were also helped by increases in some key commodities prices, including oil. Economic activity in the industrial world was being underpinned by generally benign inflation, low interest rates, and improved fiscal positions in most cases. Directors also concurred with the staff's projections of a further pickup in growth in 2000, with expected mild slowdowns in the United States and Canada more than offset by stronger activity in other industrial countries and in most emerging market economies.

While Directors agreed that the risks surrounding these projections appeared reasonably well balanced, several emphasized the uncertainties in the outlook. Of particular concern was the potential impact of a slowdown in the United States. Most Directors agreed that such a slowdown was inevitable and necessary given the rising domestic and external imbalances in the U.S. economy. Several noted, however, that a smooth transition to a somewhat slower and more sustainable growth rate could not be taken for granted. Moreover, they and other Directors questioned whether growth in Japan and Europe would be sufficiently robust to compensate for slower expansion in the United States.

At their March 2000 meeting on the World Economic Outlook, Directors noted with satisfaction the rapid recovery in the world economy in 1999, and the prospect of even stronger growth in 2000. Global economic and financial conditions had improved dramatically during the past year, with growth picking up in almost all regions of the world. Directors noted that the remarkable strength of the U.S. economy and the robust growth apparent in western Europe had provided key support for faster-than-expected recoveries in Asia, Latin America, and other emerging market regions. Determined actions to deepen adjustment and reform efforts by policymakers in the crisis-affected countries, together with support from the international community, were also important. Directors considered that, at least in the near term, staff projections for global growth might well require adjustment on the upside.

At the same time, Directors expressed some concern about the potential for a correction of highly valued stock prices around the world (especially in the technology and information sectors), the mixed signals regarding economic recovery in Japan, the vulnerabilities in emerging market regions, and the possibility that growing global economic and financial imbalances could, if unchecked, disrupt world growth. A sustained pickup in domestic demand in western Europe and Japan, together with some slowing of U.S. growth, would help achieve a more balanced pattern of growth among the major industrial countries. Several Directors cited added uncertainties arising from the increases in world oil prices. In view of these concerns, and notwithstanding the overall improvement in the global economy, policymakers worldwide faced important, but widely varying, challenges. In some countries, macroeconomic policies had to be directed toward providing ongoing support for recovery while, elsewhere, further firming in the macroeconomic stance was probably needed to reduce risks of overheating. More broadly, prospects for sustained growth in almost all developing countries, and in many advanced economies, would be enhanced by more vigorous and wide-ranging structural reforms.

Developments in the Major Currency Areas

In considering developments in the *United States*, Directors saw few signs of slowing economic activity despite several interest rate increases by the U.S. Federal Reserve; indeed, growth accelerated toward the end of 1999. They suggested that the combination of strong investment and productivity growth, subdued wage pressures, and ongoing low inflation—resulting from fundamental changes in the economy—had raised the U.S. potential growth rate. Nevertheless, many Directors were concerned about rising internal and external imbalances in the economy that had accompanied the prolonged expansion, including a record-high current account deficit, strongly negative net private saving, and high stock market valuations. Directors recognized the central role that U.S. demand had played in supporting recovery worldwide, as well as the importance of the strong domestic investment climate and increases in national saving in the evolution of the current account. Many Directors agreed, however, that some further firming in U.S. interest rates would probably be unavoidable, absent clearer signs of a moderation in demand. Such a strategy would improve the prospects for a "soft landing" in the economy, whereas a delayed response could increase the risk of a further buildup of the imbalances and of a subsequent "hard landing." A more balanced pattern of global growth would help reduce the U.S. external deficit.

Some Directors noted, however, that further increases in U.S. interest rates could set back the prospects for sustained recovery in some key emerging market economies, notably among the Latin American countries requiring significant external financing in the coming years. These Directors advocated a cautious approach to further monetary tightening and considered that, alternatively, reliance on further fiscal consolidation to slow domestic demand growth would avoid the risk of spillover effects on world capital markets. They recognized, however, that implementing further fiscal tightening with a budget already in surplus could prove politically difficult. More generally, Directors agreed that further fiscal stimulus, whether through substantial tax cuts or spending increases, would be dangerous under the circumstances. Instead, they argued that the welcome increases in public saving should be assigned largely to reducing debt and meeting the longer-term fiscal requirements associated with an aging population.

Turning to *Japan*, Directors agreed that economic indicators provided unclear signals regarding prospects for recovery. The data on fourth-quarter 1999 GDP, along with trends in household spending, confirmed that real activity had again weakened following the short-lived upturn in the first half of 1999, while the index of leading indicators provided scope for more optimism about the economic outlook.

Most Directors considered that a strong, self-sustaining recovery in Japan led by private domestic demand still appeared some distance away, and that supportive macroeconomic policies should therefore be maintained. Directors agreed that Japan's zero interest policy remained appropriate for monetary policy, with several suggesting a further easing of monetary conditions, especially if the yen were to appreciate again. Some Directors also considered that the introduction of an inflation-targeting framework could help improve the monetary framework. Most Directors believed that fiscal policy also should continue to support recovery, although a number of them suggested that the focus should soon start moving toward fiscal consolidation, given the rapid rise in public debt, pressures on longer-term interest rates, and the need to deal with the approaching fiscal pressure from public pension arrangements. In this connection, several Directors were concerned about the efficacy of successive fiscal packages to put the economy on a self-sustained growth path. Directors underscored the crucial role of structural reforms in boosting confidence and thus enhancing the efficacy of Japanese macroeconomic policies, noting also that with zero interest rates and high levels of public debt, the scope for continued expansionary macroeconomic policies might be reaching its limits. Against this background, Directors were concerned about delays in implementing some important structural reforms, and what they perceived as a weakening of other initiatives. They believed that, while structural adjustment could have a downside impact on some sectors, this would be more than offset over time by the broader-based improvements in confidence and activity that would follow from measures to liberalize domestic markets, strengthen the financial system, and address other structural weaknesses.

Directors welcomed the pickup in confidence and activity in the *euro area*. They noted the improvements in economic performance of the largest economies in the region, but observed that growth remained substantially more dynamic in several of the smaller countries. Fiscal policy had to play a central role in moderating risks of overheating among the fast-growing economies, even though fiscal adjustments might be politically difficult given the emerging budget surpluses in some of these countries. A broad program of fiscal reform was also required in most euro-area economies to reduce current and longer-term expenditure pressures and provide greater scope for tax relief. Directors argued that the recovery under way provided an important opportunity to push ahead with these fiscal reforms, and with complementary structural adjustment—especially in labor and product markets—to help sustain the recovery. While all Directors agreed that monetary policy should continue to focus on maintaining low inflation, some thought that monetary conditions should continue to support recovery in view of the slack still evident in the region. Some other Directors, however, suggested that firming monetary conditions could be expected in the year ahead, given the risk of price pressures—including in asset markets—developing in some countries.

Asset Prices

In considering developments in the advanced countries, Directors gave particular attention to trends in asset prices. They noted that asset price inflation was a general concern, encompassing the United States and much of western Europe. High asset prices posed a formidable challenge for macroeconomic policy in the prevailing environment of low inflation in goods and services markets. On the one hand, given the practical difficulties in determining the equilibrium value of asset prices and the fact that they are traded in relatively efficient markets, Directors felt it was unsuitable for macroeconomic policy to try to target those prices. On the other hand, as rapid and prolonged buildups in asset prices might worsen inflationary pressures and threaten financial stability through their impact on aggregate demand and domestic credit, asset price developments could well be a serious concern for central banks. Directors agreed that, to the extent asset prices provided valuable information about future developments in economic activity and inflation, such information should be taken into account in inflation and monetary targeting frameworks—but that prices of goods and services should remain the policy target. While agreeing that targeting asset prices should not become a permanent policy goal, some Directors considered that there may be instances in which macroeconomic policy should "lean against the wind" and try to stem financial market excesses, even though inflation in goods and service markets remained quiescent—although they recognized the practical difficulties in determining when and to what extent such a policy should be implemented.

In the United States, Directors noted that, despite some uncertainty, many valuation analyses pointed to some degree of overvaluation in key broad indices. In light of evidence that wealth effects stemming from the stock market might contribute to fueling growth of domestic demand well in excess of increases in potential output, Directors felt that the U.S. steps to tighten monetary conditions had been appropriate—and that the need for further tightening would have to be kept under close review.

As for the euro area, Directors agreed that the main challenge for macroeconomic policy arising from asset price movements remained the magnitude of regional divergences, with property prices, in particular, rising far more rapidly in some fast-growing euro-area countries on the periphery than in the region as a whole. While faster growth on the periphery was at least in part justified by regional convergence in incomes associated with economic integration and the introduction of the euro, the potentially significant impact of asset price corrections on financial conditions in some small European countries posed a problem for the conduct of monetary policy.

Prospects for Emerging Markets

Turning to economic developments in *Asia*, Directors welcomed the rapid recovery in the crisis-affected countries and the projections of continued strong growth. Rising exports had played a key role in this recovery, adding to the support from public spending and, more recently, from private domestic demand. Directors agreed that fiscal stimulus should be steadily withdrawn as growth became self-sustaining. Indeed, several Directors suggested that in the countries with recoveries most advanced, macroeconomic policies should focus on reducing risks of overheating and containing the growth in public debt. Directors urged the crisis-affected countries to maintain the momentum of structural reforms—especially in the financial and corporate sectors and in the institutional and prudential framework—and cautioned that the recoveries could prove short-lived if these reform efforts were relaxed. And to maintain the prevailing robust growth rates in China and India, further structural reforms were needed.

In *Latin America* as a whole, the downturn in 1999 had proved to be milder than expected because of the sustained pursuit of prudent macroeconomic and structural policies, although several countries experienced severe recessions. Directors agreed with staff projections that a broader-based recovery should emerge in 2000 and continue into 2001. Several elements were contributing to the improvement in regional economic conditions; these included strong growth in the United States, rising commodity prices, and declining inflation and interest rates. Nevertheless, several Directors cited remaining vulnerabilities—especially the high external financing needs of the largest countries and persistent weaknesses in some smaller economies. Directors urged these countries to continue to take steps to reduce risks and maintain the confidence of international investors. Key measures would include reducing fiscal deficits, where further progress was expected in 2000; implementing monetary policy frameworks designed to achieve or maintain low inflation; and, to support these objectives, enacting further structural and institutional reforms, including greater trade liberalization. Directors also emphasized the importance of increasing public and private domestic saving to help reduce reliance on foreign financing.

Russia's economy experienced a rapid turnaround in 1999, but prospects for a sustained recovery remained uncertain. The reductions in Russia's fiscal and external imbalances in 1999 largely resulted from higher oil prices, with import compression and substitution also contributing to growth. Directors agreed that a firm and wide-ranging reform effort was needed to improve the investment climate and medium-term growth prospects. Priority had to be given to strengthening the institutions and processes that underpinned market economies—including the legal framework, competition policy, transparency, and governance. Such reforms would reinforce efforts to tackle key structural weaknesses in the economy, particularly in the tax regime, in the banking system, and in many parts of the corporate sector.

Economic conditions were strong among the *central and eastern European transition economies* seeking accession to the European Union (EU). Growth was expected to pick up in all these countries in 2000, helped in most cases by growing exports to western Europe and stronger investor confidence. But further progress with structural adjustment would be needed for sustained improvements in economic prospects and to prepare for eventual EU membership. In some countries, more rapid progress with fiscal consolidation was also desirable as growth strengthened, to reduce pressures on inflation and interest rates.

For many countries in the *Middle East* and several in *Africa*, the rise in international oil prices had contributed to improvements in fiscal positions, current account balances, and other dimensions of economic performance. Increases in some nonoil commodity prices (such as metals) also supported external earnings growth in several African countries, although low prices for other products (such as tea, coffee, and cotton), combined with unfavorable weather (particularly in Mozambique), had slowed growth prospects elsewhere. In this regard, Directors agreed on the importance of continued economic diversification to reduce these countries' vulnerability to swings in the prices and volumes of commodity exports. They were encouraged that substantial progress had been made in these regions, including among many of the smaller countries in Africa, in laying the groundwork for broader-based growth. In view of the remaining economic and social challenges, these reform efforts had to be expanded to make substantial inroads on poverty and provide a better environment for economic development.

Strengthening Growth in the Poorest Countries

At their March 2000 discussion of the World Economic Outlook, Directors also reiterated their commitment to policies aimed at raising the living standards of the least well-off. Although economic performance in most developing countries had on average been unsatisfactory over the past 30 years, Directors were generally encouraged by gains in real per capita income in many poor countries in Asia—notably in China and India—and, more recently, in several countries in Africa, where programs directed at achieving reasonable price stability, prudent fiscal balances, and sustainable exchange rate regimes had been successfully implemented.

Directors emphasized the critical relevance for economic development of market-friendly institutions and an environment in which individuals and businesses could save and invest, and expect to enjoy the future benefits of their endeavors. Political instability, war, and the absence of the rule of law were critical impediments to such a setting and to development more generally. Directors called for continued progress in removing distortions in domestic markets by eliminating price controls and subsidies, liberalizing external trade, and combating corruption through effective and transparent government. Many developing countries also had to establish sounder financial markets to allocate efficiently savings to profitable investments. Many of these countries, especially the poorest, would also benefit from giving higher priority to health and education programs to help break the poverty cycle by increasing productivity. Directors cautioned, however, that there was no unique formula for starting and sustaining economic growth; each country would have to decide how best to provide the necessary fundamentals for economic prosperity through the combined efforts of government and representatives of civil society. In this respect, Directors emphasized that local "ownership" of the reform process was crucial to its success.

Unsustainable levels of external debt are a critical impediment to economic growth and poverty alleviation, especially in some of the poorest countries. Without significant debt relief, incentives for government reform and private investment are dulled, and countries can be caught in a vicious debt and poverty trap. Directors emphasized the opportunity provided by the recently enhanced Initiative for Heavily Indebted Poor Countries (HIPCs), under which debt would be lowered to sustainable levels through concerted efforts by the international community (see Chapter 5).

Directors recognized the important contributions to debt relief being made by the membership, and in particular the advanced economies, both directly and through international organizations. Several Directors called for a reversal in the downward trend in official development assistance, and cautioned that debt relief associated with the HIPC Initiative should not be seen as a substitute for future development assistance. These Directors drew attention to the more effective use of development assistance, for example, through strengthened incentives for reform in the recipient countries and through better targeting of aid to address these countries' needs. Many Directors also called on advanced economies to enhance the effectiveness of the HIPC Initiative by reforming their trade policies, especially in such areas as agricultural products and textiles, where current policies had particularly damaging effects on trade opportunities and growth prospects for developing countries.

International Capital Markets

At the end of July 1999, Executive Directors conducted their annual review of developments in, and prospects for, international capital markets. Directors also discussed the lessons learned from the 1998 global financial market turbulence and the emerging market crises. Although financial market conditions had improved in the past year, Directors underscored some risks and uncertainties in the outlook. They differed about the lessons of the turbulence of 1997–98 and the initiatives being considered to address shortcomings in the global financial architecture. Although Board members broadly supported efforts to enhance market discipline, prudential supervision, and regulation, they achieved less consensus on the specific measures to be taken and whether the problem of ensuring appropriate incentives was being adequately addressed. The risks of globalization and how to address them, Directors agreed, should remain at the center of the IMF's research activities.

Issues and Risks

As of July 1999, the Board noted that the operation of international capital markets was considerably more favorable than in 1998, but cited several remaining risks and uncertainties, and sentiment was still unusually fragile. Even though financial market activity had in many respects returned to normal in the advanced countries, external financing remained unusually tight for many emerging markets. Spreads on these countries' external debt instruments remained in several cases very high, and internationally active banks continued retreating from the emerging markets. As a result, volatility continued to be high and significant vulnerabilities remained.

The continued strong macroeconomic performance of the U.S. economy, signs of a broader pickup in continental Europe, and Japan's progress in addressing its financial sector and macroeconomic problems augured well. The main risks related to the sustainability of the current combination of exceptionally high U.S. equity prices and U.S. dollar strength and the possibility that either a spontaneous reassessment or further moves by the Federal Reserve to tighten monetary policy could trigger a significant correction in equity prices. While many Board members were confident that the advanced countries could withstand a modest U.S. equity correction, a number of Directors felt uncertainty about the extent and distribution of leverage in advanced financial systems that risked a more severe fallout—one with adverse implications for the emerging markets, especially countries whose markets were already weak.

While welcoming the rally in emerging market asset prices since the start of 1999, a number of Directors pointed to the risks resulting from continued tight external financing conditions and the ongoing pullback of international investors. This reduced access to capital markets had put severe pressures on several emerging market banking systems; this, in turn, contributed to cutbacks in local funding for domestic corporate securities, making debt service more difficult. A number of Directors noted that a vicious cycle had been evident since Russia's August 1998 unilateral debt restructuring, as pullbacks of international investors from emerging markets contributed to low liquidity and relatively high volatility, which in turn discouraged participation by other investors. While expressing some confidence about the near-term outlook, some Directors remained concerned about the degree of effective financial and corporate restructuring in several of the Asian-crisis countries.

Turbulence in Mature Markets and Highly Leveraged Institutions and Activities

Executive Directors discussed the systemic and other issues related to highly leveraged institutions and activities in 1998 and the reforms being considered to contain excessive leverage. The buildup of financial risks that preceded the 1998 turbulence had raised important questions about the current lines of defense against systemic risk—especially weaknesses in market discipline, prudential supervision and regulation, and macroprudential surveillance. Directors differed somewhat, however, on the importance of different lines of defense and what could be done to strengthen them. While a few Directors argued for direct controls over hedge funds, most saw major difficulties in seeking to regulate these institutions directly; they supported ongoing efforts—including by the Basel Committee on Banking Supervision—to influence hedge funds indirectly by significantly strengthening oversight by counterparty banks and through improved market discipline.

Many Directors believed insufficient market discipline by creditors, counterparties, and shareholders was a key element allowing the buildup in vulnerabilities and leverage that preceded the 1998 turbulence. These Directors believed that the lack of adequate market discipline may have reflected other, more fundamental, deficiencies that pointed to the need for improving financial disclosure and transparency and better aligning internal, market, and regulatory incentive structures. In this connection, several Directors saw a key challenge for private financial institutions and for public policy in maintaining the efficiency-enhancing aspects of modern finance while reducing the system's tendency toward financial excesses and virulent market dynamics. Several Directors noted that more proactive prudential supervision and market surveillance could help detect and avoid a buildup in vulnerabilities. They suggested that the presence of the public safety net for financial institutions created countervailing incentives that may work against market discipline. Some Directors felt that the staff's analysis could have given further consideration to the issue of moral hazard and to the analysis of options to reduce it; some others, however, were not convinced that safety nets had given rise to moral hazard or had been excessive. Directors agreed that the ability to supervise and monitor modern financial systems would remain critical.

Directors unanimously welcomed the reform proposals on improved transparency and disclosure by both private sector groups and officials. Such proposals would likely require all financial institutions—including highly leveraged institutions—to provide more information. An important next step was to agree on a core set of data on firms' risk exposures, and on the frequency with which it should be disclosed to market investors, counterparties, and, where relevant, supervisors.

Many Directors observed that greater disclosure and improved transparency may not in themselves be sufficient to improve credit and counterparty risk assessment; rather, internal incentive structures were required to encourage firms to obtain information and act upon it. Several Directors felt that current reform proposals did not generally address the need for such changes in incentives. In this connection, a number of Directors pointed to the proposed revisions to the Basel Capital Accord as a first step toward correcting possible regulatory distortions.

Several Directors expressed concern that the ongoing rapid pace of financial liberalization, innovation, and globalization was contributing to changes in the nature and sources of systemic risk that were not fully understood. They thus suggested the need for additional consideration of how regulators who supervise internationally active financial institutions could stay abreast in an increasingly dynamic and interrelated global economy.

As to market dynamics, Board members noted that there was no unambiguous answer to the question of optimal design of risk control mechanisms that would strike a balance between the slow adjustment to shocks that has traditionally characterized relationship banking and the rapid adjustment that takes place in modern capital markets. Some Directors felt the key to avoiding the turbulence seen in the fall of 1998 was strengthening risk management and control procedures to avoid a buildup in excessive leverage. Others suggested that the mechanical and rigid use of risk management practices—together with frequent marking to market—might unnecessarily worsen financial market strains once a crisis had erupted, because of the speed with which they call for portfolio rebalancing and deleveraging.

Regarding macroprudential oversight, several Directors cited the need to better understand and monitor the complex nexus between monetary and financial policies—in particular, the role that abundant liquidity conditions might have played in the 1998 buildup of leverage. Several Directors called for greater attention to how the growth of global liquidity might be monitored and, more broadly, to its possible role in foreshadowing a buildup of leverage and imbalances—although a few Directors underscored the difficulty in defining and measuring such a concept. A number of Directors also wondered whether national authorities were adequately exploiting the synergies between macroprudential surveillance and the supervision of individual financial institutions. Several Directors suggested that more proactive and countercyclical prudential supervision and market surveillance could play a key role in helping avoid excessive leverage. Some Directors were concerned, however, noting the difficulty in appropriately timing any changes in capital adequacy ratios relative to the business cycle, as well as to divergences in business cycles around the world.

A number of Directors observed that, while improvements in the lines of defense (private sector risk management, banking supervision, and market surveillance) should help address the systemic issues associated with the highly leveraged institutions, they would not address concerns about the impact of such institutions on small and medium-sized markets. Several Directors therefore suggested that further work was needed to better understand the conditions under which the activities of highly leveraged institutions could destabilize small and medium-sized markets.

"Nonstandard" Policy Responses

A number of national authorities had resorted to relatively "nonstandard" responses to deal with extraordinary external pressures, including official intervention in bond and equity markets and the imposition or intensification of capital and foreign exchange controls. A number of Directors defended using such tools in the face of pressures seen as out of proportion to underlying fundamentals and given the aggressive tactics adopted by some investors. These Directors considered that such measures should not be ruled out in exceptional situations, to complement other policy adjustments. They recognized, however, that over the longer term, nonstandard official responses could negatively affect the risk-reward profile of various financial market investments. Other Directors suggested that the evidence on the efficacy and desirability of these interventions was at best inconclusive.

A number of Directors considered the capital controls that Malaysia adopted useful insurance against future speculative activity and believed that, in that sense, the controls had served their purpose. These Directors also argued that Malaysia had effectively used the protection provided by controls to continue restructuring its banking and corporate sectors. Some other Directors, however, noted that the use of controls might prove damaging to Malaysia's longer-term interests and could deter future capital inflows. They thus urged other countries to use caution in adopting similar measures.

Credit Rating Agencies

The major credit rating agencies had become important providers of independent assessments of sovereign and private credit risks, Directors noted. The credit ratings issued by these agencies could have a strong impact on both the borrowers' cost of funding and the willingness of major institutional investors to hold certain types of securities. Also, since the Basel Committee on Banking Supervision had proposed to make credit ratings a key determinant of the risk weights attached to bank exposures, many Directors believed that the influence of the credit rating agencies was likely to expand.

In view of the potential impact of rating changes on capital flows to emerging markets, a number of Directors were concerned about the performance of the major rating agencies before and during the recent emerging market crises. These agencies had introduced a procyclical element into global capital flows, contributing to the excessive capital flows into emerging markets, as well as to their abrupt reversals. Moreover, some Directors observed that the rating agencies failed either to give a warning of the crisis or accurately reflect economic fundamentals. Some Directors noted, however, that the lessons drawn by the credit rating agencies from their experiences were similar to those reached by the IMF staff for improving surveillance.

Several Directors expressed reservations about reliance on credit ratings, especially for sovereigns, in determining risk weights for bank lending. They noted that there was no clear track record regarding the accuracy of sovereign ratings and saw a clear need for the rating agencies to improve significantly the quality of their analysis—including by taking into account increased international interdependence and greater market complexities.

Regional Surveillance

Central African Economic and Monetary Community

At a February 2000 meeting, Executive Directors discussed recent developments and regional policy issues in the Central African Economic and Monetary Community (CEMAC). They commended the efforts of CEMAC member countries (Cameroon, the Central African Republic, Chad, the Republic of Congo, Equitorial Guinea, and Gabon) to strengthen economic integration and to pave the way toward the creation of a single domestic market. The growing range of economic policies formulated and implemented at the regional level meant that a policy dialogue by the IMF with regional institutions could usefully complement bilateral surveillance, and should facilitate the monitoring of IMF-supported programs in the CEMAC area.

Directors noted that, in contrast to the impressive economic improvements of the community members after the devaluation of the CFA franc in early 1994, the economic and financial situation of the region deteriorated sharply in 1998 and in the first part of 1999. The substantial decline in the terms of trade had been aggravated by a loss of fiscal control in one of the major countries and the accommodating monetary policy of the regional central bank, as well as domestic conflicts in two other countries.

In this context, Directors welcomed the adoption by the CEMAC, in September 1999, of a regional policy package prepared by the central bank to promote macroeconomic policy convergence, fiscal discipline, and economic cooperation. This package, together with the recovery in the international price of oil, an improved security situation in the region, and the adjustment under way in member countries, should help improve the economic outlook of the region in 2000 and beyond. Directors urged the member governments and the regional institutions to seize the opportunity of CEMAC's creation to establish a solid framework for close coordination of fiscal and structural policies, so as to provide firm support to the common pegged exchange rate regime.

Directors noted that the exchange rate realignment of January 1994 had helped improve the competitive position of the region and led to a strong increase in the growth of nonoil output and of exports. While the available indicators suggested that the competitive position of the CEMAC remained broadly adequate, Directors stressed that those indicators should be monitored closely, in view of the demonstrated high vulnerability of the external current account. Sound macroeconomic policies and decisive progress in structural reforms—including improved governance—were essential in all member countries to boost productivity growth, maintain the region's competitiveness, and promote economic diversification.

The envisaged system of mutual regional surveillance of member countries' fiscal policies will contribute to the financial stability of the CEMAC. Firm fiscal discipline should remain a priority for all the member countries. Directors saw merit in the proposal to introduce oil stabilization funds to gear central bank lending more appropriately to broader macroeconomic objectives. They welcomed the intention to phase out the current mechanism that grants automatic credit to the government (subject to ceilings) in the context of the development of a regional government securities market as a vehicle for nonbank financing of the treasury's domestic borrowing requirements.

Board members cited the progress made by the COBAC, the regional banking commission, in conducting bank supervision in the region but stressed the importance of completing promptly the bank restructuring programs in the two remaining countries of the region and achieving the full privatization of banks. They also encouraged the authorities to strengthen further their prudential arrangements along the lines of the core principles for effective banking supervision recommended by the Basel Committee, and to expand COBAC's technical capacity.

The quality of financial intermediation in the region would benefit from a better functioning of the regional interbank market, the introduction of a single zonewide licensing agreement for banks, and more competition among financial institutions. Directors urged the CEMAC to move quickly to establish a functioning regional financial market.

The Board welcomed the major trade policy reforms initiated in 1994 by the CEMAC countries, particularly the adoption of a common external tariff and the liberalization of intraregional trade. Directors encouraged the authorities to further liberalize trade by simplifying the tariff structure, reducing average tariff rates, and eliminating remaining intraregional barriers.

Any strategy for regional integration and economic growth would have to include the establishment of a common legal and regulatory environment conducive to development of the private sector and investment, and efficient resource allocation, Directors emphasized. They underscored the need to implement the recent initiatives in the areas of business laws, investment charter, and competition policy. Directors also stressed the need to enhance the production of timely and reliable regional statistics to strengthen regional surveillance, and encouraged the authorities to seek technical assistance in this area.

Some Directors hoped that eligible CEMAC countries would obtain debt relief under the enhanced Initiative for Heavily Indebted Poor Countries.

Monetary and Exchange Rate Policy in the Euro Area

In March 2000, discussing the monetary and exchange rate policies of the euro area, Directors noted that the near-term outlook had brightened with the deepening and broadening of the recovery, but that the key policy challenge remained to create conditions for sustained rapid growth. To this end, Directors urged a monetary strategy firmly focused on price stability, national fiscal policies aimed at promoting public saving and favorable supply-side responses, and intensification of structural reform efforts.

Directors commended the European Central Bank (ECB) for a policy stance that had been supportive of the euro-area economy throughout 1999, without endangering medium-term price stability. While acknowledging the need for a gradual return to a more neutral position as the cycle matured, many Directors thought this supportive orientation should be maintained in 2000. In particular, they saw no pressing need for an increase in interest rates in the near future, in light of the remaining slack in labor and product markets, the gradual pace at which it had been taken up, the prevailing moderation in wage claims, and downward price pressures stemming from deregulation in key sectors. These Directors also argued that monetary policy should be mindful of the need to probe cautiously the margins of untapped resources, taking into account some signs of an improved inflation-output trade-off in the euro area, as had occurred in the United States. Some Directors, on the other hand, saw risks to price stability on the upside—owing to, among other things, generous liquidity conditions in 1999 and rising oil and commodity prices; they felt it remained necessary to react quickly to threats of inflation. Directors generally agreed that the steadfast pursuit of structural reforms offered the best chance for noninflationary growth in the euro area and maintenance of market confidence, while allowing monetary policy to focus on continued price stability.

The ECB had made important strides in providing information to the public on its strategy and its assessment of economic conditions, but Directors felt that greater transparency could make monetary management more effective. They welcomed the ECB's intention to publish macroeconomic projections—including projections of inflation—which, without implying a departure from the accepted monetary policy strategy, would promote a better understanding of how the ECB forms its view of the inflation outlook and enhance the credibility and predictability of policy.

Against the backdrop of stronger activity in the euro area and of the current and capital account imbalances among the major currency zones, Directors agreed that the prevailing weakness of the euro was undesirable. Lagged exchange rate responses of trade flows, they emphasized, could worsen existing patterns of trade imbalances and heighten the risks of abrupt exchange rate reversals and of protectionist pressures.

Nonetheless, Directors observed, a monetary policy reaction was appropriate only in the face of a threat to medium-term price stability. To the extent that a weak euro reflected the relative cyclical positions of the United States and the euro area, as well as markets' concerns about the structural rigidities that could undermine the sustainability of the expansion, a monetary response in the absence of clear risks to price stability would do little to strengthen the currency. In the Board's view, a recovery of the euro would come from markets becoming better attuned to the fundamental strength of the euro-area economy, greater cyclical convergence between the United States and the euro area, and greater progress on structural and fiscal reform in many euro-area countries.

Directors acknowledged the progress toward fiscal sustainability in the run-up to Stage 3 of the European Economic and Monetary Union, which occurred on January 1, 1999. Most Directors pointed out, however, that the adjustment effort had slackened in 1998–99 and needed to be reinvigorated. Such improvements were necessary to create the scope for discretionary fiscal policy, which is particularly important in the framework of a uniform monetary policy. These Directors indicated that, although the updated stability programs for 2002–03 were, in some cases, more ambitious than the previous ones in proposing tax cuts, the programs did not go far enough in providing the area as a whole with the necessary improvements in structural primary balances and reductions in tax burdens.

In the improved cyclical setting, Directors emphasized that manageable targets for 2003 should include the achievement of fiscal balances or surpluses in all euro-area countries, and reductions in the euro-area revenue-to-GDP ratio. They also stressed the need to ensure durable improvements in the fiscal positions of most countries by further reforming health care and modifying pension systems to guarantee lasting reductions in public spending. Such spending restraint was essential for allowing tax rates to be reduced significantly from current levels, while maintaining fiscal prudence and achieving the approximate fiscal balances or surpluses envisaged under the Stability and Growth Pact.[3]

While the euro-area countries had made considerable progress in reforming the product, services, and capital markets, the euro-area reform strategy was still too limited in scope. To continue cutting area-wide unemployment, Directors urged the governments to accelerate labor market reform.

In the labor market, most Directors felt that many countries needed to reassess the eligibility conditions for unemployment compensation and welfare assistance, promote a less rigid and more differentiated wage structure, and broaden the scope of the most effective vocational and apprenticeship programs. In the product and service markets, Directors welcomed the ongoing progress in privatization and deregulation but called for stepped-up efforts to lock in the beneficial effects of competition. They cited ample scope for further opening up access to still-sheltered sectors, as well as for removing administrative barriers to business formation, and to job creation in the service sectors and commercial activities.

Finally, some Directors noted that trade liberalization offered important benefits not only for augmenting world growth potential, but for the euro countries themselves, in terms of the implications for domestic prices, resource allocation, and the external position. They encouraged the euro countries to allow increased market access to exports from low- and middle-income countries, noting that trade protection, especially in agriculture, remained high.

[3]The Stability and Growth Pact, approved by the European Council in June 1997, sought to secure budgetary discipline in member states during the final stage of European Economic and Monetary Union.

CHAPTER 3

Evaluations of IMF Surveillance and Research Activities

Recent world economic developments led to broad international agreement in 1998 on the main elements of a strengthened international monetary and financial system and on the IMF's key role in the effort to strengthen the system (see Chapter 4). And since IMF surveillance is the central mechanism though which the results of much of the work on strengthening the global financial architecture will come together, efforts to enhance its effectiveness and relevance intensified in FY2000.

As part of these efforts, an external evaluation of surveillance, commissioned by the Executive Board in June 1998, was undertaken and subsequently discussed by the Board in September 1999. The external evaluators were asked to assess the effectiveness of IMF oversight and offer recommendations for improvements consistent with the IMF's mandate. The external evaluation was an important input to the Board's March 2000 biennial review of surveillance, whose purpose was to ensure that surveillance remains relevant to evolving global economic conditions.

The Executive Board also commissioned a review by external evaluators of the contribution of IMF research to achieving the goals of the IMF. Soon after the report's completion and its discussion by the Board, the IMF took steps in response to the evaluators' recommendations. In addition, the Board commissioned a study by outside experts to review the current formula for calculating quota shares of IMF member countries (see Chapter 6).

Toward the end of the financial year, the Board approved the establishment of an independent evaluation office to complement the IMF's ongoing internal audit and self-evaluation activities. This decision was a response to growing calls for greater transparency and accountability of the IMF itself. The Board requested that the evaluation office be made operational before the fall 2000 Annual Meetings.

External Evaluation of IMF Surveillance

The panel of evaluators for the Report of External Evaluators on IMF Surveillance *consisted of John Crow, formerly Governor of the Bank of Canada, who served as Chairman; Ricardo Arriazu, Economic and Financial Consultant, Buenos Aires, and formerly Alternate Executive Director at the IMF; and Niels Thygesen, Danske Bank Professor of International Economics at the University of Copenhagen. Jonathan Portes, formerly of the United Kingdom Treasury, served as secretary to the team.*

The main recommendation of the external evaluators was that bilateral surveillance should focus as much as possible on the core issues of exchange rate policy and directly associated macroeconomic policies (including financial sector and capital account issues). Furthermore, the international implications of such policies should be given significantly greater attention. In regard to the latter, the evaluators identified three distinct areas where the IMF has a clear comparative, and as yet underexploited, advantage:

- in relating a country's position to the international economic situation and prospects;
- in analyzing the experiences of other countries confronting similar policy problems; and
- in discussing the likelihood of, and possible responses to, significant negative external shocks, whether originating from direct effects through trade flows or interest rates or from more general contagion.

To bring the IMF's expertise to bear on surveillance more effectively in this way will require some reallocation of resources. Accordingly, among the recommendations of the external evaluators for IMF surveillance were the following:

- Curtail the expansion of the scope of surveillance into nonfinancial structural areas, with consequent savings in resources. Analysis outside the areas of core expertise—exchange rate policies, the associated macroeconomic framework, and financial sector and capital account issues—should only be undertaken if directly relevant to macroeconomic performance.

- Give more emphasis to more continuous surveillance, through shorter, leaner, more focused visits, and more regular long-distance communication and exchange.
- Reduce the resources devoted to surveillance of small and medium-sized industrial countries (and, more generally, participants in the euro area). This would essentially be achieved through the prioritization described above, and through longer intervals between Article IV country consultations, in part replaced by more continuous surveillance.
- Give surveillance of the largest industrial countries—the United States, Japan, and the euro area—added focus on the international aspects of policy.
- Devote substantially more attention in surveillance to identifying vulnerabilities.
- Publish quarterly World Economic Outlook forecasts.

At their September 1999 meeting to discuss the external evaluation, Directors expressed appreciation for the careful work and considered judgments of the panel of evaluators. They welcomed the comprehensive evaluation of IMF surveillance and the evaluators' high regard for the *World Economic Outlook* and *International Capital Markets* reports. They noted the value that member countries placed on IMF surveillance of their economies. In this regard, the evaluators' observation that IMF surveillance should be viewed as an input to a country's policies underscored that the IMF's analysis had to be first rate and stay focused on issues of serious and immediate concern.

Directors underlined the substantial common ground between the evaluators' report and the IMF's own internal evaluations. They noted, in particular, the need to revisit the definition of the IMF's core areas; give more attention to international aspects of a country's macroeconomic policies and spillover issues; focus more on cross-country comparisons and regional developments; devote substantially more attention to vulnerability analysis; and give more emphasis to financial sector and capital account issues.

The focus of surveillance remained a challenge for the IMF in light of the forces driving an expanding agenda. Core surveillance issues had changed over time, Directors acknowledged, moving from a narrow focus on exchange rate policy and the balance of payments and attendant monetary and fiscal policies, to greater emphasis on capital account, financial sector, and nonfinancial structural issues.

Most Directors thought that a key recommendation of the external evaluation—that surveillance should focus only on the core areas of exchange rate policy and directly associated macroeconomic policies—ran counter to the demands of IMF members and the international community for more emphasis on the interactions among macroeconomic, structural, and social policies. They saw the broader focus of surveillance as appropriate in light of global developments and the need for surveillance to remain relevant to the policy challenges faced by IMF members. Nevertheless, a number of these Directors saw scope for sharpening the focus of surveillance case by case: coverage of issues could differ depending on the circumstances of a particular country, but IMF staff should present a clear case for considering "noncore" issues as relevant to the core concerns of the IMF. Other Directors, however, felt that IMF surveillance had moved inappropriately beyond the original core issues, including into areas such as labor markets, pension reform, social policy, and governance. Most Directors nonetheless agreed that the IMF should, as far as possible, use outside expertise in areas beyond its conventional mandate and when it has little in-house expertise. In this regard, Directors stressed the importance of close cooperation with other international institutions, taking due account of comparative advantage and expertise and avoiding duplication of effort.

Directors strongly supported giving more explicit attention to the international and regional aspects of surveillance—another recommendation of the external evaluators. They saw the need for increased cross-country comparisons, in which the IMF had a unique advantage. They also endorsed the evaluators' recommendation to heighten the interaction between country and global surveillance, and looked forward to a better integration of the International Capital Markets and World Economic Outlook analyses with country surveillance. At the same time, Directors agreed that Article IV country consultations should stay focused on a country's own policies.

Directors strongly supported more explicit attention to vulnerability issues in IMF surveillance, as recommended by the evaluators; this would entail enhanced analysis of the capital account, the financial sector, and the treatment of financial contagion. Directors agreed that, with increased financial and trade flows between countries, IMF surveillance at the country level should pay more attention to the sequencing and pace of moves toward capital account liberalization. The stepped-up level of IMF staff work on financial sector issues in collaboration with the World Bank, the Bank for International Settlements, and other international organizations was being reflected in more comprehensive coverage of vulnerabilities in this area. Directors agreed that surveillance should look more closely at policy interdependence and the risks of contagion, noting that global surveillance had an important role to play in identifying potential spillover effects.

On the evaluators' recommendations for surveillance procedures, Directors observed that one of the IMF's strengths as an institution derived from its uniform treatment of countries. While many saw annual consultations as a cornerstone for ensuring the continuity of IMF surveillance, the need for some procedural flexibility was recognized, given the institution's strained resources. Directors thus agreed that, for most industrial economies, in light of their systemic impact, annual consultations remained appropriate. Most Directors thought that surveillance of these countries should continue to focus on their domestic policies while also covering the international implications of those policies.

To ensure more continuous and resource-efficient surveillance, some Directors suggested shorter annual consultation visits, in some cases, supplemented with interim electronic communications. Other Directors, however, felt this should not diminish the attention paid by national authorities to the formal consultation discussion.

Most Directors felt that annual consultations with smaller industrial countries—particularly members of the euro area—provided a number of critical advantages that could be lost with less frequent consultations. Several Directors pointed out that, in the case of the euro-area countries, fiscal policy remained a national prerogative and many other policies continued to be conducted at the national level; it would thus be impossible to cover these areas adequately in consultations with the European Central Bank or European Union institutions. While several Directors saw possible scope to reduce the size and duration of missions to these countries as European integration proceeded, others were not in favor of diminished attention to the euro area.

Directors noted that the transparency of IMF surveillance had increased considerably in recent years and that a pilot project for the voluntary release of Article IV consultation staff reports had been launched. They agreed that the review of the pilot project in the summer of 2000 would inform the development of a general publication policy for Article IV staff reports.

Looking ahead, Directors stressed that strengthening IMF surveillance was an ongoing process, and that the evaluators' report provided an informed outside perspective that would be an important input in deliberations on enhancing surveillance. Directors looked forward to further consideration of many of the issues addressed in the report. The key issues to return to could include the focus of surveillance; the increased attention to international, regional, and cross-country issues; vulnerability analysis and early warning systems; and the coverage of financial sector and capital account issues.

Biennial Review of Surveillance

At their March 2000 biennial review of surveillance, Executive Directors looked at the experience with surveillance since the 1997 biennial review and reflected further on the conclusions of the external evaluation of surveillance. Directors observed that a complex agenda of initiatives designed to strengthen the international financial architecture had been put in place in response to the crises in emerging market countries since the mid-1990s (see Chapter 4). These initiatives would have profound consequences for IMF surveillance. Directors noted that the results of pilot projects under way in several areas would also have to be carefully assessed, as they would influence the future course of the IMF's surveillance work.

Directors observed that the modalities for bringing the outcomes of the various initiatives to strengthen the international architecture into surveillance remained to be identified; also to be addressed was how to draw on the expertise and resources of other institutions. Many external forums had made proposals for the conduct and coverage of IMF surveillance; these would need to be taken into account by the Board in providing guidance to IMF staff, and to ensure that surveillance remained focused on its main objectives.

Although the work on new initiatives was under way, Directors were encouraged that surveillance was being strengthened in important areas. These included the treatment of exchange rate policies, the increasing coverage of financial sector and capital account developments, and the assessment of external vulnerability—particularly for emerging market countries. The ongoing strengthening of surveillance had drawn on, and benefited from, the recommendations made by the external evaluation of IMF surveillance.

Directors welcomed the analysis in the staff paper of the coverage of *core* and *noncore issues* in Article IV staff reports—an area of much focus in the external evaluation of IMF surveillance. Most Directors felt that this analysis indicated that the coverage of core issues (notably, exchange rate policies and their consistency with macroeconomic policies, financial sector issues, the balance of payments and capital account flows and stocks, and related cross-country themes) in Article IV staff reports had been broadly appropriate. In the period under review, the staff had been selective in covering noncore issues, applying macroeconomic relevance tests—that is, covering noncore issues in most cases only when these had a direct and sizable influence on macroeconomic developments. Directors believed that macroeconomic relevance remained a pertinent test for including issues in Article IV staff reports. Directors observed that, in parallel with the rapid integration of international financial markets, capital account and financial sector issues had been added to the set of core issues in recent years; and given the continuing changes in the global economy, the set of issues considered core was likely to keep evolving.

While some Directors preferred drawing a clearer distinction between core and noncore issues, many others saw a hierarchy of concerns: all issues related to external sustainability and vulnerability to balance of payments or currency crises would continue to be at the apex of this hierarchy. These Directors also recognized that the hierarchy of issues could vary over time and from country to country, with greater scope for overlap with other international agencies on issues further down the hierarchy. It was noted that the IMF did not have the breadth of expertise and experience necessary to cover many areas that, while outside traditional core areas, might at times be critical to a country's macroeconomic stability. On such issues, staff needed to draw on the expertise of other institutions. Surveillance teams thus had to be aware of the work being done on a country in other institutions, and could feed the results into the surveillance process, whenever they were relevant to the IMF's core concerns.

On *exchange rates*, most Directors observed that surveillance over exchange rate policies had been strengthened and better focused. While recognizing a member's prerogative to choose its own regime, they stressed that an assessment of both the exchange rate regime and the exchange rate level was needed in all cases. Directors welcomed the use of more sophisticated analytical techniques and the greater candor of staff assessments and policy advice, and recommended that these techniques be used for a greater range of countries. Some Directors cautioned, however, that explicit judgments in staff reports on either the exchange rate level or the exchange rate regime could, in some situations, risk an undue and disruptive influence on markets. These Directors suggested that, where such risks existed, the views of staff should be presented to the Board orally or through some other mechanism. It was acknowledged that the potential trade-offs between transparency and candor would have to be kept under review, especially in the context of the pilot project for publication of Article IV staff reports (see Chapter 4).

Directors noted the greater emphasis on *financial sector* soundness and *capital flows* in IMF surveillance, and the inclusion of *vulnerability analysis* in country surveillance for some countries, particularly emerging market economies. Surveillance in these areas had been deepened, supported by the collection of more comprehensive and timely data.

Article IV consultation reports should contain clear and candid information on the *quality of data* available to staff for the conduct of surveillance, drawing attention clearly to the gaps or deficiencies in data that hamper analysis. For effective diagnosis of financial vulnerabilities and incipient crises, most Directors thought that all countries vulnerable to large capital account swings should provide high-quality and timely information on the usability of reserves, on short-term debt, and on developments in market sentiment. Directors looked forward to the Board discussion on external debt and reserves with a view to making further progress in this area.

Most Directors agreed with the prevailing selective approach to disseminating and using *early warning system* models, given the state of the art and the sensitivity and imprecision of the results. Since actual currency crises had occurred in only about half the cases for which such models would have issued warning signs, their results needed to be tempered with a good deal of judgment and, in any event, used selectively and carefully. Directors supported stepping up collaboration with the World Bank in the analysis of *corporate sector vulnerability*, with a view to identifying useful operational indicators. They encouraged staff to continue looking for signs of linkages between potential weaknesses in the corporate sector and external vulnerability, following up, if warranted, on a case-by-case basis.

Directors welcomed the increasing attention paid to *cross-country issues* and *policy interdependence*. They emphasized that the IMF had a key role to play in developing and disseminating information and judgments in these areas. Some Directors, while noting the progress, stressed that such issues had to be more systematically included in country surveillance and thought that the IMF's increasing participation in regional forums was an appropriate way to advance this work.

Directors were satisfied with the focus of *global surveillance* as reflected in the World Economic Outlook and International Capital Market reports, and in the Board's informal World Economic and Monetary Developments sessions. They called for continuing periodic assessments of exchange rates and current accounts and of early warning system indicators; the discussion of risk; and the use of alternative scenarios in the World Economic Outlook, which had helped sharpen the analysis. While welcoming recent progress, Directors requested that efforts continue to better integrate IMF global and country surveillance activities.

Maintaining uniform treatment of member countries was important, Directors agreed, and annual consultations constituted the cornerstone for the *continuity of surveillance*. In the context of strained staff resources, however, most Directors supported some flexibility in consultation frequency, mission size, and documentation to ensure an effective focus of surveillance—provided that adequate contact was maintained with all countries.

External Evaluation of IMF Research Activities

The panel of evaluators for the Report of External Evaluators on the IMF's Economic Research Activities *consisted of Frederic S. Mishkin, A. Barton Hepburn Professor of Economics, Graduate School of Business, Columbia University, who served as Chairman; Francesco Giavazzi, Professor of Economics, Bocconi University, Italy; and T.N. Srinivasan, Samuel C. Park, Jr., Professor of Economics and Chairman of the Department of Economics, Yale University. Johanna Honeyfield, Special Projects Officer, served as coordinator.*

The external evaluation of IMF economic research activities was another in a series of outside evaluations looking at different aspects of the IMF's work. The purpose of the evaluation was to assess whether IMF economic research contributed successfully to the achievement of the IMF's objectives. The evaluators therefore assessed the appropriateness of the current scale and organization of research activities, how the level of resources are chosen, and how they relate to the overall work of the IMF. The evaluation also sought to assess the quality and the added value of different aspects of the IMF's economic research and to appraise its utility in the IMF, among its member countries, and within the wider economics community.

The external evaluators concluded that the contribution of research to the work of the IMF depends on ensuring that research is relevant, of high quality, and disseminated effectively. They saw room for improvement in the following key areas:

- While the IMF produces some excellent research products, there is substantial scope for improvement in the overall quality of the research.
- The mix of research at the IMF needs to be directed more to areas where it can add the most value, such as cross-country analysis, research on developing and transition countries, and on financial sector research.
- Research in functional departments (for example, those dealing with fiscal, monetary, and other policy development) needs to be integrated to a greater extent into operational work.
- IMF researchers do not have the visible profile in the outside world that they had in the past.

The Executive Board met in September 1999 to discuss the report. Directors agreed that research contributed importantly to all areas of the IMF's work: oversight of the international monetary system; multilateral and bilateral surveillance; policy and financial support for members' adjustment programs; and technical assistance, cooperation, and training. In all these areas, strong in-house research work was essential for ensuring that the IMF could learn from experience and generate and absorb ideas. As the external evaluators suggested, such research support had necessarily to be multifaceted and to encompass policy foundation, policy development, and policy analysis research. Research had to be carried out by high-quality personnel in a supportive but inevitably demanding environment, and staff had to be free to challenge accepted wisdom.

While welcoming the overall usefulness of the external evaluation, several Directors considered that a longer-term perspective and inclusion of a broader range of research activities would have provided a richer basis for the evaluation. These Directors questioned some aspects of the methodology the evaluators were able to employ in the time available for their study. This meant that the recommendations had to be reviewed carefully, as the evaluators had themselves suggested, not least because several of the recommendations raised significant issues of resource allocation in an institution already characterized by rising work pressures and binding resource constraints.

The evaluators saw no major omissions in the IMF's research agenda and praised the quality of much of the IMF's research output. At the same time, they saw substantial room for improvement, particularly in the areas of policy development and research on policy analysis. Directors agreed it was important that the IMF environment support research and researchers, while holding them accountable for their work. They also saw scope for improvement in the quality, focus, and dissemination of IMF research.

Directors reviewed the key recommendations of the report proposing organizational changes in the IMF, or changes in the emphasis of current practices. They agreed that the existing decentralized structure for conducting research in the IMF (where over half of the research output was from departments other than the Research Department) should be maintained, as it encouraged research specialization among departments. Nevertheless, they called for greater coordination than provided by the Working Group on

Fund Policy Advice[1] in order to help direct research more toward high-value activities, including the analytical underpinnings of IMF policy recommendations. In this light, Directors generally saw merit in creating a (higher-level) internal Committee on Research Priorities that would elaborate research priorities for the IMF. They agreed it should not operate in a top-down manner to specify individual research projects as this would stifle creativity.

While broadly agreeing with the evaluators that there had been no major gaps in the coverage of research topics in the IMF in recent years, Directors saw a strong argument for shifting the mix of research toward topics that added most value and for minimizing duplication of work done outside the IMF. They also noted that a refocusing of research work as proposed by the evaluators was already under way—especially concerning financial sector research.

Directors expressed appreciation for the excellent work of the IMF's Research Department in recent years. They supported more Research Department attention to policy foundation research as compared with policy analysis and policy development research,[2] where the generally high quality of the department's work was widely recognized. The Department should attempt to do this, Directors indicated, but a larger rebalancing of work between current research and operational activities was probably not possible within existing resource constraints.

Box 3.1
Follow-Up to the External Evaluation of IMF Research

In the wake of the external evaluation of research, the IMF took a number of initiatives. Responding to a key recommendation, a Committee on Research Priorities (CRP) was established on November 2, 1999. The committee is chaired by the First Deputy Managing Director and includes heads of a number of IMF departments, with the Editor of the *IMF Staff Papers* serving as an ex-officio member.

At its first meeting, in December 1999, the CRP agreed that its main tasks would be to identify priority research areas based on the input provided by departments, review ongoing work in priority areas, and, more generally, increase the profile of IMF research. The CRP also decided to publish and widely distribute an IMF research newsletter, initiate an annual IMF research conference series, and increase the travel budget for staff attendance at outside conferences.

Progress in these areas is already under way. The first annual IMF research conference is scheduled for early November 2000. Conference papers will include those by IMF staff as well as of external researchers. In addition, to enhance World Bank–IMF collaboration on research, a monthly joint Bank-Fund seminar has been initiated.

At its second meeting, in March 2000, the Committee identified four topics as priority areas for research, in line with the recommendations of the evaluators to focus on cross-country studies and work on financial markets and developing countries:

- Adjustment policies and their macroeconomic impact;
- IMF-supported programs in countries with high capital mobility;
- Poverty reduction in the context of IMF-supported programs and macroeconomic policies; and
- Financial sector vulnerabilities and program design.

While the CRP is responsible for identifying critical priority topics—and ensuring departmental commitments—the Working Group on Fund Research (previously the Working Group on Fund Policy Advice) will continue to serve as the interdepartmental clearinghouse that gathers and disseminates information on ongoing and planned IMF research projects.

With respect to improving the internal review process for all staff papers and recommendations to management and to the Executive Board, Directors felt that management had to address this from the broader perspective of the role of the review process in the IMF. The issue of how to feed research findings into operational work was among the several considerations that should be brought to bear on any proposals for changes in the review process.

Directors also supported several supplementary recommendations: encouraging research staff to participate in relevant external conferences; identifying significant contributors to IMF publications; improving collaboration with the World Bank and other researchers in central banks and treasuries; writing and disseminating of nontechnical summaries of the most important research; underscoring the preliminary nature of IMF Working Papers; improving the dissemination of research to nontechnical audiences outside the IMF; and creating an ongoing external review process for research products.

[1]An internal IMF working group whose purpose was to coordinate research projects within the IMF. Subsequent to the external evaluation, the working group was renamed Working Group on Fund Research; it now gathers and disseminates information on important research planned or under way in the IMF for a new high-level Committee on Research Priorities (see Box 3.1).

[2]Policy foundation research develops basic analytical tools and frameworks on which the development and analysis of policy rests. Policy development research draws on policy foundation research to create the broad strategy that guides IMF operations.

Independent Evaluation Office Established

On April 10, 2000, the Executive Board considered a paper authored by the Evaluation Group of Executive Directors, "Review of Experience with Evaluation in the Fund," and a background paper by the Office of Internal Audit and Inspection on independent evaluation in the IMF and other international institutions.

In discussing these papers, the Board agreed to establish an independent evaluation office in the IMF, with the office's terms of reference, structure, staffing, and operating procedures to be determined by the time of the Annual Meetings in September 2000. Directors noted that the work of the evaluation office would complement the IMF's ongoing internal and external evaluation activities, and lead to the IMF becoming more open and accountable to its membership.

CHAPTER 4

Reform of the Global Financial Architecture

> The Committee's deliberations have taken place today against the background of a growing public debate about the directions in which the IMF and the international financial system should evolve to adapt to a rapidly changing economic environment. The debate also reflects a concern that the benefits the world economy is deriving from freer trade and more integrated and deeper international capital markets are not reaching everyone, especially in the developing countries. The Committee reaffirms its strong support for the IMF's unique role as the cornerstone of the international monetary and financial system and its ability, by virtue of its universal character, to help all of its members. With the support of all its members, the IMF has undergone continuous change to equip itself better to assist members to build the strong macroeconomic and institutional underpinnings required for international financial stability and the broader sharing of the benefits and opportunities of an open world economy. But more needs to be done, and the Committee therefore pledges to continue to work toward making the IMF more effective, transparent, and accountable.
>
> —*Communiqué of the International Monetary and Financial Committee, April 16, 2000*

The financial crises of the 1990s exposed weaknesses in the international monetary and financial system, underscoring that globalization entails risks as well as potentially substantial benefits. The international community has also had to deal with the challenges of helping countries in transition from central planning to market economies, and of promoting growth and reducing poverty in the poorest countries. In response, it has mobilized to reform the system's "architecture"—that is, the institutions, markets, rules of the game, and practices that governments, businesses, and individuals use to carry out economic and financial activities. A strengthened architecture, in turn, helps make the global economy less vulnerable to damaging financial crises, and enhances prospects for all countries to reap the benefits of globalization through improved growth prospects and reduced poverty (see Box 4.1).

While the effort to reform the financial system, including the IMF, is a longer-term one, by the end of April 2000 substantial progress had been made. In several areas—such as increasing transparency and accountability, assessing observance of standards and codes, and better identifying financial sector vulnerabilities—experimental pilot programs were under way, designed to set the stage for decisions on longer-term action. Work on developing and spreading standards to guide member policies was increasingly focused on promoting implementation with the help of IMF technical assistance, and work was under way to develop better analytical tools and data for assessing vulnerability. In other areas—such as capital account liberalization, exchange rate systems, and involving the private sector in crisis resolution—progress had been made on developing workable recommendations, and discussions were continuing.

The IMF's efforts in FY2000 were part of a coordinated and comprehensive response from the international community. Many institutions and forums are playing key roles in efforts to strengthen the international financial architecture—including the World Bank, the Financial Stability Forum (FSF), the Bank for International Settlements (BIS), other Basel-based groups, the Group of Twenty (G-20)[1] and the Organization for Economic Cooperation and Development (OECD). In addition, the efforts of such standard-setting bodies as the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the International Accounting Standards Committee (IASC), the International Federation of Accountants (IFAC), and others—and of such

[1]The G-20 consists of the Group of Seven industrial countries plus 11 major emerging market economies and 2 institutional representatives (European Union and IMF/World Bank).

Box 4.1

Globalization: Threat or Opportunity?

The term "globalization" has acquired considerable emotive force. Some view it as a process that is beneficial—a key to future world economic development—as well as inevitable and irreversible. Others regard it with hostility, even fear, believing it increases inequality within and between nations, threatens employment and living standards, and thwarts social progress.

In reality, globalization offers extensive opportunities for truly worldwide development but it is not progressing evenly. Some countries are becoming integrated into the global economy more quickly than others. Countries that have been able to integrate are seeing faster growth and reduced poverty. Outward-oriented policies brought dynamism and greater prosperity to much of East Asia, one of the poorest areas of the world 40 years ago. And as living standards rose, it became possible to make progress on democracy and on such issues as the environment and work standards.

What Is Globalization?

"Globalization" in its economic aspect refers to the increasing integration of economies around the world, particularly through trade and financial flows. The term sometimes also refers to the movement of people (labor) and knowledge (technology) across international borders.

At its most basic, there is nothing mysterious about globalization. The term has come into common usage since the 1980s, reflecting technological advances that have made it easier and quicker to complete international transactions—both trade and financial flows. It refers to an extension beyond national borders of the same market forces that have operated for centuries at all levels of human economic activity—village markets, urban industries, or financial centers.

Markets promote efficiency through competition and the division of labor—the specialization that allows people and economies to focus on what they do best. Global markets offer greater opportunity for people to tap into more and larger markets around the world. It means that they can have access to more capital flows, technology, cheaper imports, and larger export markets. But markets do not necessarily ensure that the benefits of increased efficiency are shared by all. Countries should be prepared to embrace the policies needed both for the country to benefit from globalization and to ensure that its benefits are shared fairly. The poorest countries, and others, may need the support of the international community as they do so.

Are Periodic Crises an Inevitable Consequence of Globalization?

The succession of crises in the 1990s—Mexico, Thailand, Indonesia, Korea, Russia, and Brazil—suggested to some that financial crises are a direct and inevitable result of globalization. Indeed, one question that arises in both advanced and emerging market economies is whether globalization makes economic management more difficult.

Clearly the crises would not have developed as they did without exposure to global capital markets. But neither could most of these countries have achieved their impressive growth records without those financial flows.

These were complex crises, resulting from an interaction of shortcomings in national policy and the international financial system. Individual governments and the international community as a whole are taking steps to reduce the risk of such crises in the future.

At the national level, even though several of the countries had impressive records of economic performance, they were not fully prepared to withstand the potential shocks that could come through the international markets. Macroeconomic stability, financial sector soundness, open economies, transparency, and good governance are all essential for countries participating in the global markets. Each of the countries came up short in one or more respects.

At the international level, several important lines of defense against crisis were breached. Investors did not appraise risks adequately. Regulators and supervisors in the major financial centers did not monitor developments sufficiently closely. And not enough information was available about some international investors. The result was that markets were prone to "herd behavior"—sudden shifts of investor sentiment and the rapid movement of capital, especially short-term finance, into and out of countries. The international community is responding to the global dimensions of the crisis through a continuing effort to strengthen the architecture of the international monetary and financial system. The broad aim is for markets to operate with more transparency, equity, and efficiency.

Conclusion

That the income gap between high-income and low-income countries has grown wider is a matter for concern. But it is wrong to jump to the conclusion that nothing can be done to improve the situation. To the contrary: low-income countries have not been able to integrate with the global economy as quickly as others, partly because of their chosen policies and partly because of factors outside their control. No country, least of all the poorest, can afford to remain isolated from the world economy. Every country should seek to reduce poverty. The international community should endeavor—by strengthening the international financial system, through trade, and through aid—to help the poorest countries integrate into the world economy, grow more rapidly, and reduce poverty. That is the way to ensure all people in all countries have access to the benefits of globalization.

For more on globalization, see IMF Issues Brief, "Globalization: Threat or Opportunity?" April 2000, on the IMF website.

forums as the United Nations Commission of International Trade Law (UNCITRAL)—have become increasingly important given the heightened focus on assessment of financial stability and on standards.

Much of the work on reforming the global architecture will be integrated in the context of IMF surveillance (see Chapters 2–3), which poses new challenges for the IMF, especially on how to draw on the expertise of other institutions in its surveillance. At its April 2000 meeting, the International Monetary and Financial Committee encouraged the Executive Board to continue examining how to incorporate into surveillance the various "architecture" initiatives and asked for a status update at its September 2000 meeting.

This chapter describes the progress made on key elements of a strengthened financial architecture as of the end of April 2000. Detailed and up-to-date information on the range of initiatives can be found on the IMF website.

Transparency and Accountability

Improved provision of information to the markets and the broader public is a central element of the reform of the international financial system. It is also a cornerstone of the IMF reforms put in place in the past few years—and planned for the future.

Transparency, on the part of IMF member countries and the IMF itself, helps foster better economic performance in several ways. Greater openness by member countries encourages more widespread analysis of their policies by the public; enhances the accountability of policymakers and the credibility of policies; and critically informs financial markets so they can operate in an orderly and efficient manner. Greater openness and clarity by the IMF about its own policies, and the advice it gives members, contributes to a more informed debate on policy and to a better understanding of the IMF's role and operations. By exposing its advice to public scrutiny and debate, the IMF can also help raise the level of its analysis.

The IMF's Executive Board has adopted a series of measures aimed at improving the transparency of members' policies and data, and at enhancing the IMF's own external communications (see also Appendix V). In taking these steps, the Board has been sensitive to balancing the IMF's responsibility to oversee the international monetary system with its role as a confidential advisor to its members.

As of April 30, 2000, the Executive Board had agreed to:

Make available more information about IMF surveillance of members

- About 80 percent of member countries choose to publish Public Information Notices (PINs) following their country (Article IV) consultations.
- Sixty member countries have agreed to participate in the pilot program for the voluntary release of Article IV staff reports begun in April 1999.

Make available more information on countries' IMF-supported programs

- Letters of Intent and other country program documents are being released for most countries' requests for, and reviews of, the use of IMF resources (or financing).
- Statements by the IMF's Chairman of the Board are being issued in News Briefs and Press Releases on the Board's discussions of requests for the use of IMF resources and reviews.

Carry out internal and external evaluations of IMF practices

- The internal and external evaluations of the Enhanced Structural Adjustment Facility (ESAF), the IMF's concessional lending facility (now the Poverty Reduction and Growth Facility)—and the solicited public comments on the tentative conclusions of these studies—were published.
- Further internal and external evaluations of IMF operations have been conducted and published, including the *External Evaluation of IMF Surveillance*, in September 1999, and the *External Evaluation of IMF Research Activities*, in March 2000. In April 2000, the Board agreed to establish an independent evaluation office in the IMF, the modalities for which will be determined in FY2001. (See Chapter 3.)

Continue dialogue and consultation with the public on IMF activities

- The IMF has carried out, in conjunction with the World Bank, consultations with nongovernmental organizations (NGOs), other members of civil society, and the public at large, as part of the comprehensive review of the Heavily Indebted Poor Countries Initiative (HIPC Initiative), and incorporated their views into the enhanced HIPC Initiative announced in September 1999 (see Chapter 5).
- Also in conjunction with the World Bank, the IMF is releasing to the public IMF policy and country documents under the HIPC Initiative and, in the future, will make available staff assessments of members' Poverty Reduction Strategy Papers.
- Key internal reports on IMF policies and operations are being released, including papers and Board discussions on the Asian financial crisis and the link between debt relief and poverty reduction.
- Periodic summaries of the Executive Board's work program and a wide range of policy documents are also being released.
- Preliminary standards and codes are being posted for public comment.

Release more financial information about the IMF

- The IMF posts on its website "Members' Accounts in the IMF," which provide timely information on every member country's financial position with the IMF.
- A new website section, "IMF Financial Activities," updated weekly, provides key IMF financial statistics, including lending, resources, arrears, and IMF rates; tables on current financial arrangements with members; and the status of commitments to members under the HIPC Initiative.
- Information on the IMF's liquidity position is posted.
- The Board decided in March 2000 to post the outcome of the IMF's quarterly financial transactions plan (formerly called the operational budget), which gives information on the sources of financing for IMF lending.
- Public access to the IMF's archives has been expanded substantially.

The commitment to increased transparency has also led to measures to better explain the IMF's work to the wider community. Steps have been taken to provide more information to the media and to the public, notably through the IMF website. Further efforts are being made to reach out to civil society, strengthen the IMF's publications program, and increase dialogue with the private financial sector. In addition, the IMF has implemented a number of elements of a strategy for strengthening its external communications, based on reviews by external consultants (see Appendix V).

In its April 16, 2000, communiqué, the International Monetary and Financial Committee reiterated the importance it attaches to greater transparency in policymaking in improving the functioning of national economies as well as the international financial system. It underscored as well the importance of enhanced transparency and accountability of the international financial institutions themselves. The Committee welcomed continuing progress in a number of areas, and encouraged further actions to make the policies of the IMF, and of its members, more transparent, without compromising the IMF's role as confidential advisor.

Developing Standards, Principles, and Guidelines

Executive Board discussions on strengthening the international financial architecture have stressed the need to develop and implement internationally recognized standards and codes of good practice. Adopting such standards in areas central to economic and financial system stability can contribute to better-informed lending and investment decisions, increased accountability of economic policymakers and private sector decision makers, and improved economic performance.

Following the development of standards in areas of direct operational concern to the IMF—data dissemination; transparency of fiscal, monetary, and financial policies; and banking supervision—efforts have focused on disseminating and implementing these standards, including by providing technical assistance. Material has been prepared to help countries implement the standards: A manual for the *Code of Good Practices on Fiscal Transparency* has been available on the IMF website since 1998, and the IMF is finalizing a supporting document to the *Code of Good Practices on Transparency in Monetary and Financial Policies,* which was adopted by the IMFC in September 1999. The operational guidelines for the data template on international reserves and foreign currency liquidity for the Special Data Dissemination Standard (SDDS) will be finalized by the end of 2000, after taking into account members' experience with its implementation.

The experience with standards must also be reviewed periodically to ensure that their design and implementation remain appropriate. During the financial year, the Board reviewed the experience with the SDDS and the General Data Dissemination System (GDDS) and agreed to changes in the areas of international reserves and external debt.

The Executive Board established the Special Data Dissemination Standard in March 1996 and the General Data Dissemination System in December 1997. The SDDS aims to guide countries that have, or seek, access to international financial markets in disseminating economic and financial data to the public. The GDDS is targeted at countries not yet able to subscribe to the SDDS but which seek to improve their statistical systems. It emphasizes the development of sound statistical systems as preparation for the timely dissemination of data to the public.

In March 2000, the Executive Board concluded a third review of the IMF's data standards initiatives, citing substantial progress in meeting the requirements of the SDDS. Most subscribers were expected to be fully observing the requirements of the SDDS by the end of June 2000, and systematic monitoring of observance of the standard would begin at that time. The GDDS was moving into its operational phase.

Among the conclusions of the Board review were the following:

- To strengthen the provision of data for assessing external vulnerability, a standard format for disseminating data on official reserves and foreign exchange liquidity will be used, based on the SDDS reserves template approved in 1999. Template data will be distributed in this format on the IMF's website.
- A separate SDDS data category for external debt statistics will be introduced; it will involve the dissemination of comprehensive and timely data broken down by major sectors on a quarterly basis. This will be phased in over three years.

Box 4.2

Experimental Assessments of the Observance of Standards

The IMF and World Bank have developed an organizing framework to assess the observance of standards in cooperation with national authorities and other international bodies. Assessments are prepared using a range of different instruments.

- The joint IMF–World Bank pilot *Financial Sector Assessment Program (FSAP)* is focused mainly on assessing financial sector vulnerabilities and identifying developmental priorities. This involves, in part, assessing those financial sector standards that are key to stability in each particular case. All FSAPs assess compliance with the Monetary and Financial Policy Transparency Code and the Basel Core Principles. The FSAP is a collaborative effort involving expert support by a range of national agencies and standard-setting bodies.
- Adherence to standards on data dissemination and fiscal transparency is assessed in connection with the IMF's technical assistance activities and in stand-alone exercises connected with surveillance and program reviews.
- The World Bank, in cooperation with other bodies, is experimenting with assessments in the areas of corporate governance and accounting and is developing methods of conducting assessments.

The IMF–World Bank Reports on the Observance of Standards and Codes (ROSCs) provide a framework for assembling these assessments. Experimental ROSC "modules" describe country practice in a particular area, along with an assessment of the extent to which practice is consistent with the relevant international standard. At the end of FY2000, ROSC modules covering 15 industrial, emerging market, and developing economies were completed by IMF staff in cooperation with national authorities for countries that had volunteered to join in the pilot program, and modules were being prepared for another 18 countries. World Bank staff plan to prepare about six corporate governance modules by mid-2000, and about the same number of accounting modules by the end of September 2000. Publication of the ROSCs remains at the discretion of national governments, although most completed assessments have been made available on the IMF website.

Self-assessments of the observance of standards complement external assessments. Self-assessments can help promote ownership by national authorities, and, if based on clear and well-developed methodologies, use scarce international resources more effectively. Without external assessments, however, self-assessment may lack credibility and rigor. Clear "how-to" manuals are critical to guide self-assessments, ensure complementarity between self-assessments and outside assessments, and promote comparability across jurisdictions. Greater international support for efforts by standard-setting bodies to develop methodologies would help encourage the adoption of standards. Market and official incentives could also boost the commitment of countries to implement and observe standards.

- The GDDS will also be enhanced with respect to external debt, with public and publicly guaranteed debt and the associated debt-service schedule in the core data categories of the GDDS.
- As to data quality, IMF staff is extending earlier work on a framework for assessing quality more systematically. In addition, a Data Quality Reference Site was established on the Dissemination Standards Bulletin Board (www.dsbb.imf.org) to foster a common understanding of data quality, drawing on contributions from the international statistical community.

The Board asked the staff to issue a new quarterly report on the SDDS to increase awareness of progress being made and to give the initiative more prominence. It also asked the staff to explore ways to include references to countries' subscription to the SDDS in country surveillance staff reports and PINs, including how observance should be discussed.

Assessing Standards

While adopting any individual standard is voluntary, the international community has also recognized the importance of information on the extent to which countries comply with internationally recognized standards and codes. The IMFC has agreed that country (Article IV) consultations provide the right framework within which to organize and discuss with national authorities the implications of assessments of compliance with standards and codes. How this work will best be incorporated into IMF surveillance remains to be decided. Support for these "transparency reports"—now referred to as *Reports on the Observance of Standards and Codes (ROSCs)*—has nonetheless been wide-ranging, and an experimental program has been under way since early 1999 (see Box 4.2).[2]

[2]See, for example, the Report of the Group of Twenty-Two *Working Group on Transparency and Accountability* (October 1998) and the April and September 1999 Interim Committee communiqués. More recently, the experimental work on ROSCs has been supported by the recommendation of the Group of Twenty to "undertake the completion of Reports on the Observance of Standards and Codes ('Transparency Reports') and Financial Sector Assessments" (*G-20 Finance Ministers and Central Bank Governors Meeting*, Finance Canada Press Release, December 15–16, 1999). Similarly, Western Hemisphere finance ministers have endorsed ongoing work on standards and codes. They encouraged members to undertake Financial Stability Assessment Programs and committed themselves to support and participate in ROSCs (*Joint Ministerial Statement*, February 3, 2000).

There is a critical distinction, however, between *undertaking* assessments of a member's observance of particular standards and *using* those assessments in IMF surveillance. The former requires detailed knowledge of the relevant standards and the expertise to use this information to benchmark individual country practices. The latter involves an appreciation of how these practices have been changing over time and how they affect economic and financial system stability.

The Board has stressed that, in undertaking assessments, staff should concentrate mainly on areas within the IMF's direct operational focus—that is, fiscal and monetary transparency, financial sector soundness, and data dissemination. Directors have also emphasized the importance of assessing standards in other areas—with these assessments drawing on the skills of other expert bodies. To this end, the Board endorsed a shared ownership approach to preparing ROSCs. Under this approach, different international institutions take primary responsibility for assessments in different areas, in line with their mandates and expertise. The World Bank has agreed to join the IMF in co-preparing ROSCs and is experimenting with assessments in corporate governance and accounting.

Even working jointly, there are limits to what standards the IMF and World Bank can assess. Other international financial organizations, standard-setting bodies, and national authorities all have roles to play, and mechanisms need to be developed to involve them. In this regard, the pilot project of the joint World Bank–IMF Financial Sector Assessment Program has been particularly effective in bringing the expertise of national agencies and standard-setting bodies to the assessment process (see the discussion on "Strengthening Financial Systems" below).

Country (Article IV) surveillance provides the appropriate framework within which to organize and discuss the implications of assessments with national authorities, although the methods for doing so remain experimental during the period of the ROSC pilot. In addition, linking the monitoring of standards and codes to the country consultation process—with its near universal coverage and uniformity of treatment—ensures a continued focus on promoting standards. A comprehensive range of assessments will also be valuable for the World Bank's work in helping countries determine reform and development priorities. Similarly, feedback from assessments can help standard-setters identify the strengths and weaknesses in existing standards and guide future work. If assessments are published, they would also help markets make better-informed lending and investment decisions. This should, in turn, encourage greater efforts to carry out and adhere to standards.

Strengthening Financial Systems

Recent episodes of financial crises in a number of countries, and cross-border "financial contagion," have underscored the importance of sound financial systems in member countries, and particularly the need to better identify financial sector risks and vulnerabilities at an early stage (see Box 4.3 for a review of the Board discussion on lessons for financial sector restructuring of the Asian financial crises). Banks and other financial institutions need to improve such internal practices as risk assessment and management, and the official sector must upgrade its supervision and regulation of the financial sector to keep pace with the modern global economy.

Although the IMF has, for some time, given prominence to covering and assessing financial sector soundness in its surveillance and lending activities, deeper and more focused analysis in this area is needed. Priorities are to examine the health of financial sectors systematically and to identify the linkages among macroeconomic policies, the real economy, and structural and developmental issues in the financial sector. To do this work most effectively, and to use scarce expert resources efficiently, the IMF is collaborating with the World Bank

The IMF–World Bank Financial Sector Assessment Program (FSAP)—introduced as a one-year pilot in May 1999—has been the core instrument for more focused financial sector analysis. The program aims to underpin a more effective dialogue with national governments, to help countries reduce vulnerabilities in their financial sectors, and to help decide priorities for financial sector development. To increase collaboration and consistency in policy advice between the IMF and the Bank on financial sector work, and to better coordinate technical assistance, a Financial Sector Liaison Committee (FSLC) has been operating since late 1998.

Within the IMF, staff prepare Financial System Stability Assessments (FSSAs)—with a focus on vulnerability issues—based on the Financial Sector Assessment Program reports for each country. Staff assessments of risks to the macroeconomy from the financial sector are brought into the country consultation process and are used in IMF program design.

The Financial Sector Assessment Program pilot was well under way by the end of FY2000. Of the planned pilot assessments for 12 countries—covering a range of financial systems and geographic regions—4 had been completed and 8 were in progress. Owing to the resource-intensive nature of the program, the specialized skills needed, and the limited staff resources in the World Bank and the IMF, national central banks and supervisory agencies, as well as international standard-setting bodies, have been invited to provide experts to contribute to the assessments of individual countries. Feedback so far from national governments has been

Box 4.3

Lessons from the Asian Financial Crisis

Executive Directors discussed in early September 1999 the lessons for financial sector restructuring from the Asian crisis. In the most affected countries—Indonesia, Korea, and Thailand—financial sector reforms were at the core of IMF-supported programs. The crisis originated in a combination—in differing proportions across countries—of financial and corporate sector weaknesses and macroeconomic vulnerabilities. A key source of vulnerability had been the large capital inflows in the earlier part of the 1990s, particularly, unhedged short-term foreign borrowing. This had made the three crisis countries vulnerable to capital outflows and exchange rate depreciations. Capital inflows had also fueled a rapid credit expansion that led to asset price inflation and financing of low-quality investments. The credit expansion also reflected weaknesses in lending practices, ineffective market discipline, deficiencies in prudential regulation and supervision, and, in some countries, the close links among governments, banks, and corporations. The banking crisis was further deepened by weaknesses in the corporate sector, which, in some countries, was highly leveraged. Many Directors suggested that pegged exchange rate regimes and implicit guarantees were also leading sources of vulnerability, because they induced investors to ignore the foreign currency risks, thereby increasing unhedged external borrowing and maturity mismatches in banks' portfolios. Those measures had also undermined the incentives to implement efficient prudential rules on foreign exchange exposures.

Once market sentiment had changed, the size and speed of the impact on the financial systems were unprecedented and required substantial and far-reaching government intervention. The Asian crisis had thus highlighted the close linkage between financial sector soundness and macroeconomic stability.

Directors supported the measures taken by the national authorities to address the emergency and stabilize their financial systems. The experience showed the importance of explaining measures clearly to the public and implementing them as a package to reassure the markets of the government's determination to address the crisis.

In summing up lessons from the Asian crisis for the IMF, Directors highlighted the following:

- "Ownership" of IMF-supported programs by governments is critical for the success of the reform process. The IMF should help countries achieve effective ownership and gain public support for the envisaged reforms.
- Transparent information and rules, regulations, and administrative procedures can help prevent or lessen the impact of financial crises and facilitate IMF surveillance. At the same time, market participants must use the available information to guide their investment decisions.
- Surveillance over financial and corporate sectors is important and should focus on identifying vulnerabilities, assessing the quality of policies, and ensuring transparency of information and regulations.
- Prompt and decisive action to deal with banking problems is also important. Preparation should include contingency plans to address potential financial sector difficulties. Specific measures to reduce the possibility and impact of any future crisis should be examined; these could include the adoption of countercyclical prudential policies. Directors cautioned, however, that such policies should not be part of demand management or an excuse for forbearance.
- The IMF's role in dealing with crises—which increasingly have had financial sector turmoil as a major ingredient—points to the need to develop further IMF conditionality and policies to deal with financial sector issues, in close collaboration with the World Bank. To be effective, reform programs should be designed to convince markets that they will be implemented successfully. In this regard, many Directors stressed the need for appropriate sequencing and for setting realistic targets and timetables. The management of these crises has also required intensive technical assistance from the IMF and from other institutions, particularly the World Bank and Asian Development Bank. The IMF therefore needs to have expertise and human resources to support members, especially in developing robust financial systems and in managing financial crises.

positive and their suggestions for improvements are helping refine the program.

In March–April 2000, the Executive Boards of the IMF and World Bank discussed a progress report on the Financial Sector Assessment pilot (see Box 4.4). On the basis of the experience gained with the pilot, both Boards agreed to continue the program. The pace of country coverage is expected to pick up to 24 countries in FY2001.

External Vulnerability and Capital Flows

Countries can benefit substantially from capital account liberalization, if liberalization is properly sequenced and managed. IMF surveillance aims to assess risks and vulnerabilities at both the national and international level. Timely, frequent, and high-quality data are critical for an effective assessment. With the benefit of hindsight, limitation on the availability of such data delayed the early detection of some of the strains that led to the emerging market financial crises and worsened the difficulties in fashioning a timely policy response. As a result, much effort is being focused on how to improve both data quality and reporting and the use of vulnerability indicators in conjunction with standard economic analysis.

Work to develop better methods for evaluating external vulnerability has advanced on several fronts in

Box 4.4

Progress Review of the Pilot Financial Sector Assessment Program: Key Conclusions

The FSAP has helped country authorities identify areas needing strengthening and guided the adoption and sequencing of necessary reforms. In some cases, it has spurred officials to focus attention on significant financial system issues earlier, and in more depth, than otherwise.

At the same time, the FSAP can be improved further. The linkages between macroeconomic and structural conditions and developments need to be better understood. To this end, the research agenda on financial stability and structural issues must be given a high priority. Even greater emphasis on focusing individual assessments as early as possible on the key financial issues for each case will help make most efficient use of the staff resources of both national governments and FSAP missions.

Carrying out the FSAP has required capacity building in the IMF and World Bank. Staff skills in both institutions are being strengthened, particularly in the areas of analytical methods and techniques to assess the health of financial institutions and financial sectors as a whole. In this connection, attention is being paid to stress test methodologies and developments of macroprudential indicators.

The participation of staff from national authorities and other standard-setting bodies provided a valuable contribution to the FSAP pilot, particularly in the areas of supervision and payment systems. Outside participation brought in important specialized expertise and an element of peer review, thereby increasing the credibility and acceptance of the assessments.

the IMF (see Box 4.5), World Bank, and in other international institutions. The increased emphasis on the dissemination of comprehensive and timely data on external debt and official reserves under the SDDS is discussed above. Work to make data on external debt and foreign exchange liquidity more available is also under way in other forums. The IMF-chaired Inter-Agency Task Force on Finance Statistics[3] has kept a quarterly database of creditor-side data on external debt on the Internet since March 1999. The Task Force is working to increase the timeliness and coverage of these data. The BIS has announced several initiatives to heighten the coverage and analytical usefulness of its international banking statistics. The Financial Stability Forum Working Group on Capital Flows has recommended improvements in data from national, creditor, and market sources. Western Hemisphere finance ministers have called on interested participants to prepare discussion papers on their debt and fiscal management policies and have asked the Inter-American Development Bank, IMF, and World Bank to host a seminar to discuss these papers in FY2001.

In response to a request from the Financial Stability Forum Working Group on Capital Flows, the IMF hosted a conference on capital flow and external debt data in February 2000. The conference brought together a wide range of data users in the public and private sectors and data compilers for an exchange of views on how to produce better and more timely data on debt and capital flows. Views among participants on directions for future work differed widely, although all considered that initiatives to date to promote methodological and data dissemination standards had been useful. (The agenda, background material, and a summary of the conference are posted on the IMF's website.)

The IMF and World Bank are collaborating on a series of papers on external debt management. Drawing on research at the World Bank, the IMF, and elsewhere, staff have undertaken work on *debt- and reserve-related indicators of external vulnerability,* which considers the analytical usefulness of various indicators and the scope for the derivation of simple benchmarks (such as threshold levels for certain indicators) to better gauge countries' abilities to withstand external shocks. Also in preparation are a study on sound practices in sovereign debt management, a set of guidelines on sovereign debt management, and a manual for developing domestic capital markets.

In other related areas:

- The Board held a number of discussions in FY2000 that dealt with *structural and institutional elements in the management of foreign exchange reserves.* The results of these discussions will feed into IMF surveillance, financing, and technical assistance activities.
- With IMF support, systems for *high-frequency monitoring* of external liabilities of domestic banking systems have been established in a number of countries to improve the authorities' capacity to detect emerging signs of vulnerability and help in crisis management. The usefulness of these and other systems for high-frequency monitoring of foreign exchange transactions is being assessed by the IMF staff in consultation with member countries.
- The IMF has initiated a project to identify statistical data (referred to as "macroprudential indicators") needed to support the evaluation of financial systems and to develop strategies to compile the data and encourage their dissemination to the public. A research program has been launched, and the staff is surveying members regarding their needs and practices related to macroprudential indicators. Investigations of data on financial soundness are also being undertaken in conjunction with the joint IMF–World Bank Financial Sector Assessment Program.

[3]Current participants in the work of the TFFS include the World Bank, Bank for International Settlements, Organization for Economic Cooperation and Development, European Central Bank, Eurostat, Paris Club, Commonwealth Secretariat, and United Nations Development Program.

Box 4.5

Conference on Reform of the International Monetary and Financial System

In late May 1999, the IMF's Research Department hosted a conference on the reform of the international monetary system. Participants from academia, the public and private sector, and international financial institutions were invited to take a critical look at issues central to the discussion of how to strengthen the system. These issues covered coping with capital flows, coordinating exchange rate policies, providing financial assistance to countries facing external payment difficulties, and preventing and resolving financial crises.

The main topics of discussion included the exchange rate among major currencies, the exchange rate regime for emerging market economies, analysis of emerging market crises, the role of capital controls, private sector involvement in crisis prevention and resolution, and international official assistance and the role of the IMF.

In summing up the conference, First Deputy Managing Director Stanley Fischer focused on three issues:

- *Should capital flows to developing and emerging markets be encouraged, in view of the recent crisis experience?* There is a serious and analytically coherent case for freedom of capital account transactions, Fischer said. For one thing, the same analytical apparatus that economists use to justify free trade in goods at a point in time applies to trade in assets over time. Second, although net capital flows may be small relative to either domestic saving or domestic investment, they are not necessarily small relative to net investment and can thus make a significant difference to growth. Third, capital account transactions allow for better risk sharing for both lenders and borrowers. Fourth, international capital flows, and direct investment in particular, make for healthy competition for domestic financial institutions and are often accompanied by significant technology transfers. Finally, there appears to be an association between tight controls on capital movements and generally inward-looking anti-competitive national economic structures.

  This is not to deny there are a number of serious problems associated with capital flows to developing and emerging market economies, including excessive volatility in response to changing market sentiment. In addition, risk often appears not to be priced correctly, as indicated by the behavior of spreads on emerging market debt, signaling the existence of systemic problems. On balance, however, governments have not pulled out of international capital transactions despite the many shortcomings of financial markets. This indicates that the net balance of benefits and costs is, on the whole, perceived to be on the side of remaining open rather than retreating into autarky. It is all the more important to make the world a more stable one and to lessen the dangers countries are subject to when opening up the capital account. In this context, Fischer stated that there was, in some circumstances, a case for market-based controls on short-term capital inflows and, certainly, for prudential regulations.
- *What is the appropriate exchange rate regime?* Among countries facing currency crises, those that had fixed or pegged rates tended to get hit the hardest when they tried to defend their rate or maintain the peg. Countries with floating rates that have suffered speculative attacks in the past seem to have suffered less serious hits. The move toward floating, with prudential controls, will likely continue, although hard currency pegs would also be favored by some countries.
- *Can moral hazard be avoided?* Moral hazard will always exist. The question to be asked is: How much moral hazard can be contained in a sustainable equilibrium? A crisis is obviously not a sustainable equilibrium, so measures need to be taken to keep moral hazard within permissible limits. The advanced economies should take the lead in implementing changes.

Mr. Fischer concluded by stressing that, as the worst effects of the Asian crisis fade, the international community, far from relaxing its vigilance, is redoubling its efforts to find new and effective means to deal with future crises.

A seminar volume entitled *Reforming the International and Monetary System* will be published by the IMF.

- The IMF has also joined in efforts to develop *early warning systems* for external crises—that is, formal models that estimate the probability of crisis from a compact set of variables—to better inform surveillance. The Board has noted that while early warning systems could be a useful additional tool for surveillance, they must be used cautiously. Work is continuing to improve the accuracy of these models and find their most useful applications.

Work at the IMF and elsewhere on the analytical framework for evaluating external vulnerability underscores the importance of timely information on the external liabilities and foreign exchange exposures of all sectors of the economy, as well as analysis of the risks posed by derivatives exposures and contingent liabilities. In parallel with the effort to develop better information on these sources of vulnerability, further research is under way on how to measure vulnerability from off-balance-sheet operations. The World Bank is also conducting research on issues of corporate sector vulnerabilities.

Capital Account Liberalization and Capital Controls

In several discussions during FY2000, the Executive Board underlined the substantial benefits of capital account liberalization but stressed the need to manage and sequence liberalization carefully to minimize risks.

In September 1999, Directors agreed there was no single approach to securing the benefits of international capital flows while limiting the risks. Views continued to differ as to the net benefit or cost of capital controls and, hence, the usefulness of controls. Based on a series of country studies, the following tentative observations could be made:[4]

- Capital controls cannot substitute for sound macroeconomic policies, although they may provide a breathing space for corrective action. The room for policy maneuver that controls can provide has varied greatly across countries, reflecting a variety of factors including the degree of flexibility in exchange rate policy, the level of financial market development, the quality of prudential policies, and the administrative and enforcement capacities of the authorities. Countries with serious macroeconomic imbalances, and no credible prospects for correction in the short run, however, have regularly been unable to address large-scale capital outflows by using capital controls. Moreover, in some cases, controls have reduced pressures on the authorities to introduce needed policy reform. Some have also pointed to the possible harmful consequences on other countries from the imposition of capital controls.
- Although comprehensive and wide-ranging controls appear more effective than selective controls, they also tend to be more distortionary, impede desirable transactions, dampen financial market development, and adversely affect investor confidence and access to international capital markets. Nonetheless, many Directors believed that controls on capital inflows to supplement other policy measures may be warranted in situations where a country experiences large persistent inflows; thus, the possible benefits of controls had to be weighed carefully against their costs.
- Building effective regulatory and supervisory institutions for financial markets may take a long time. More work is needed, however, to determine whether capital controls—particularly on short-term inflows—may temporarily and partially substitute for full-fledged prudential arrangements.
- Strong prudential policies for the financial sector can play an important role in orderly and sustainable capital account liberalization, and in reducing the vulnerability of an economy to outside shocks. Directors agreed that work in international forums to address potentially destabilizing capital flows should concentrate on efforts to improve prudential regulation and supervision, both in creditor and debtor countries, and aim for coherence in prudential policies among countries.
- A case-by-case approach to capital account liberalization was needed. The sequencing and pace of capital account liberalization, capital account opening, and financial sector reform were ongoing and interrelated processes, which are closely linked to the overall level of economic development and a country's other individual circumstances.

Discussions will continue on these issues in FY2001.

Since the emerging markets crises, the surveillance of capital account developments has been given greater prominence in country consultations. Staff reports have increasingly included discussions of vulnerabilities arising from capital flows. Policy discussions have focused increasingly on the composition of capital flows and capital account regulations. Special attention has been given to risks posed by the potential reversal of capital inflows, the impact of selective capital account liberalization, and the rapid buildup of foreign-currency-denominated debt. Looking ahead, Directors saw scope to expand the systematic use of vulnerability indicators in surveillance and to investigate the adequacy of prudential safeguards to ensure that the financial sector and the wider economy are resilient to possible shocks.

Exchange Rate Regimes

The choice of the right exchange rate regime has become ever more important as an increasing number of countries have become more integrated in world capital markets. During the financial year, the Executive Board considered the key issues concerning exchange rate regimes in an environment of increasing international capital mobility. Directors drew the following conclusions:

- *No single exchange rate regime is suitable for all countries or in all circumstances.* Whatever exchange rate regime is adopted, its consistency with underlying macroeconomic policy is essential.
- *The existing system of flexible exchange rates among the three major currencies is likely to continue.* Thus, countries need to adapt to a global environment of exchange rate variability. Large misalignments and volatility in major currencies are a cause for concern, particularly for small, open, commodity-exporting countries. IMF surveillance must fully take into account spillover effects of macroeconomic and structural policies in major currency countries.
- *In recent years, several emerging market countries have adopted a flexible exchange rate regime.* The

[4]The review of country case studies included in-depth studies for Chile, India, and Malaysia, and case studies on the experience with capital controls to limit short-term capital inflows (Brazil, Chile, Colombia, Malaysia, Thailand); selective controls on outflows to reduce exchange rate pressures in the context of financial crises (Malaysia, Spain, Thailand); extensive controls during financial crises (Russia, Venezuela); and issues associated with the liberalization of longstanding and extensive controls (China, India) and with rapid liberalization (Argentina, Kenya, Peru).

requirements for upholding a peg when capital is internationally mobile are exacting. Even with flexibility, supporting macroeconomic policies should be coherent and credible; an alternate framework to the peg, such as monetary or inflation targeting, is needed to provide a nominal anchor.

- *Large exchange rate swings in small or medium-sized open economies may have significant economic costs.* Although exchange rates must be allowed to adjust in response to market pressures, it may also be appropriate to use domestic monetary policy or intervention to limit swings.
- *If credible supporting policies and institutions are in place, a peg could still be viable for the smaller, more open economies,* especially those less open to short-term capital flows or with a dominant trade partner. In particular, very constraining pegs—such as currency boards—can be sustainable when supported by credible macroeconomic policies.
- *The IMF should continue to respect the exchange rate regime choices of members, but its surveillance and programs must seek to ensure that countries' policies and circumstances are consistent with their exchange rate regimes.* The IMF should not provide large-scale assistance to countries intervening heavily to support an exchange rate peg if this peg is inconsistent with underlying policies. In some cases, it should offer advice on a suitable exit strategy.

In recent years, the assessment of exchange rate policies in the context of IMF surveillance has been strengthened for most countries, and particularly so for advanced and emerging market economies. Analyses of exchange rate determinants have been deepened, and greater candor in assessments and policy advice is evident. There is scope, however, for further improving the analysis of exchange rate policy issues in developing countries, despite the constraints imposed by data limitations. Looking ahead, efforts are under way to extend to a broader group of members the existing framework used in the analysis of exchange rate behavior and policies in advanced countries.

Involving the Private Sector in Forestalling and Resolving Crises

Involvement of the private sector in the resolution of financial crises[5] is appropriate in order to have the burden of crisis resolution shared equitably with the official sector, strengthen market discipline, and thereby increase the efficiency of international capital markets and the ability of emerging market borrowers to protect themselves against volatility and contagion. An additional goal is to avoid moral hazard—the danger that investors' expectations of international "rescues" encourage risky lending.

Prevention is key. Recent experience has confirmed that consistent macroeconomic and exchange rate policies, sound debt management, and effective prudential supervision of financial systems are all vital to prevent and mitigate the severity of crises. At the same time, policies designed to improve the environment for private sector decision making can also help reduce vulnerability. Improvements in the transparency of both the public and private sectors and efforts to promote the adoption of, and adherence to, standards should facilitate risk management by investors. Country authorities also need to maintain regular contacts with private market participants, to ensure the regular reporting of information on economic developments and policies, and to maintain lines of communication both in good times and when difficulties in the country's economic situation begin to emerge.

In its discussions during the financial year, the Executive Board noted that the international financial community recognized the need to secure the involvement of the private sector in resolving financial crises. In reviewing recent experience, Directors considered the two cases of efforts to secure private sector involvement with members that had lost spontaneous access to capital markets through the restructuring of international sovereign bonds—Ukraine and Pakistan—had been encouraging. Debt exchanges were arranged successfully and disruptive litigation has not, so far, been a problem. While it was premature to assess whether litigation may eventually become an issue, Directors agreed that the risks of such litigation in cases to date were not as great as previously thought. Successful debt exchanges in these cases involved the recognition by creditors of the limited debt-servicing capacity of the debtors, and of the lack of palatable alternatives. The precise form of the recent debt restructurings depended on the structure of the payments falling due and the particular country circumstances and did not necessarily involve comparable treatment of all debt categories or maturities.

The Board saw merit in continuing to work toward an operational framework for securing private sector involvement, building on the principles articulated by the Group of Seven finance ministers in their report to the Cologne Economic Summit in June 1999 and endorsed by the Interim Committee in their September 1999 Communiqué. Directors agreed that flexibility was needed in handling individual cases. The form of

[5]The term "private sector involvement," in this context, refers to the participation of private creditors in providing financing for an IMF-supported adjustment program. This can be done in a variety of ways, including through bond exchanges, coordinated rollovers of interbank credit, or the direct provision of new money. In recent discussions on involving the private sector, the term has been used to refer to the broad task of strengthening the international architecture to lessen the incidence and severity of crises involving a sharp withdrawal of private capital.

continued private sector involvement would depend on the circumstances of each case, as would the methods used to ensure it. Private sector involvement in resolving a financial crisis could, in some cases, be achieved mainly on the basis of the IMF's traditional catalytic role, with the strength of an IMF-supported adjustment program boosting market confidence and leading to the restoration of spontaneous private capital flows. In cases where greater assurance was needed, the catalytic role of the IMF would have to be supplemented by more direct or explicit measures to improve coordination among creditors.

In assessing the appropriate means to secure private sector involvement in individual cases, however, a range of complex issues requiring considerable judgment will have to be addressed. These include the size of financing needs, both during the program period and over the medium term; the prospects for a spontaneous return to capital market access; the availability of tools for securing concerted private sector involvement; and the desirability of minimizing possible spillover effects on other countries.

The basic principles underlying the IMF's approach to private sector involvement should be to allow the IMF to support effective balance of payments adjustment programs leading to sustained growth and medium-term viability, while safeguarding the revolving character of IMF resources. These principles, in turn, require that programs with member countries be fully financed. In addition, the availability of official financing, as far as possible, should not create moral hazard by providing incentives for inappropriate lending or borrowing.

The Executive Board stressed that, in making operational a framework for private sector involvement:

- contracts should be honored to the extent possible;
- members should seek cooperative solutions to emerging debt difficulties;
- no one category of private creditor should be regarded as inherently privileged relative to others; and
- the approach taken in individual cases should reflect a country's specific circumstances—including the composition of outstanding debt instruments—and should be based on an analysis of the country's medium-term balance of payments prospects and debt sustainability.

Executive Directors considered that, in conjunction with these principles, the framework suggested by staff for private sector involvement (outlined below) constituted a useful start. Nonetheless, they pointed to several problems in making the framework operational, including the difficulty of the underlying analytical judgments.

Under the approach discussed by the Board, private sector involvement could be ensured mostly through reliance on the IMF's traditional catalytic role:

- if the member's financing needs are moderate; or
- even when the financing needs are large, if the member has good prospects of rapidly regaining market access on suitable terms.

More concerted forms of private sector involvement could be required:

- if the financing need is large and the member has poor prospects of regaining market access in the near future; or
- if the member has a debt burden that appears unsustainable in the medium term.

The IMF's approach to a given case requires a decision on how much financing the official sector is willing to make available in support of a member's adjustment program. Most Executive Directors noted that IMF financing beyond that available under the IMF's access policy was limited and, while the Supplemental Reserve Facility (SRF) was available under specified circumstances, care had to be taken to avoid the impression that the IMF, or the official sector as a whole, would fill all financing gaps. At the same time, the difficulty of determining ex ante the precise distribution between official and private sector financing was noted. Some Directors favored a presumption that private sector involvement would be secured if the IMF's financing relative to the member's quota exceeds some limit. Others, however, felt that the size of the financing requirement was only one element in deciding on concerted involvement; they emphasized having a strong program that would assure the rapid restoration of market confidence and limit demands on official resources.

In cases when the IMF's traditional catalytic role and the assumption about the return to market access proved to be wrong, the risks to the program financing and the IMF's resources would grow unless there was a switch to more concerted forms of private sector involvement. To justify the strategy of relying on the catalytic role, the member country's program must be directed to rebuilding market confidence and removing any barriers to the right sort of capital inflows. The government must also be fully committed to sustained implementation. Some Directors felt reduced official financing might be needed in certain cases to ensure proper balance in the contributions of the private and official sectors.

When a member has an unsustainable debt burden, private sector involvement in restructuring or reducing that burden would be required. Determining whether a debt burden is unsustainable is a matter of judgment, and it could take time for the member and its creditors to agree on the extent of the problem and its solution. In such cases, the IMF would be prepared to lend to a member in arrears to its private creditors, as in other cases in which early support for a member's adjustment program was considered necessary, and provided the member was negotiating with its creditors in good faith.

Where private sector involvement is needed, its precise form will have to be decided case by case. Some Executive Directors considered the approach to be taken in individual cases should seek to avoid prohibitive increases in the future cost of borrowing for the country concerned. Directors believed that, in general, efforts to involve the private sector would be concentrated on the debt payments associated with the immediate financing problem, and would thus not necessarily be comprehensive across all classes of private instruments. Experience suggests, however, that comprehensiveness within an asset class can contribute to a successful outcome. In addition, it is particularly important that no one category of private creditor be seen as inherently privileged.

Only limited progress has been made in lifting institutional constraints to debt restructuring. Directors encouraged the establishment of creditor committees, if needed and on an ad hoc basis, and saw merit in incorporating collective action clauses into international sovereign bond contracts. The inclusion of such clauses in certain U.K. and Canadian sovereign bonds was welcomed, as was the clarification of the status of such clauses by the German government. Directors noted that temporary and voluntary market-based standstill arrangements could be desirable in some circumstances to minimize the risk of disruptive litigation; some believed there should be further consideration of issues related to changing the IMF's Article VIII, Section 2(b) (which describes members' obligation to avoid restrictions on current payments).

IMF staff have a role in informing creditors of the status of negotiations between the IMF and the member, and of the member's economic situation—including its adjustment program and payment capacity—if this is acceptable to the member concerned. Nevertheless, it is important to preserve the principle that the IMF is not a party to the negotiations between a member and its creditors.

In its April 2000 communiqué, the International Monetary and Financial Committee underscored the importance of prevention as the first line of defense against crises and noted that countries participating in international capital markets and their private creditors should seek, in normal times, to establish a strong, continuous dialogue. Collective action clauses could help facilitate orderly crisis resolution.

The Committee noted that the IMF had an important role with regard to crisis resolution and agreed that the approach adopted by the international community should provide for flexibility to address diverse cases within a framework of principles and tools, and be based on the IMF's assessment of a country's underlying payment capacity and prospects of regaining market access.

In some cases, the combination of catalytic official financing and policy adjustment should allow the country to regain full market access quickly. In some cases, emphasis should be placed on encouraging voluntary approaches, as needed, to overcome creditor coordination problems. In other cases, the early restoration of full market access on terms consistent with medium-term external sustainability may be judged to be unrealistic, and a broader spectrum of actions by private creditors—including comprehensive debt restructuring—may be warranted to provide for an adequately financed program and a viable medium-term payments profile.

In cases where debt restructuring or debt reduction may be necessary, the Committee agreed that IMF-supported programs should emphasize medium-term sustainability and strike an appropriate balance between the contributions of the private external creditors and the official external creditors, in light of financing provided by international financial institutions. The Committee stressed the need to aim for fairness in the treatment of different classes of private creditors, and that no class of creditors should be considered inherently privileged. The IMF should review the country's efforts to secure needed contributions from private creditors in light of these considerations, as well as medium-term sustainability. The responsibility for negotiation with creditors must be placed squarely with debtor countries. The international financial community should not micromanage the details of any debt restructuring or debt reduction negotiation.

The International Monetary and Financial Committee agreed that the IMF should consider whether private sector involvement was appropriate in programs supported by the IMF. In this regard, the Committee also agreed on the need to provide greater clarity to countries about the terms and conditions of their programs. When all relevant decisions were made, the IMF should set out publicly how and what policy approaches have been adopted.

Reform of IMF Facilities

The Board initiated in FY2000 a review of IMF financial facilities or policies to determine whether and how they need to be modified. The review led to the elimination of four obsolete facilities (and expiration of the temporary Y2000 (Y2K) facility) and consideration of modifications to other nonconcessional facilities (see Chapter 6).

International Monetary and Financial Committee

On September 30, 1999, the IMF's Board of Governors adopted a resolution approving a proposal of the Executive Board to transform the Interim Committee of the Board of Governors on the International Monetary System into the International Monetary and Financial Committee of the Board of Governors. In addition to the name change, the Board of Governors explicitly provided for preparatory meetings of representatives of the Committee members (deputies). The new Committee continues to advise and report to the Board of Governors with respect to the functions of the Board of Governors in:

- supervising the management and adaptation of the international monetary and financial system, including the continuing operation of the adjustment process, and in this connection reviewing developments in global liquidity and the transfer of real resources to developing countries;
- considering proposals by the Executive Board to amend the Articles of Agreement; and
- dealing with sudden disturbances that might threaten the system.

The members of the International Monetary and Financial Committee reflect the composition of the Executive Board: each country that appoints, and each group that elects, an Executive Director, appoints a member of the Committee.