Overview

The IMF's 2005 financial year, the period covered by this Annual Report,[1] marked an important stage in the Fund's development. The 60th anniversary of the July 1944 Bretton Woods Conference, at which the establishment of the IMF and the World Bank was agreed, was a notable landmark for these institutions. Rodrigo de Rato was appointed by the Executive Board to be the Managing Director of the IMF beginning in June 2004, and under his leadership the Fund embarked on a broad strategic review of its activities. In addition, several other, specifically targeted, reviews already under way were concluded.

The IMF's work during the year covered by this report is set out in detail in subsequent chapters. The Fund's work is largely dictated by developments in the world economy and in the economies of its 184 member countries, and by the need to anticipate the challenges that these developments pose. The aim of this introductory chapter is to give a brief overview of the Fund's activities and to set them in the context of global economic developments.

World economy

The past year saw the most rapid global growth in three decades, with improved economic performance in almost every region of the world, subdued inflation, and a marked absence of serious financial crises. There was thus a very favorable international environment for the IMF's operations. Yet the going was not entirely smooth: oil prices rose sharply and substantially; there were continuing geopolitical uncertainties; global payments imbalances widened further; and many of the Fund's member countries continued to grapple with significant social and economic problems, including poverty.

[1]May 1, 2004–April 30, 2005 (FY2005).

At the same time, the benign global economic situation and outlook provided an important opportunity to introduce and implement the economic reforms needed to tackle deep-seated problems. It also provided an opportunity for the Fund to embark on a broad examination of its strategic direction, aimed at assessing its role and activities in the evolving circumstances of the years ahead.

The IMF's 2005 financial year was a period of remarkable expansion for the global economy. At 5.1 percent in calendar 2004, annual growth was the fastest in nearly thirty years. In the first quarter of 2005 (the final calendar quarter of the Fund's financial year), growth remained more buoyant than had been expected. Even more striking, and additionally welcome, was the extent to which this rapid growth was experienced by all regions of the world, including those, such as Latin America, the Middle East, and sub-Saharan Africa, where growth performance had tended to lag well behind.

Among the industrial countries, the United States continued to be the most rapidly growing economy, maintaining its strong recovery from the modest downturn of 2001–02 and continuing to underpin the global expansion. In Japan, the economic recovery that began in 2003 paused in mid- and late 2004 but regained momentum in early 2005. Growth in the euro area continued to be disappointing, with domestic demand remaining weak, especially in Germany.

Most emerging market and developing countries recorded relatively rapid growth. In Asia, growth in the region as a whole was fueled by continuing strong expansion in China and rapid growth in India. Emerging Asia was the fastest-growing region during the period. But in Latin America there was evidence of strong recovery in most parts of the continent; the Middle East recorded higher growth than expected; and growth in sub-Saharan Africa was more rapid than at any time over the past eight years. And in spite of the sluggish growth performance of their close trading partners in the euro area, the countries of the Commonwealth of Independent States (CIS) continued to experience strong expansion.

World trade grew even faster than output, by 9 percent in 2004, continuing the long-term tendency for trade to expand relative to output, and underlining the contribution that the expansion of trade has consistently made to economic growth. In early 2005, however, there were signs of a slowdown in the growth of trade, possibly related to slower expansion in manufacturing in a number of countries.

Inflation increased slightly in most parts of the world compared with 2003 but generally remained subdued, which also contributed to the strong global expansion. It has become increasingly clear in recent decades that low inflation is essential for sustained and rapid growth, which in turn provides the most reliable route to the lasting reduction of poverty that is an important priority for many of the IMF's members.

The strong global expansion, and especially its widespread nature, owed much to the adoption in many countries of appropriate policies. In recent years, there has been a growing recognition of the importance of establishing a stable macroeconomic framework as a precondition for strong growth that can be sustained over a long period. Sound macroeconomic policies make it easier for countries to withstand the downturns that are an inevitable part of the economic cycle. They also increase an economy's resilience in the face of shocks.

Global economic risks

The rapid growth of the world economy in FY2005 brought opportunities and challenges for the IMF's members and the IMF itself. However, two issues threatened to cast a shadow over the world economic outlook: higher oil prices and large global payments imbalances.

Rising oil prices posed risks for oil-importing countries, and were especially painful for low-income countries. The extent of the problems that higher energy prices posed in different countries depended on the energy intensity of production and consumption, the impact on the terms of trade, and economies' flexibility in responding to shocks. The experience of earlier oil price shocks had underlined the risks of higher prices for oil-exporting countries as well. Rising oil revenues have tended to tempt policymakers to relax fiscal discipline more than is desirable. History has shown that dealing with oil revenue windfalls while preserving macroeconomic stability is a difficult challenge for governments in both industrial and developing countries.

Concern about the possibility of a sudden adjustment of global payments imbalances continued to preoccupy the IMF and many policymakers during FY2005. The large and rising U.S. current account deficit, and the corresponding surpluses in Japan, emerging Asia, the oil-producing countries of the Middle East, and other countries, were the focus of these concerns. The IMF made its view clear that resolving these imbalances is a shared responsibility of the international community and endorsed a broad strategy that included medium-term fiscal consolidation in the United States, continued structural reforms to boost growth of demand and output in Europe and Japan, and, in emerging Asia, steps toward greater exchange rate flexibility, supported by continued financial sector reform. There was widespread agreement that implementation of this strategy would help correct these imbalances in an orderly manner and avoid a sudden and painful adjustment.

In the event, concerns that rising oil prices and global imbalances would undermine global growth did not materialize during the period under review; but nor did they dissipate. If high oil prices persist, some countries will remain more vulnerable than they otherwise would be. And without widespread policy adjustments, global imbalances continue to pose risks for future global growth.

At the same time, the expansion of the world economy brought opportunities. The most important of these in the short term was the chance for many countries to take the policy measures necessary to make current growth rates sustainable, and then to go further and raise the sustainable growth rate. These include the adoption of fiscal policies that curb budget deficits and make possible countercyclical policies during downturns. Many industrial and developing countries have budget deficits that are uncomfortably large for the peak of a cycle, which restricts their room for maneuver in the event of a downturn. Improving long-term growth potential also requires removing the structural impediments to more rapid growth—freeing up labor and product markets, and liberalizing trade. Such policy adjustments would benefit both industrial and developing countries.

Strengthening fiscal policy and taking steps to make economies more flexible and thus capable of faster expansion inevitably pose difficult political challenges for policymakers who have to account to their electorates, especially given that reforms take time to deliver tangible benefits in terms of growth. Although history shows that necessary changes are sometimes implemented at times of economic difficulty, when pressure for adjustment is strong, periods of relatively rapid global expansion should offer the best environment in which to pursue economic reforms.

This is equally true of the longer-term reform agenda, where it has become increasingly clear that looming demographic changes pose important challenges for a large number of IMF member countries. The fraction of post-retirement-age dependents in the population is already rising in many industrial economies; and some large emerging market economies, such as China and Korea, will also see their dependency ratios—defined as the number of retirees expressed as a percentage of the workforce—rise sharply in the short to medium term. In other emerging market economies, the full impact of these demographic changes will not be felt for some time, but in many of these countries the public finances are already under strain because of existing pension arrangements that are underfunded. There is increasing evidence that confronting these demographic problems sooner rather than later will mean that the adjustments, whether to pension contributions, benefits, or the retirement age (or a combination of all three), can be much more modest than if remedial action is postponed.

The work of the Fund

The IMF's mandate is clearly defined by its Articles of Agreement: to promote macroeconomic and financial stability at the global and national levels, to promote international monetary cooperation in the interests of all its members, to foster a liberal system of trade and payments, and to prevent international crises, as far as possible. The aims are clear, but how they are best achieved inevitably evolves over time. The Fund is, and must remain, a learning institution, seeking to strengthen its work, including by listening to, and learning from, its official and nonofficial interlocutors. It seeks to adapt on the basis of experience. But it also seeks to work pre-emptively, by anticipating challenges and responding to them in a timely manner—an important part of its crisis prevention work.

In FY2005, in the global context described above, an important challenge for the Fund was to continue to be an effective advocate for policies, including reforms, that, at the national level, would foster macroeconomic stability, rapid growth, rising living standards, and poverty reduction, and to argue the case for pre-emptive action in an unusually favorable global economic environment.

The IMF's surveillance work, one of its core activities, remains the principal channel for the advocacy of appropriate policies. As Chapter 1 outlines in more detail, the Fund's surveillance work has three dimensions: global, regional, and national. At the global level, through instruments such as the *World Economic Outlook* and the

Global Financial Stability Report, the Fund assesses the international outlook and examines and highlights the risks to its central projections. At the regional and national levels, principally through its work on Article IV consultations, the Fund assesses national policies and objectives, and the accompanying risks, and provides advice on appropriate responses.

IMF policy advice, provided by the Executive Board in the context of Article IV consultations, reflected the concerns highlighted earlier about rising oil prices and global imbalances. In preparing Article IV reports on countries where macroeconomic stability had yet to be achieved, Fund staff focused on the need to ensure that policies were directed to implementing appropriate fiscal reforms, lowering inflation, and creating the conditions for sustained and fast-paced growth. In the many other member countries where a stable macroeconomic framework was in place, Fund advice was directed more toward ensuring the implementation of structural reforms aimed at medium-term sustainability and at raising potential output and growth. Attention was also paid to longer-term issues such as demographic changes. IMF staff, and the Executive Board, always seek to be constructive when identifying policy weaknesses and to identify superior alternatives. Staff and the Board also strive to endorse sound macroeconomic policies identified in Article IV consultations.

In addition to its operations with member countries, the IMF in FY2005 reviewed its own activities on several fronts. The core responsibilities of the IMF, as envisaged by its founders more than sixty years ago, remain essential for the effective functioning of the global economic and financial systems. But just as national economies and economic policies must adapt to keep pace with global economic developments, the Fund, too, must be ready constantly to review the ways in which it conducts its business, so that it can best serve its member countries. IMF advice to its members stresses the importance of continuous evolution, and this is a fitting principle for the Fund to apply to its own work and working methods. Transparency, which has become a vital ingredient of the IMF's work over the past decade, has enabled the Fund to conduct large-scale reviews of its activities in an open manner, alert to the needs of all its members while avoiding the impression of undue introspection.

FY2005 saw the conclusion of a number of specific reviews targeting different aspects of the IMF's work. Central among these were the biennial review of the Fund's surveillance work, including an assessment of the increasing importance of financial sector surveillance (described in Chapter 2), and a new review of conditionality, the first since 2000–02 (Chapter 3). Reports from the Independent Evaluation Office provided the opportunity to review, for example, the growing role of IMF technical assistance and the Fund's role in the run-up to the crisis in Argentina in 2001.

More fundamentally, the IMF has taken advantage of the opportunity provided by the relatively favorable global economic environment to embark on a major review of its strategic direction. Such a stocktaking is timely. The global economic and financial system has evolved rapidly in the last decade or two, and the Fund has made considerable changes in response, especially in the past decade, as part of broader reforms of the international financial architecture. With these initiatives maturing, the time has come to step back and review the challenges ahead. The strategic review was started in 2004, and work on the Fund's medium-term strategy—intended as a guide to decision making on the medium-term budgetary framework and work program—is due to be completed in time for the Annual Meetings in September 2005, when the conclusions will be considered by the International Monetary and Financial Committee (IMFC).

The strategic review is anchored in a shared understanding of the IMF's purposes: it became clear at a very early stage in the review process that the Board is generally agreed on the Fund's core mission, as set out in the Articles of Agreement. But the Fund needs to have clear priorities if it is to achieve its principal aims in an effective manner. The focus of the strategic review is on how the IMF can best fulfill its mandate; it aims to develop priorities for the Fund's future activities, and to identify trade-offs and possible organizational changes. Adopting a medium-term budgetary framework is a key component of this effort, which will enable priorities to be determined and kept under review.

Thus surveillance, financial support, and technical assistance will remain the principal components of the Fund's work. But their effectiveness will depend on their continuing evolution to meet the changing global financial environment and the changing needs of member countries. The rapid growth of private capital flows, for example, has had a major impact on the international financial system. Such capital flows can improve both access to investment capital, for industrial and developing countries, and the efficiency of resource allocation. But they can also pose important risks, for individual countries and for the world economy as a whole.

The increasing interdependence of economies has made it more important than ever for the international community to help countries implement policies that will promote domestic and global prosperity. The IMF, with its virtually global membership and mandate to promote international monetary cooperation and sound economic and financial policies, is the natural forum for multilateral cooperation to promote stability and growth in the world economy. It has a responsibility to help countries get their macroeconomic policies and institutions right—a responsibility that shines a spotlight on the quality, persuasiveness, and focus of its policy advice. A special challenge in this regard, particularly given the increased appreciation in recent years of the importance for stability and growth of a broad range of structural and institutional factors, is for the Fund to be focused in its operations on the issues that matter most in each member country, while maintaining evenhandedness of treatment. In a world of increasingly integrated capital markets, it is also important that the Fund continue to develop its understanding of capital flows and their implications. This will strengthen the basis for its advice to members on ways to foster sound domestic financial systems, to gain access to the international capital markets, and to reduce vulnerability to capital account shocks and volatility.

Work on the strategic review has underlined the importance of the IMF's work in low-income countries: how can the Fund do more to support these countries, especially in helping them achieve the Millennium Development Goals? The Poverty Reduction Strategy process is one of the tools that the Fund uses to meet its responsibilities in this area. The improved macroeconomic performance of some low-income countries during the period under review in this report reflected in part the widespread recognition that macroeconomic stability is a prerequisite for raising growth rates to levels that, sustained, can lead to significant and lasting poverty reduction. And macroeconomic reforms in many poor countries have already brought benefits, such as lower inflation and more rapid growth and poverty reduction. In this context, additional transfers from the donor community could help some low-income members build on the progress achieved thus far, provided these are used to buttress policies promoting sustained growth and not substitute for them. A challenge for the Fund remains to identify clearly how its activities—its surveillance, its financing instruments, the design of the programs it supports, its technical assistance, and, potentially, further debt relief—should be shaped to meet the special circumstances of these countries.

The strategic review has also reconfirmed that providing temporary financial assistance to members with short-term balance of payments problems remains a central element of the IMF's work. The Fund is continually working to ensure that its financial resources are used efficiently and in a way that best meets the needs of the membership as a whole. This means that the revolving character of IMF resources must be protected and that countries should "exit" from Fund financial support as and when they are able to do so. The Fund must structure its lending instruments accordingly, and the maturities and charges associated with IMF financial assistance—which are being reviewed in FY2006—are an important element in this respect. More broadly, challenges remain in forging a more solid consensus on the appropriate circumstances and scale of Fund lending, including in cases where countries need a signal of policy soundness rather than financing, and in cases of capital account crises.

The past year was, in some ways, one of intense reflection for the IMF, and this will continue as some of the questions highlighted in the strategic review are explored in more detail. Such reflection is appropriate for an institution that seeks continuously to be ready to serve the needs of its members, and of the international financial system as a whole, in a rapidly changing global economy. To carry out those responsibilities effectively requires a readiness, and an ability, to adapt to changing circumstances—sometimes very quickly. Having a medium-term framework that permits the Fund to establish priorities, and to alter them in a transparent way, could have a profound and positive impact.