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GLOBAL FINANCIAL CRISIS

IMF Backs Coordinated Action to Combat Crisis

Coordinated global action is starting to reverse the tide of the financial crisis, but governments also need to "deploy all instruments" to limit damage to the real economy, IMF Managing Director Dominique Strauss-Kahn told world financial leaders meeting in Washington.

"Until this weekend, the collapse in confidence in the markets has been almost matched by a collapse in confidence between countries. We saw a very bad trend toward unilateral measures taken with national interests in mind. Now things are beginning to turn around," Strauss-Kahn said in a speech at the end of the October 10–13 IMF–World Bank Annual Meetings.

But he said there was still a long way to go to stabilize financial markets and revive the battered world economy. "Action in the financial markets is essential, but it is not sufficient. We also need to deploy all of the instruments of modern macroeconomic policy to limit the damage to the real economy," he stated.

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Stephen Jaffe/IMF photo

U.S. Federal Reserve Chairman Ben Bernanke (left) with IMF Managing Director Dominique Strauss-Kahn at the IMFC meeting.

IMF Predicts Major Global Slowdown

The world economy is decelerating quickly—buffeted by an extraordinary financial shock and by still-high energy and commodity prices—and many advanced economies are close to or moving into recession, the IMF says in its latest *World Economic Outlook* (*WEO*).

The October 2008 report, which was released two days prior to the IMF–World Bank Annual Meetings in Washington, said that growth in emerging economies is also weakening after years of strong performance, though emerging markets will still drive global growth.

Speaking at the *WEO* press conference, IMF Chief Economist Olivier Blanchard emphasized the importance of implementing joint financial and macroeconomic policies at this point "to stem the negative momentum on multiple fronts." On the financial side, "this implies the design of comprehensive programs to deal with systemic problems," while on the macroeconomic side, "this implies the use

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Layne Bailey/Charlotte Observer

Financial turmoil effects are spreading to firms that rode oil price hikes but now face sharply slowing demand.

IMF Asked to Take Lead on Crisis Lessons

The IMFC called on the IMF to take the lead in drawing the necessary policy lessons from the current crisis and recommending effective actions to restore confidence and stability (see Communiqué, page 154).

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IMF Backs Coordinated Action to Combat Crisis

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The IMF will take the lead to draw lessons from the crisis and recommend to member countries further action to restore confidence and stability.

Padraic Hughes/IMF photo

U.S. President George W. Bush (at left) with G-20 Chair Guido Mantego.

World has learned from 1930s

In an address to the IMF's Board of Governors, Strauss-Kahn said that the world was going through the most dangerous financial crisis since the Great Depression of the 1930s. But because of lessons learned, the world now had the economic tools to "emerge from this crisis with our economies and our societies intact."

During the weekend, world financial and political leaders meeting in Washington and Paris put together a series of plans and statements to combat the financial crisis and restore confidence in the global financial system hit by a severe credit crunch triggered initially by the collapse in the United States.

Leaders of the Group of Seven (G-7) advanced economies, the 15 members of the euro area, the International Monetary and Financial Committee (IMFC) representing the IMF's 185 member countries, and the Group of 20, which represents both advanced and developing economies, all agreed on the need for coordinated action around the world.

New approaches

Strauss-Kahn said governments were willing to try new approaches to end the downward spiral in markets. "Increasingly, these approaches are comprehensive, attacking all aspects of financial market problems: liquidity, bad assets, shortage of capital, and, especially, confidence," he said.

The centerpiece of the G-7 plan is a stronger than ever commitment to use all available tools to support systemically important financial institutions. The plan outlines specific mechanisms that countries can use to support the system, jump-start credit, and restore confidence.

Euro area countries announced that they would buy into banks to boost their finances and guarantee interbank lending until the end of next year. British Prime Minister Gordon Brown said after leaving the meeting, "I believe that in the next few days confidence in the banking system will be restored."

Strauss-Kahn said that the worldwide response did not have to be uniform but should be coordinated. "We still have a very long way to go. We don't all need to have the same policies, but we must all talk to each other about our policies and consider the effects of our actions on our partners. This weekend is just the beginning of a long effort."

Spurring the real economy

Strauss-Kahn said action was needed to limit damage to the real economy. Growth in the world economy, according to the IMF's latest *World Economic Outlook,* is set to slump to about 3 percent in 2009. The IMF Managing Director outlined how advanced economies, emerging markets, and developing countries should react.

- ***Advanced economies*** should use "fiscal policy when they can." The most obvious use of fiscal policy is to ease pressures where they are greatest: in the financial and housing sectors. But governments that can afford it should also be ready to undertake a broader fiscal stimulus. Scope exists to use monetary policy to support growth, building on the collaborative easing of interest rates already implemented by central banks.
- ***Emerging economies*** have differing degrees of freedom to act. Some can afford to draw down reserves to finance a temporary and sudden shortfall in capital flows.

Others will need to raise policy interest rates in line with rising risk premiums to stem outflows and bolster confidence in their currencies. Some may need very substantial help, including from the IMF. "We have plenty of liquidity," Strauss-Kahn said.

• ***Developing countries*** face reduced export demand and reduced access to trade credit. And many are already suffering from the other crisis—the food and fuel crisis that has strained budgets and balances of payments, and raised inflation and living costs. Strauss-Kahn committed IMF help to countries in difficulty. He urged developed countries not to cut aid budgets because of the financial crisis.

Learning lessons

Strauss-Kahn said the crisis in financial markets was the result of three failures: a regulatory and supervisory failure in advanced economies, a failure in risk management in the private financial institutions, and a failure in market discipline mechanisms.

"Preventing a recurrence of these failures will require an international effort, because borders do not confine financial institutions or keep out financial turmoil," he said.

The IMFC has asked the Fund to take the lead in drawing the necessary policy lessons from the current crisis and recommending effective actions to restore confidence and stability. The Fund will work with the Financial Stability Forum, the G-20, and others, and is scheduled to report to the IMFC at the latest at its next meeting, which will be in April 2009.

The IMFC called for "further intensive Fund engagement across the membership to discuss and develop robust policy responses to the crisis." Both new IMFC head Youssef Boutros-Ghali (see box, page 156) and Strauss-Kahn acknowledged that actions taken by individual governments would vary, depending on their situation and structure of their financial system.

In a speech on October 10, ahead of the G-7 announcement, Strauss-Kahn had proposed a four-point action plan to help stem the downward spiral in world markets and begin to rebuild confidence. The proposal included a temporary government guarantee of liabilities, government action to take out troubled assets and force the recognition of losses, government provision of capital to the financial system, and a high degree of international cooperation.

Stephen Jaffe/IMF Photo

Strauss-Kahn (second from left) with G-7 leaders in White House Rose Garden: Government responses to the crisis are increasingly comprehensive.

IMF ready to lend quickly

The former French Finance Minister, who took over as Managing Director of the IMF last year, has stressed that the Fund stands ready to lend quickly through its emergency financing mechanism to any member country in financial difficulty. "The IMF has the resources and we are ready," he said. The IMF's Emergency Financing Mechanism was set up in 1995 and has been used on six occasions—in 1997 during the Asian crisis for the Philippines, Thailand, Indonesia, and Korea; in 2001 for Turkey; and this year for Georgia.

The IMF has more than $200 billion of lendable funds and can draw on additional resources through two standing borrowing arrangements.

The difficult global financial environment, including elevated food and fuel prices, adds to the challenges for emerging market and developing countries to preserve macroeconomic stability, sustain growth, and make progress on poverty reduction. For these reasons, it is critically important that collaborative action be coordinated between advanced and emerging economies. ■

Wealth Funds Group Publishes Voluntary Principles

The International Working Group of Sovereign Wealth Funds (IWG) published October 11 a set of 24 voluntary principles designed to ensure an open international investment environment. The IWG also started examining the creation of a permanent international body to represent sovereign wealth funds. The IWG, representing 26 sovereign wealth funds, presented the Santiago Principles—agreed in the Chilean capital in September—to the IMF's policy-setting body, the International Monetary and Financial Committee.

An IWG statement said the purpose of the Santiago Principles was to

• Establish a transparent and sound governance structure that provides for adequate operational controls, risk management, and accountability

• Ensure compliance with applicable regulatory and disclosure requirements in the countries in which SWFs invest

• Ensure SWFs invest on the basis of economic and financial risk and return-related considerations, and

• Help maintain a stable global financial system and free flow of capital and investment.

SWFs are open to being more transparent, IWG co-Chair Hamad Al Suwaidi told a news conference, noting that the Santiago Principles specifically commit wealth funds to make a series of public disclosures.

IWG co-Chair Jaime Caruana, Director of the IMF's Monetary and Capital Markets Department, noted that investors with long-term horizons contributed to financial stability. "That's exactly the role that SWFs can play, because they have this kind of long-term view."

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of monetary and fiscal policies to support growth and break negative feedback loops between the financial and real sectors," he said.

"With the right macro and financial policies—and these policies are available—we can ride the storm, and expect a recovery to start in the course of 2009," he added.

Very gradual recovery

The world economy is entering a major downturn in the face of the most dangerous financial shock in mature financial markets since the 1930s, according to the *WEO*, which now expects world growth to slow to 3.0 percent in 2009—0.9 percentage point lower than forecast in the July 2008 *WEO Update*.

Following sluggish growth through the remainder of 2008 and early 2009, the anticipated recovery later in 2009 will be exceptionally gradual by past standards. This is because financial conditions are expected to remain very difficult, even assuming that actions by the U.S. and European authorities succeed in stabilizing financial conditions and in avoiding further systemic events.

"In advanced countries, the crisis is now being driven by a downward spiral of loss of confidence and trust," Blanchard said. The effects are spreading to consumers and firms, he warned, which had so far weathered the recent price hikes in oil and commodities well but are now experiencing sharply slowing demand.

However, despite the emerging economies' cooling momentum, they are still expected to provide a source of resilience, benefiting from strong productivity growth and improved policy frameworks. But the longer the financial crisis lasts, the more the emerging economies' growth is likely to be affected, Blanchard said.

Inflation easing in advanced economies

The combination of rising economic slack and stabilizing commodity prices is expected to contain the pace of price increases in advanced economies. But in many emerging and developing economies, inflation is projected to remain elevated through the end of 2008 as recent commodity price increases continue to feed through to consumers, before easing somewhat by the end of 2009.

Despite the deceleration of global growth, headline inflation has risen around the world to the highest rates since the late 1990s, pushed up by the surge in fuel and food prices. In the advanced economies, 12-month headline inflation registered at 4¼ percent in August 2008, down modestly from a peak in July in the wake of some commodity price easing.

The resurgence in inflation has been more marked in the emerging and developing economies, with headline inflation reaching 8¼ percent in the aggregate in August and with a wide swath of countries now experiencing double-digit inflation.

Wage increases

To some extent, the difference reflects the considerably greater weight of food prices in consumption baskets in these economies—typically in the range of 30–45 percent, as opposed to 10–15 percent in the advanced economies. However, inflation—excluding food and fuel—has also accelerated markedly, and there are signs of rising inflation expectations and wage increases, although such data are not as systematically available as in the advanced economies.

The *WEO* notes that commodity prices remain at much higher levels in real terms than at any time in the past 20 years, despite some decline since mid-July amid the slowdown of the global economy. The driving force behind the sustained run-up in commodity prices has been the tightness of demand-supply balances for many key products and the realization that markets are likely to remain tight for the foreseeable future, after many years of ample capacity.

Risks to baseline projections

The latest report sees the principal downside risk to growth from two related financial concerns: persistent financial stress and the credit constraints from deleveraging, which could be deeper and more protracted than in the baseline scenario; and the U.S. housing market deterioration, which could be deeper than forecast, while European housing markets could weaken more broadly than envisaged in the baseline.

As noted in the October 2008 *Global Financial Stability Report* released on October 7, a failure to restore confidence in the global financial system through internationally coherent and decisive policy measures could lead to an increasingly disorderly unwinding of leverage. This, in turn, would imply greater costs to the real economy than are built into the baseline projections of the *WEO*.

In this exceptionally uncertain situation, there are substantial downside risks to the baseline outlook. In addition to concerns related to protracted financial stress and the deteriorating U.S. housing market, potential disruptions to capital flows to emerging economies and the risks of rising protectionism represent additional risks to the recovery. Inflation risks to growth, however, are now more balanced because commodity prices have retreated in response to slowing global growth.

Prospects for a turnaround

The advanced economies grew at a collective annualized rate of only 1 percent from the fourth quarter of 2007 through the second quarter of 2008. The U.S. economy suffered the most from the financial crisis that originated in its subprime mortgage market, which has tightened credit conditions and amplified the housing correction that has been under way since 2006.

Emerging and developing economies have not decoupled from this downturn. The *WEO* notes that growth has also eased for this group of countries as a whole. Growth has been most resilient in commodity-exporting countries, while countries with strong trade links to the United States and Europe are slowing markedly. Also, some countries that rely heavily on bank-related or portfolio inflows to finance large current account deficits have been hit hard by an abrupt tightening of external financing.

The baseline projections show the global economy undergoing a major downturn, with growth falling to its slowest pace since the 2001–02 recession. Although a gradual recovery is envisaged in late 2009, global growth is not expected to return to trend until 2010. The report sees the eventual recovery as being supported by the unwinding of adverse terms-of-trade effects as commodity prices stabilize, a turnaround in the U.S. housing market, and rising confidence that the liquidity and solvency problems in core financial institutions are being resolved.

On an annual basis, global growth is expected to moderate from 5.0 percent in 2007 to 3.9 percent in 2008 and 3.0 percent in 2009 (see table).

For the remainder of 2008 and early 2009, the U.S. economy faces flat to negative growth as support from the fiscal stimulus ebbs, export momentum moderates, and tight financial conditions take an increasing toll. An emerging turnaround in the housing sector and more stable oil prices should help lay the basis for incipient recovery in the second half of 2009, but the revival is expected to be much more gradual than in previous business cycles, as tight credit conditions continue to weigh heavily on domestic demand.

Most other advanced economies are also expected to go through a period of extremely sluggish growth or contraction in 2008 and the first half of 2009, and experience only a modest upturn in the latter part of the year.

Growth in emerging and developing economies is also projected to continue to decelerate, falling somewhat below trend during the second half of 2008 and early 2009, before picking up in the course of the year. During this period, overall growth in these countries is projected to remain well above rates experienced in the 2001–02 global downturn.

Export growth will continue to slow and domestic demand will also moderate, although demand will continue to be supported by the strong productivity gains made in recent years. Commodity-exporting countries—particularly oil exporters—are expected to maintain their momentum, but growth in countries dependent on food and fuel imports or external financing will slow quite sharply. Net external capital inflows are projected to fall by half in the aggregate, and some countries could face substantial pressure on reserve positions.

Serious global downturn

A deep financial crisis and continuing high commodity prices have led to fast deteriorating global growth.

(percent change, unless otherwise noted)

	Year-on-Year		
		Projections	
	2007	2008	2009
World output	**5.0**	**3.9**	**3.0**
Advanced economies	2.6	1.5	0.5
United States	2.0	1.6	0.1
Euro area	2.6	1.3	0.2
Germany	2.5	1.8	—
France	2.2	0.8	0.2
Italy	1.5	–0.1	–0.2
Spain	3.7	1.4	–0.2
Japan	2.1	0.7	0.5
United Kingdom	3.0	1.0	–0.1
Canada	2.7	0.7	1.2
Emerging and developing economies	8.0	6.9	6.1
China	11.9	9.7	9.3
India	9.3	7.9	6.9
Western Hemisphere	5.6	4.6	3.2

Source: *World Economic Outlook*, October 2008.
Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during August 18–September 15, 2008.

Policy challenges

The *WEO* underscores that policymakers around the world face the imperative of stabilizing global financial markets, while nursing their economies through a global downturn and tight credit and ensuring that the recent rise in inflation is reversed.

Policymakers also face the enormous challenge of dealing with the immediate threat to financial stability, while also paving the way for rebuilding a firm underpinning for financial intermediation. Achieving this daunting task will require comprehensive solutions that address the systemic problems—the proliferation of illiquid problem assets, the shortage of capital, and the collapse of counterparty confidence—while dealing rapidly and effectively with emerging problems in individual institutions.

Macroeconomic policymakers are seeking to find a balance between supporting activity during a global downturn and extremely difficult financial conditions and ensuring that the sustained shift in relative prices implied by the surge in commodity prices does not drive a ratcheting-up of inflation, as occurred in the 1970s.

Commodity market strains

The appropriate policy approach will vary across countries. A turn to more supportive stances is justified in some economies now facing recession as a result of financial strains, housing downturns, and terms-of-trade losses. Nevertheless, policy tightening is still called for in a number of countries that are still growing well above their speed limits.

The recent decline in commodity prices as the world economy slowed should not be allowed to undercut policy efforts to relieve strains in commodity markets. The focus should be on policies to improve supply and demand responsiveness, while avoiding measures that could exacerbate market tightness in the short term.

Finally, it will be important to ensure that large imbalances in trade flows do not lead to a buildup in protectionist measures on either the current or capital account. Breaking the current deadlock on the Doha Round of multilateral trade talks would help strengthen the open multilateral trading system. ■

Subir Lall
IMF Research Department

IMFC Communiqué

World Finance Chiefs Endorse Action Plan to Counter Crisis

At the IMFC meeting on October 11, world financial leaders endorsed an action plan to combat the international financial crisis.

Stephen Jaffe/IMF Photo

The International Monetary and Financial Committee held its eighteenth meeting in Washington, D.C. on October 11, 2008 under the Chairmanship of Youssef Boutros-Ghali, the Minister of Finance of Egypt. The Committee welcomes Dr. Boutros-Ghali, the new IMFC Chairman. The Committee expresses its deep gratitude to Mr. Tommaso Padoa-Schioppa for his invaluable role as the Committee's Chairman in securing the membership's support for critical IMF reforms, and extends its best wishes.

Yesterday, October 10, the G-7 met and agreed the following plan of action:

- "Take decisive action and use all available tools to support systemically important financial institutions and prevent their failure.
- Take all necessary steps to unfreeze credit and money markets and ensure that banks and other financial institutions have broad access to liquidity and funding.
- Ensure that our banks and other major financial intermediaries, as needed, can raise capital from public as well as private sources, in sufficient amounts to re-establish confidence and permit them to continue lending to households and businesses.
- Ensure that our respective national deposit insurance and guarantee programs are robust and consistent so that our retail depositors will continue to have confidence in the safety of their deposits.
- Take action, where appropriate, to restart the secondary markets for mortgages and other securitized assets. Accurate valuation and transparent disclosure of assets and consistent implementation of high quality accounting standards are necessary.

The actions should be taken in ways that protect taxpayers and avoid potentially damaging effects on other countries. We will use macroeconomic policy tools as necessary and appropriate. We strongly support the IMF's critical role in assisting countries affected by this turmoil. We will accelerate full implementation of the Financial Stability Forum recommendations and we are committed to the pressing need for reform of the financial system. We will strengthen further our cooperation and work with others to accomplish this plan."

Today the International Monetary and Financial Committee strongly endorsed the above commitments.

The Committee recognizes that the depth and systemic nature of the crisis call for exceptional vigilance, coordination, and readiness to take bold action. It underscores that the Fund has a critical mandate to foster the multilateral cooperation needed to restore and safeguard international monetary and financial stability. The Committee considers that, using its emergency procedures, the Fund stands ready to quickly make available substantial resources to help member countries cover financing needs. The Committee calls for further intensive Fund engagement across the membership to discuss and develop robust policy responses to the crisis.

Moreover, the Committee notes that many emerging market economies, which have implemented sound policies in recent years, may experience spillover effects from the financial crisis. The difficult global financial environment, including elevated food and fuel prices, adds to the challenges for emerging market and developing countries to preserve macroeconomic stability, sustain growth, and make progress on poverty reduction. For these reasons, it is critically important that collaborative action be coordinated between advanced and emerging economies.

The Committee calls on the Fund—given its universal membership, core macro-financial expertise, and its mandate to promote international financial stability—to take the lead, in line with its mandate, in drawing the necessary policy lessons from the current crisis and recommending effective actions to restore confidence and stability. It asks the Fund to focus discussion, and enhance cooperation, with a wide range of perspectives with the FSF, the G-20, and others on this issue in an inclusive setting. The Committee asks the IMF to start this initiative immediately and to report to the IMFC at the latest at its next meeting.

The next regular meeting of the IMFC will be held in Washington, D.C., on April 25, 2009.

The following attachment summarizes the Committee's discussion on other key points.

* * * * *

Supporting Growth and Tackling Global Challenges

The Committee emphasizes that macroeconomic policies in the advanced economies need to provide essential stimulus in the face of the risk of a pronounced economic downturn, as confidence in the financial system is restored. Given the decline in commodity prices from their recent peaks and the expected slowing activity in many countries, policymakers should consider the most appropriate policy actions depending on national conditions. The Committee welcomes the recent coordinated monetary policy actions undertaken by several central banks. In a number of economies, fiscal policy has provided timely support to boost activity. Further fiscal initiatives should take account of medium-term consolidation objectives and, if undertaken, should give priority to dealing with financial problems. While macroeconomic policy priorities vary considerably across emerging market and developing economies, the Committee notes that the risk of a marked slowdown owing to financial market strains and sluggish export markets is becoming the primary concern for many of them. The Committee calls on the IMF to stand ready to assist members to prepare timely, effective, and appropriate policy responses to alleviate the impact of negative spillovers from the financial crisis.

The Committee is concerned that the progress made by low-income countries in achieving macroeconomic stability, fostering growth, and reducing poverty is being undermined by the adverse global environment. Many low-income countries, particularly in sub-Saharan Africa, have been severely hit by higher food and fuel prices. The Committee calls on low-income countries to pursue strengthened adjustment efforts with increased donor assistance, in particular grants, to limit the effects on real income and poverty. The Committee welcomes the mission statement on low-income countries, and considers that the Fund should continue to play its part in the areas of its core expertise. The Committee welcomes the reforms to the Exogenous Shocks Facility, which allow it to be used more quickly and adequately.

The Committee notes the challenges posed by higher commodity prices in many countries, even though food and fuel prices have receded from their recent peaks. It recommends that shifts in international food and fuel prices be passed through to domestic markets, backed by targeted measures and adequate safety nets to protect the poor and taking into account country-specific circumstances.

Progress toward a more multilateral trading system has never been more important given risks to global growth. The Committee therefore calls on members to resist protectionist pressures, and reiterates its strong support for a prompt and ambitious conclusion of the Doha Development Round of trade negotiations.

The Committee emphasizes that it remains important to guard against global imbalances. The multilateral strategy for addressing global imbalances remains relevant, even though short-term measures will need to focus on stabilizing financial markets.

Advancing the IMF's Surveillance Agenda

The Committee underscores the central role of Fund surveillance in providing clear, advance warning of risks, helping members understand the interdependence of their economies, and promoting globally consistent policy responses. The Committee takes note of the conclusion of the Triennial Surveillance Review, and endorses the Fund's first Statement of Surveillance Priorities [see News Briefs, page 168].

The Committee calls on all members to work together cooperatively and with the Fund toward achieving the economic and operational objectives that it sets forth. The Committee calls on the Fund to press ahead with the enhanced early warning of risks and vulnerabilities, including through enhanced financial sector liaison, analysis of macro-financial linkages, and scenario analysis, and by completing the extension of its vulnerability exercise to advanced economies. The communication of these risks and vulnerabilities should be concise, authoritative, and timely, including through an enhanced *World Economic Outlook* and *Global Financial Stability Report*. Work should also be undertaken toward a reshaped Financial Sector Assessment Program that is better integrated with the Fund's surveillance mandate, and embraces regional perspectives. The Committee looks forward to regular reporting by the Managing Director on the progress made against surveillance priorities.

Reviewing the IMF's Lending Role

The Committee stresses that Fund financing has a critical role to play in giving confidence to members—subject to adequate safeguards—by helping them cope with the challenges of globalization in general and the current financial crisis in particular. It emphasizes that the Fund is ready to make full use of the flexibility already embodied in its lending instruments, particularly in the emergency procedures and provisions for exceptional access. But additional efforts are needed to review the Fund's lending instruments, which might need to be adapted to the evolving needs of the membership. The Committee welcomes the ongoing review of the Fund's lending role, and supports the plan to advance work in the following five areas: (i) reviewing the analytical framework for Fund lending and its coherence, including the scope for innovation in and streamlining of lending instruments, and exploring new modalities for Fund financing; (ii) creating a new liquidity instrument; (iii) re-examining Fund conditionality; (iv) reviewing the Fund's lending facilities for low-income members; and

(v) increasing access limits and financing terms for using Fund resources. The Committee urges the Executive Board to take this agenda forward expeditiously. The Committee strongly recommends that decisions be taken on an accelerated basis in those areas where there is strong consensus and particular urgency—such as the establishment of a new liquidity instrument—and on the full range of issues by the time of the 2009 Annual Meetings.

The Santiago Principles—Generally Accepted Principles and Practices for Sovereign Wealth Funds

The Committee welcomes the development of the Santiago Principles by the International Working Group of Sovereign Wealth Funds (SWFs). The Principles represent a collaborative effort by SWFs from across advanced, emerging, and developing country economies to set out a comprehensive framework, providing a clearer understanding of the operations of SWFs. Their adoption on a voluntary basis signals strong commitment to the Principles and their implementation should further enhance the stabilizing role played by SWFs in the financial markets, and help maintain the free flow of cross-border investment. The Committee welcomes the intention of the International Working Group to consider establishing a Standing Group to keep the Principles under review and explore the scope for collecting and disseminating aggregated information on SWF operations. It emphasizes that continued Fund support, if requested, should be consistent with budgetary constraints. The Committee also stresses the importance of clear and nondiscriminatory policies by recipient countries toward SWF investments. It looks forward to the completion of the work of the OECD [Organization for Economic Cooperation and Development] in this area, and encourages continued dialogue and coordination between the OECD and SWFs.

Other Issues

The Committee welcomes the approval by the Board of Governors of the Resolution on quota and voice reforms, including the amendment of the Fund's Articles of Agreement to enhance voice and participation in the Fund. It notes that this is an important first step toward a realignment of members' quota and voting shares. These realignments are expected to result in increases in the quota shares of dynamic economies, and hence in the share of emerging market and developing economies as a whole. The Committee also looks forward to further work by the Executive Board on elements of the new quota formula that can be improved before the formula is used again. The Committee also welcomes the approval of the amendment broadening the Fund's investment authority as part of the Fund's new income model. The Committee urgently calls on all members to work toward the early completion of the domestic legislative steps required for making the quota and voice reforms and the Fund's new income model effective.

The Committee recommends members' acceptance of the amendment of the Articles of Agreement for a special one-time allocation of SDRs.

The Committee welcomes the ongoing re-assessment of the Fund's governance. This involves the follow-up by the Fund's Executive Board to the Independent Evaluation Office's *Evaluation of Aspects of IMF Corporate Governance*; the work of the committee of eminent persons on IMF governance reform, chaired by Mr. Trevor Manuel; and the engagement of civil society and other concerned audiences. The Committee underscores that governance reforms will require joint and collaborative efforts by all organs of the Fund. It looks forward to a progress report at its next meeting. ■

Boutros-Ghali Is First IMFC Head from an Emerging Economy

Egyptian Finance Minister Youssef Boutros-Ghali has been selected as the new Chair of the International Monetary and Financial Committee, which sets the IMF's political direction and overall policy priorities.

Boutros-Ghali served as IMFC Chair at this year's IMF-World Bank Annual Meetings held in Washington, D.C., from October 10–13. He has accepted the IMFC chairmanship for a term of up to three years.

Boutros-Ghali is the first IMFC head from an emerging market or developing country, succeeding former Italian Finance Minister Tommaso Padoa-Schioppa, who resigned in May.

"I hope that it will be easier for emerging market economies to be heard because I am chairman of the IMFC," Boutros-Ghali said, noting the increasingly important role that emerging economies play in the world today.


Stephen Jaffe/IMF photo

Youssef Boutros-Ghali

Boutros-Ghali has been a member of the Egyptian government since 1993. Prior to becoming Minister of Finance in July 2004, he held a range of ministerial positions in the areas of international cooperation, economic affairs, and foreign trade. Boutros-Ghali has an intimate knowledge and first-hand experience of the Fund and its relations with member countries, both as a former IMF staff member and as chief negotiator of Egypt's fundamental reform programs implemented with IMF support in the late 1980s and early 1990s.

The 24-member IMFC typically comprises finance ministers and central bank governors from the same countries and constituencies as are represented on the IMF's Executive Board. The panel has operated since September 30, 1999, following a resolution of the IMF Board of Governors.

IMF Warns About Need to Contain Crisis, Rethink Financial System

The turmoil in the global financial system will require a comprehensive effort by national authorities to restore confidence, get credit markets functioning properly again, and produce longer-term policies to rebuild the system, the IMF said in its *Global Financial Stability Report*.

Authorities must develop a consistent and coherent approach to stem the credit crisis that had its origins in the U.S. subprime mortgage market. The report lays out five principles to guide the effort to restore confidence:

• Employ measures that are comprehensive, timely, and clearly communicated.

• Aim for consistent and coherent policies.

• Ensure rapid response on the basis of early detection of strains.

• Ensure that emergency government interventions are temporary and taxpayer interests are protected.

• Pursue the medium-term objective of a more sound, competitive, and efficient financial system.

The IMF said in its report, published on October 7, that the preeminent near-term challenge for policymakers is to break—and reverse—the negative feedback loop between the financial system and the real economy, in which financial institutions' distress leads to impaired credit intermediation and slower economic growth, which in turn leads to further credit deterioration.

The report noted that the U.S. authorities have abandoned their piecemeal approach to the credit crisis and are trying to develop a comprehensive and systematic strategy—to encourage private markets to function again and facilitate the rebuilding of capital. Among other steps, the current plan provides for further liquidity support to the credit markets, frozen because institutions fear making loans to one another; purchasing problem assets to free up bank balance sheets; and extending deposit insurance.

But the IMF questions whether the new measures will be enough to restore confidence in the credit system, because many of the details have yet to be determined. But the IMF said it is a step in the right direction. The asset-purchase program must also be managed soundly and clearly set out its objective to develop public support.

Karen Bleier/AFP

U.S. Treasury Department building: U.S. measures to address financial crisis are "a step in the right direction," the IMF says.

To break and reverse the spiral afflicting financial markets and to restore confidence, three interrelated areas need to be addressed simultaneously, according to the report: falling asset values, dysfunctional funding markets, and insufficient capital to support credit growth. Specifically:

• ***Capital:*** Some $675 billion of additional capital is needed by banks globally. With the ability to raise new private capital constrained, the authorities could consider injecting capital into viable institutions, coupled with the orderly resolution of nonviable banks.

• ***Funding:*** Because of the extreme difficulties in obtaining wholesale funding for many institutions, guarantees could be considered for senior and subordinated debt liabilities of banks for a temporary period. Deposit insurance of individual accounts could also be temporarily expanded.

• ***Assets:*** Public sector balance sheets can be used to absorb assets to prevent "fire sale" liquidations that threaten to reduce bank capital. Countries whose banks have large exposures to problem assets could consider government asset purchases or funding through an asset management company to provide legal clarity and accountability.

Even as national authorities deal with the immediate crisis, they must also begin to think of the longer run. Because the turmoil has caused such an upheaval, pressure to protect current business practices and regulatory structures has lessened, freeing authorities to rethink the global financial architecture. The private sector has a role to play as well, the IMF said.

"There is an opportunity and a need to move toward a macroprudential and regulatory architecture that is more integrated in its approach and uniform in standards, and that involves closer and more effective cross-border coordination and collaboration among supervisors, regulators, and central banks," the report stated.

To improve the global financial structure, the IMF said:

• Authorities must ensure that firms' risk measurement systems take a sufficiently long-term perspective and establish standards for risk disclosure that are consistent not only across firms but also across borders.

• Banks and securities firms must improve their liquidity management, while central banks must have in place backstops that can be "applied quickly and flexibly in the event of system-wide pressures."

• Banks with significant activities in other countries must reassess their cross-border lending plans, and authorities have to work on cross-border cooperation and contingency planning to ensure that domestic laws do not interfere with international cooperation, when dealing with firms operating in more than one country.

Financial institutions' losses continue to mount, and unless they receive sufficient capital infusions, the viability of some of them is uncertain. The *GFSR* estimates that losses on U.S.-based loans and securities may rise to some $1.4 trillion—a significant increase from the estimate of $945 billion in the April 2008 *GFSR*.

While roughly $560 billion of the losses had been realized through end-September 2008, bank share prices have continued to plummet and their revenue prospects have stalled. Raising capital has become harder, making it much more difficult for banks to repair their balance sheets.

The most serious risk going forward is an intensifying adverse feedback loop between the financial system and the real economy. The *GFSR*—using forecasts from the IMF's *World Economic Outlook*—projects that credit growth in the United States, the euro area, and the United Kingdom, will slow to near zero over the next year before picking up again in 2010.

The deleveraging process is both necessary and inevitable—but it need not be disorderly. Current market conditions have meant that asset sales and the run-off of maturing assets have made the process difficult because prices of the many illiquid mortgage-backed securities are depressed and buyers are scarce. Private market solutions to put a floor under these securities haven't worked.

Recently, the U.S. government approved a plan to have the U.S. Treasury use about $700 billion, under some restrictions, to purchase U.S.-based troubled assets with the hope of curtailing "fire sales" of these assets and establishing realistic prices. But a major issue for the plan is the difficulty for anyone to determine future cash flows from these assets under such uncertain conditions.

Supporting asset prices is necessary, but it is only one element in a three-part solution, the *GFSR* notes. Financial institutions need to raise more capital but cannot do so under current conditions. Some potential investors stepped forward earlier, but now are reluctant. Current business models and revenue streams are more uncertain because mortgage securitization has nearly halted, making private capital investments in banks more chancy.

Without the ability to obtain new capital from private markets, recapitalization using the public sector balance sheet should now be considered, as solvency concerns have led to a seizing-up of interbank funding markets. Finally, public action is being taken to provide much-needed liquidity to the financial sector and its clients.

Until recently, emerging markets had appeared resilient to spillovers from mature markets. But in recent weeks, that has changed. Capital outflows have intensified, leading to tighter external and, in some cases, domestic liquidity conditions. The problems were more serious in those economies with leveraged banking systems and corporate sectors that rely on international financing.

Although "decoupling"—the notion that emerging markets' dependence on mature economies has declined—had faded from most economists' vocabularies, some held out hope that this time, emerging markets would not succumb. It is true that emerging economies have made progress on a number of fronts.

Overall, they have higher fiscal balances, less sovereign debt, more foreign exchange reserves, better policymaking structures, and healthier economies. Many of these improvements are related to the recent commodity price boom. Nonetheless, the linkages to global markets and economies have continued to grow and these have begun to overwhelm the improved domestic fundamentals.

Moreover, although many emerging economies have made fiscal and financial improvements, others remain vulnerable. The report highlights the reasons some countries may be at particular risk—for instance, those dependent on terms-of-trade improvements or external credit.

Emerging European economies have relied on credit supplied by foreign banks or foreign investors through the issuance of local bank bonds abroad. This latter source has dried up, and even though foreign banks say they remain committed to their subsidiaries in these countries, if funding conditions in their home country become difficult, they may have little choice but to slow their credit extension abroad as well as at home. ■

Peter Dattels and Laura Kodres
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Fair Value Accounting Gathers Interest in Current Turmoil

The IMF has weighed in on a complicated and controversial question of how financial institutions should value assets and liabilities on their books.

It is rare that an arcane accounting principle becomes the subject of public debate. But the role of fair value accounting (FVA) in the financial turmoil that began last year has come under "close scrutiny," the IMF noted. Some critics allege that it made matters worse, increasing volatility and amplifying the effects of the business cycle on the net worth of financial institutions and adding to the uncertainty about how accurately institutions could price some of their illiquid assets.

But the IMF concluded in the October *Global Financial Stability Report* that the FVA approach, which seeks to value assets and liabilities at prices reflecting current market settings, ensures the most accurate assessment under most conditions.

The IMF acknowledged that the application of FVA can exacerbate procyclicality in bank balance sheets and suggested some approaches to mitigate the impact. However, under some applications, FVA has the potential to reduce procyclicality. On balance, the IMF said, with some enhancements, FVA is "the preferred accounting framework for financial institutions."

The Fund said that FVA is more transparent than alternative methods and that financial institutions and regulators could take steps to reduce the procyclical effects of FVA. Some of the problem lies not with the FVA framework itself, but with how financial institutions use it in their decisions and risk management, the IMF said.

The IMF suggested that financial institutions should take such steps as:

- Selectively adding information about how they value assets and liabilities;
- With regulators' support, strengthening capital buffers and provisioning to cushion the impact of business cycle fluctuations on their balance sheets; and
- Issuing shorter, more focused accounting reports targeted to specific audiences at a higher frequency than they do now.

Financial Stress Likely to Hit Real Economy Hard

Episodes of financial turmoil that are characterized by stress in commercial and investment banks are more likely to be associated with severe and protracted downturns, according to new IMF research.

Published in an analytic chapter of the October 2008 *World Economic Outlook*, titled "Financial Stress and Economic Downturns," the research shows that when financial stress hits core financial intermediaries, the downturns that follow are typically more severe than slowdowns or recessions not preceded by financial stress. In particular, slowdowns or recessions preceded by banking-related stress tend to involve 2–3 times greater cumulative output losses and tend to endure 2–4 times as long.

The chapter constructs an index of financial stress in banking, securities, and foreign exchange markets in 17 advanced economies over the past 30 years and identifies 113 episodes of financial stress. Of these, about one-half are identified as banking related, while in the remainder, the stress is mainly concentrated in securities and foreign exchange markets. Based on this metric, the current financial turmoil ranks as one of the most intense for the United States and one of the most widespread, affecting virtually all countries in the sample.

The research finds that not all episodes of financial stress are followed by a slowdown or a recession, and initial conditions are crucial. The degree to which house prices and aggregate credit have risen prior to the stress episode is associated with the likelihood of a sharper downturn. Moreover, while greater reliance on borrowing by firms is associated with a sharper downturn in the aftermath of financial stress, the size of financial imbalances in the household sector is crucial in determining whether the downturn will turn into a recession.

The research finds that financial innovation and the move toward more arms-length financial systems—where a greater share of intermediation is channeled through securities markets rather than traditional relationship-based banking—has not increased the likelihood of banking-related financial stress. But activity tends to be weaker in the recessions following banking stress in more arms-length financial systems.

Michael Nagle/Getty Images

Household consumption behavior may play a larger role in the current U.S. downturn than is typical.

A potential explanation for why banking stress in arms-length systems is associated with more severe slowdowns in activity is because of the procyclicality of leverage. Although the so-called twin engines of financial intermediation—banking and securities markets—could be expected to provide alternative channels of financing, the research finds that leverage tends to be more procyclical even in banks in more arms-length financial systems.

As a result, when a shock hits the system, deleveraging among banks is more abrupt in more arms-length financial systems, which may more adversely affect the availability of credit to the rest of the economy.

The chapter places the current episode of financial turmoil in historical context by comparing it to six well-known episodes of financial stress among advanced economies during the 1990s. These episodes related to Finland, Norway, Sweden, the United Kingdom, and the United States in the early 1990s, and Japan throughout the 1990s.

This comparison confirms the finding that the rapid buildup in credit and house prices and a heavier reliance on credit by firms and households were associated with a more severe economic downturn in the aftermath of banking distress.

Relative to these episodes of financial stress, the adjustments and imbalances in initial conditions thus far appear to be tracking previous stress episodes followed by recession along a number of dimensions. The deleveraging process of households in the United States is even proceeding faster than in typical past recessions, although that for corporates seems to have proceeded somewhat more slowly and, more important, from a stronger initial position.

More generally, corporate balance sheets and firms' reliance on external financing were on a more solid footing entering into the current crisis, which should provide some resilience. But the sheer size of the U.S. mortgage market, which is at the heart of the current crisis, and the role of residential investment suggest that household saving and consumption behavior may play a much larger role in the current downturn than is typical.

On a positive note, the policy stance in the United States has been proactive, as exemplified by the aggressive cuts in policy rates and the measures taken to shore up liquidity in both the commercial and investment banking sectors, as well as ongoing initiatives to directly support the mortgage market.

For the euro area as a whole, the adjustment in house prices and credit has thus far been milder than in the United States, although recent evidence indicates the adjustment is gathering momentum. Firms are also starting from a stronger base in terms of their reliance on external financing.

The household sector's position in the euro area is considerably stronger, and this is a distinguishing feature of financial stress episodes that are not followed by recessions. Although true for the euro area as a whole, there are important differences among countries. ■

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What Next for Fannie and Freddie?

Exercising powers recently bestowed on him by Congress, the U.S. Treasury Secretary on September 7 acquired securities issued by the two largest housing government-sponsored enterprises (GSEs)—the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

At the same time, the newly established regulator—the Federal Housing Finance Agency (FHFA)—placed the GSEs under regulatory management (conservatorship) and replaced their existing managers. But this dramatic intervention leaves open a number of questions. Will the government choose an explicitly government-insured, and likely subsidized, mortgage market, or will it choose a clear private sector alternative? In the process, the authorities need to resolve the more fundamental questions of whether the GSEs should continue to add to the large subsidies directed to homeownership in the United States, and if so, whether mortgage borrowing should be the preferred method to finance house purchases.

What are the GSEs?

The two GSEs were established to provide liquidity to the residential mortgage market, thereby reducing mortgage rates and promoting homeownership. They were formed as competing private sector companies (with federal charters) in the late 1960s (although Fannie Mae was originally established in the 1930s as a public sector corporation).

They purchase mortgages that conform to standard criteria from lenders, package them into mortgage-backed securities (MBS) enhanced with credit guarantees, and then sell them in the market.

In addition, the GSEs purchase mortgage-related securities, loans, and other types of assets for their investment portfolios. These purchases are financed by debt securities issued at low yields owing to investors' assumption that the Treasury would not let the GSEs default.

Karen Bleier/AFP

Fannie Mae and Freddie Mac were established to provide liquidity to the residential mortgage market.

What prompted the GSE crisis?

Essentially off-balance-sheet "special purpose vehicles" of the U.S. government, the GSEs were highly leveraged combinations of specialized mortgage bond insurer and investment fund. The GSEs had an incentive to expand their own portfolios of mortgage-backed securities using the low funding costs coming from the implicit taxpayer guarantee to benefit shareholders and managers. They also enjoyed lower capital requirements than comparable private sector entities.

The degree to which U.S. mortgage borrowers benefited from this arrangement is debatable. A Federal Reserve study estimated that 30-year mortgage rates were about 7 basis points (0.07 percentage points) lower on average due to their existence, with the large majority of the implicit taxpayer subsidy going to share- and bondholders and managers.

The GSEs had already suffered interest-rate hedging difficulties in the 1990s and accounting scandals in the early 2000s. Some commentators, including the IMF, called either for them to be wound up or more tightly regulated, or for a fundamental change in their business objectives.

The GSEs were able to avoid such outcomes by claiming their activities promoted homeownership and by intensive lobbying. However, following their accounting problems, the former regulator increased the GSEs' capital requirements somewhat and froze the growth of their portfolio holdings.

The GSEs' immediate problems arose from the weakness of the U.S. housing market that resulted in growing losses on their holdings of risky MBS (including subprime and Alt-A mortgage exposures), and increasing provisions on their mortgage portfolios and guarantees, as delinquency and foreclosure rates on prime conforming mortgages (the bulk of their business) began to rise.

Simultaneously, Congress charged the GSEs with providing greater support to the falling housing market by increasing the maximum loan size they were permitted to guarantee, while their regulator relaxed constraints on their MBS portfolios. These losses and additional business lines forced the GSEs to increase fees to lenders, tighten standards, and seek more capital from the market.

Initially, they were able to raise capital, but as losses continued, the housing market deteriorated, and their share prices dropped, this became increasingly difficult and costly.

Why did the U.S. Treasury act?

The U.S. authorities intervened for three reasons. First, owing to the collapse of private-label mortgage securitization since autumn 2007, the GSEs (along with Ginnie Mae, which securitizes loans made by the Federal Housing Administration (FHA)) are effectively the only issuers of MBS, together taking 95 percent of the market in the first half of 2008.

Banks and other lenders increased the mortgages they held by only \$17.5 billion in the first half of 2008—less than 2 percent of total mortgage lending. If the GSEs had ceased doing business, mortgage availability would have relied solely on the FHA because banks are currently adding only trivial mortgage amounts on their balance sheets.

Second, mortgage rates and costs were rising as a result of yields on GSEs' MBS increasing (due to credit concerns) and the GSEs increasing fees (to compensate for earlier losses). To address this and stimulate the housing market, the Treasury agreed not just to guarantee the GSEs' capital position but also to buy new GSE MBS outright. The GSE intervention lowered 30-year mortgage rates by approximately 50 basis points (0.5 percent) and raised house price futures by 1.5–1.75 percent in the process. GSE fees are also being reduced following the rescue to cut the costs to borrowers.

Third, the Treasury intervened to promote confidence in the GSEs' MBS and debt, owing to significant holdings by banks and foreign investors. Domestic banks hold around $1.1 trillion of GSE securities, with foreign holders accounting for about $1.1 trillion, including large central bank holdings. Additional declines in the value of these securities would have further eroded the depleted capital positions of U.S. commercial banks, while an insolvency and possible default on GSE senior debt securities would have been viewed as an implicit breach of trust by foreign official investors, with potentially serious consequences for the dollar's value and the country's ability to attract capital inflows.

To achieve these ends and minimize potential costs to the U.S. taxpayer, the Treasury and FHFA undertook to inject sufficient senior preferred equity capital into the GSEs to ensure GSE solvency, while placing them into conservatorship rather than receivership. This avoided giving an explicit Treasury guarantee to existing GSE debt while giving the FHFA control over the GSEs' major financial decisions. Receivership would have entailed winding up the GSEs and accelerating various debt covenants. Therefore the authorities achieved control and severely diluted preferred and common equity-holders without making the GSEs insolvent.

How much will these actions cost?

In July, the Congressional Budget Office estimated a probability-weighted cost of $25 billion, ranging from zero to more than $100 billion. The most pessimistic outside observers put the possible cost in the region of $200–$300 billion. The Treasury's agreement with the GSEs envisages an injection of senior preferred equity of up to $100 billion in each, but this is presented as being well in excess of likely losses, in part because current operations are regarded as profitable. The IMF estimates that currently the GSEs will suffer $95–$125 billion in credit losses (of which some $18 billion has already been provided for). If the GSEs were to be capitalized further to private sector standards, an additional $80–$100 billion in capital may be needed, much of it recouped on any future sale to the private sector. The cost to the public purse would be lowered to the extent that the GSEs retain earnings from their current high-margin business.

The accounting treatment of the GSEs' debt and budget on the federal government's balance sheet is still being debated. However, according to international government accounting standards, the GSEs are now "controlled" by the government and so become "state-owned enterprises." Gross liabilities and assets (each around $5 trillion) are now to be counted on the general government balance sheet. This has a significant impact on U.S. general government gross debt, but a negligible effect on net debt.

Whither the GSEs?

Although they had the chance, the U.S. authorities did not place the GSEs in receivership. This left open the question of their future for the next administration. Nevertheless, the Treasury put two "poison pills" in their agreement to ensure that the GSEs could not continue indefinitely in their former state.

First, the GSEs agreed to wind down their portfolio holdings by 10 percent a year beginning in 2010, effectively running down the investment risk they pose. Second, the Treasury will be able to charge a market-based fee for the capital guarantee provided by the taxpayer, potentially eliminating the GSEs' implicit subsidy. These provisions almost certainly mean that the next administration must address the fundamental future of the GSEs once the housing market has stabilized. What are the options?

(1) ***Fully publicly owned enterprises:*** The GSEs could be fully taken into public ownership, with private shareholder claims extinguished. As with the FHFA and Ginnie Mae, the GSEs would then borrow in the markets with a clear government guarantee, although at higher yields than treasuries. In essence, the taxpayer would provide mortgage and bond insurance, so subsidizing homeownership. Unless the GSEs were then to face quantity or price constraints, private sector banks or securities issuers could not compete with such an operation and would be confined to the riskiest or more esoteric lending outside the GSEs' purview.

(2) ***Reformed version of the old model:*** The GSEs could gradually be recapitalized through retained profits, with the Treasury's senior preferred equity repaid and extinguished. The GSEs would revert to their "private sector" status, but with regulation of their capital and investment portfolios comparable to private sector equivalents.

(3) ***Break-up and true privatization:*** If it were deemed necessary to retain institutions that guaranteed and standardized mortgages and MBS to foster liquidity, the GSEs could be reformed into pure MBS bond insurance companies that would be stripped of their federal charters, split up into multiple institutions to ensure competition, and privatized. However, such actions would entail a fundamental reform of U.S. insurance regulation.

(4)***Run-off:*** Once the housing market has stabilized, the GSEs' business could gradually be wound down, with the investment portfolios allowed to mature, and MBS issuance gradually reduced over time to allow for replacement by private sector alternatives. Any residual public policy functions could be explicitly transferred to the FHA.

The need to clarify the status and role of the GSEs and assign public and private objectives argues against option 2. The danger with making them fully publicly owned enterprises is that the GSEs could become another means whereby covert subsidies are granted to political interest groups and the U.S. housing market becomes dependent on taxpayers taking a concentrated financial risk during a housing slump. The AAA-rating of the U.S. government could legitimately be questioned under such an arrangement. These arguments point to options 3 or 4 as the best alternatives, although the transition would be complex. Standardization of MBS structure could be achieved through private sector coordination. ■

Paul Mills
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IMF Survey Interview

IMF Brings Multilateral Perspective to Exchange Rate Analysis

The IMF's core mission is to promote economic stability around the world. It does so by overseeing the global economy and the economic and financial policies of its 185 member countries. This activity is known as surveillance. And central to surveillance is the IMF's analysis of its member countries' exchange rates. But how does the IMF's work on exchange rates actually benefit individual countries and the global economy?

In an interview with the *IMF Survey's* Archana Kumar, two IMF experts—Jonathan Ostry (Deputy Director, Research Department) and Gian Maria Milesi-Ferretti (Chief of the Exchange Rate Issues Division, Research Department)—answer a range of questions about the IMF's work and thinking on exchange rates.


Stephen Jaffe/IMF photo

Jonathan Ostry: The aim of surveillance is to forewarn of emerging problems.

IMF Survey: Exactly what work does the IMF do on exchange rates?

Ostry: Under the Articles of Agreement, a key responsibility of the IMF and its members is to "assure orderly exchange rate arrangements and promote a stable system of exchange rates." In simple terms, this means a system that facilitates the exchange of goods, services, and capital among countries; that sustains sound economic growth with reasonable price stability; and that fosters economic and financial stability. Discussions on exchange rate issues (or what we call "exchange rate surveillance") have therefore always been a central part of the dialogue between member countries and the IMF. Of course the world has changed a lot—think of the collapse of the Bretton Woods system of fixed exchange rates—and the IMF has adapted and strengthened its framework for analyzing exchange rates accordingly.

Also, as part of its Consultative Group on Exchange Rate Issues, or CGER, the IMF makes analytical assessments on whether an exchange rate is overvalued, undervalued, or broadly in line with economic fundamentals. These judgments have been an important part of our exchange rate work since the mid-1990s.

IMF Survey: And why does that work matter—why is it important?

Ostry: The objective of surveillance is to generate the information that can allow us to have a sensible discussion with country authorities about their policies. The aim is to forewarn of emerging problems, so as to avert a messier denouement. Let me give you an example. Departures from medium-run exchange rate equilibrium may reflect a number of factors. They can be the result of distortionary or unsustainable policies and create distorted incentives for the private sector; they can forewarn of an eventual return to equilibrium—for example, a large depreciation—that might have adverse domestic or external effects; or they may instead be part of an adjustment process that is already understood and internalized by markets and may thus pose no policy concerns at all. Exchange rate surveillance needs to figure out through a process of analysis and dialogue which of these stories is most likely to be true.

IMF Survey: Has the IMF's thinking and work on exchange rates evolved as the world has become increasingly globalized?

Milesi-Ferretti: Indeed, yes. The role of exchange rates has become more important as globalization has taken off. During the past 15 years, international trade and financial integration have grown very rapidly. Economies have become more tightly interwoven and developments in one economy have larger repercussions beyond its borders. Movements in exchange rates—which are the relative price of goods and financial assets in one country relative to those in another—are clearly the prime channel of transmission of shocks among different economies. Emerging market countries, which now contribute far more to world GDP, have been prime drivers of this process. These developments made it essential to adapt the IMF's "global" approach to assessing the consistency of exchange rates with medium-term fundamentals.

IMF Survey: Is the IMF's evolving approach to analyzing and assessing exchange rates serving its membership?

Ostry: We have learned a lot from our interactions with members of the IMF's Executive Board, and also from our outreach efforts. The feedback we have received is that the frameworks developed by the CGER can play a role, but that they need to be supplemented by country-specific analysis. This is important because CGER cannot encompass every single factor that matters for a specific country's exchange rate. So the CGER work is a building block, but not the end of the story.

In terms of our current priorities, we have developed a self-assessment tool to gauge the extent to which CGER assessments help to predict the direction of subsequent movements in real exchange rates. Our initial results are encouraging, in the sense that the CGER assessments appear to predict subsequent exchange rate movements over the medium term. We are also developing methodologies to assess exchange rates and external balances in exporters of exhaustible natural resources, which are currently not included in the CGER exercise. This is a particularly topical issue, given the run-up in commodity prices.

IMF Survey: Where would you say the IMF's comparative advantage lies in its work on exchange rates?

Milesi-Ferretti: I would say that there are two sources of comparative advantage. First, in its work on a specific country's exchange rate level and exchange rate regime choice, the IMF can draw not only on its expertise on the country, but also on a wealth of cross-country experiences. The cross-country perspective can provide very useful insights on the most appropriate advice the IMF can give to the country.

Second, the IMF analysis of exchange rates relies on a multilateral perspective. This perspective takes into account not only the country's exchange rate, but the whole constellation of exchange rates in the world economy. This multilateral perspective is essential for the Fund's mandate to "assure orderly exchange rate arrangements and promote a stable system of exchange rates" that Jonathan referred to earlier. But it is also essential to reach an informed assessment on a country's exchange rate level and external stability. Why? Because such an assessment has to take into account how the country's situation and policy choices affect the world economy as well as how the country itself can be affected by developments outside its borders. The multilateral perspective is also what CGER brings to the table relative to the analysis of developments in individual countries.

IMF Survey: How do you determine if a currency is "significantly" misaligned?

Ostry: Determining whether a currency is misaligned takes into account not only the estimates from the CGER and other country-specific methodologies, but also a more general assessment of whether the level of the country's exchange rate and the accompanying policies are a potential threat to external stability. In a nutshell, external instability represents the risk of sudden and disruptive movements in capital flows and/or exchange rates. Such movements can have negative macroeconomic consequences either for the country itself or for its trading partners.

Eugene Salazar/IMF Photo

Milesi-Ferretti: "IMF analysis of exchange rates relies on a multilateral perspective."

IMF Survey: The world has been under serious economic and financial stress for over a year now. Generally speaking, how has the financial crisis affected movements in exchange rates?

Milesi-Ferretti: The financial crisis initially undermined confidence in securities backed by U.S. subprime mortgage assets, which were held by U.S. banks and foreign investors alike. The Federal Reserve responded quickly by cutting U.S. short-term interest rates. But lower returns on U.S. safe assets and the big drop in demand for asset-backed securities reduced the attractiveness of the U.S. dollar to foreign investors, causing the dollar to tumble to multiyear lows.

Also, the crisis led to an overall reassessment of risk in financial markets. This implied a weakening of currencies of countries running large current account deficits and offering higher interest rates. It also led to an unwinding of the so-called "carry trades." Carry trades involve borrowing in low-interest-rate currencies, such as the yen, to invest in high-interest-rate currencies, such as the New Zealand dollar.

In more recent weeks, signs of an economic slowdown have spread to other countries outside the United States, including the euro area and especially the United Kingdom—a country that had experienced very sharp increases in house prices. The reassessment of the global macroeconomic environment, and the changes in expectations about the future path of interest rates, have led to a sharp decline in the pound sterling, as well as a strengthening of the dollar vis-à-vis the euro.

IMF Survey: The recent financial crisis has also shown us in a rather stark way how one country's economic policies can affect many other countries. Does the IMF's work on exchange rates take into account this cross-country perspective?

Ostry: It does. First, the IMF focuses primarily on so-called "multilateral" or effective real exchange rates—that is, measures that take into account not only the exchange rate and relative inflation vis-à-vis a single country (think of the euro-dollar rate), but instead vis-à-vis all main trading partners. Likewise, our work to identify equilibrium real exchange rates is focused on the effects of movements in underlying fundamentals—factors such as productivity growth or demographic trends—not only in the country itself, but relative to the rest of the world—again bringing in the cross-country context.

Second, IMF exchange rate analysis has to ensure "multilateral consistency." In simple terms, if one or more major currencies are considered to be "undervalued," then it must be the case that a number of other currencies is "overvalued." Overvaluations and undervaluations need to balance each other out in the aggregate. Again, a consistent cross-country perspective is an essential underpinning of our analysis.

Third, and more generally, IMF exchange rate analysis is part of the institution's multilateral surveillance. When assessing developments in individual countries, particularly systemically important ones, the impact on the world economy is front and center. An example of a practical application of the IMF's multilateral surveillance activities was the Multilateral Consultation on global imbalances, undertaken with China, the euro area, Japan, Saudi Arabia, and the United States. The consultation promoted policies that, while in each country's best interest, would also help to sustain growth and reduce imbalances in the global economy. ■

IMF Plans Four New Regional Technical Assistance Centers

Seeking to scale up its regional approach to helping member countries, the IMF plans to open four new regional centers for delivering technical assistance.

The new centers—one in Central America, one in Central Asia, and two in Africa—are a response to country demand and to positive experience to date with the regional assistance approach. The African centers will complement three existing centers in the region—in Tanzania, Mali, and Gabon.

The centers aim to combine strategic advice from IMF headquarters in Washington with on-the-ground capacity-building assistance for member countries. The new centers cover the following countries:

• ***Central America***—Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua, and Panama;

• ***Central Asia***—Azerbaijan, Kazakhstan, the Kyrgyz Republic, Mongolia, Tajikistan, Turkmenistan, Uzbekistan, and possibly Pakistan; and

• ***Africa***—the country composition of the new centers has not yet been decided. But the second center in West Africa could potentially cover Cape Verde, The Gambia, Ghana, Liberia, Nigeria, and Sierra Leone, and the one in Southern Africa could cover Angola, Botswana, Comoros, Lesotho, Madagascar, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Zambia, and Zimbabwe.

As with the existing regional centers, the new centers will work with IMF headquarters to design and deliver an integrated program of technical assistance and training to countries on a regional basis. The centers are also geared to support regional economic integration efforts being pursued by the relevant countries. IMF assistance will boost these efforts by, among other things, promoting the harmonization and coordination of economic policies across countries.

Jerome Delay/AFP/Getty Images

School in Maputo, Mozambique—a country covered by the IMF's proposed Southern African regional assistance center.

A decade of experience

Over the past decade, regional centers have gradually evolved to play a major role in IMF technical assistance. Experience has shown that these centers, which are largely donor financed, can be especially important vehicles for helping countries carry out economic reforms in coordination with IMF headquarters.

Each regional center covers a small group of countries and serves as a regional base for resident advisors to these countries in core areas of IMF assistance. With their physical proximity to countries, regional centers are often better placed than IMF headquarters to handle reform implementation issues on a day-to-day basis. As a complement to the work of IMF headquarters, these centers have proven to be useful platforms to enhance IMF assistance in several important ways:

• Being based in the field, resident advisors at regional centers are able to develop deeper knowledge of the needs and circumstances of countries, and provide more intensive and constant follow-up on assistance delivered.

• All regional centers are guided by steering committees comprising representatives from donors, beneficiary countries, and other international agencies. This helps promote aid coordination and ownership of reforms, in line with the objectives of the Paris Declaration on Aid Effectiveness.

• Regional centers carry a high potential for economies of scale. Neighboring countries typically have similar economic structures and assistance needs, and a regional approach enables more help to be delivered at lower cost. An added benefit is that regional centers can promote the sharing of reform experiences between countries, allowing officials to adopt tried-and-tested best practices while minimizing reform risks.

Strategic integration and synergies

Exploiting regional similarities has been a key factor behind the growth of regional centers.

For instance, for the center in Central America, recipient countries have greatly accelerated their integration in recent years, including by establishing and strengthening key regional bodies to steer that process. These include the Central American Monetary Council, the Council of Finance Ministers, and the Council of Financial Sector Superintendents.

The entry into force of the Central America–Dominican Republic free trade agreement with the United States, as well as plans to complete a Central American customs union, mark other milestones in the same direction. In support of these initiatives, IMF headquarters has been scaling up its assistance to Central American countries over the past few years. A regional center would play a critical role in pushing that effort forward.

Similar assistance needs

The proposed Central Asian and Southern African regional centers arise from similar regional factors.

Country coverage in Central Asia will largely mirror that of the Central Asia Regional Economic Cooperation program, while the Southern African center's coverage would be broadly aligned with that of the Southern African Development Community. The second West African center's potential beneficiary countries have very similar assistance needs and will benefit from the sharing of reform ideas and solutions through the center.

Additionally, the opening of the two new Africa centers will mark the fulfillment of the vision set out in the IMF's 2001 Africa Capacity Building Initiative to establish five regional centers to serve all of sub-Saharan Africa.

Strategic guidance and governance

A tripartite organizational framework extends beyond the financial dimension into the governance structure. Each center is overseen by a steering committee composed of representatives from beneficiary countries, donors, and the IMF. These steering committees provide strategic guidance for the centers' work plans, through a consultative process that helps build shared ownership of the assistance delivered.

Consistent with its complementary character to IMF headquarters work, regional assistance will be coordinated with related help that will continue to be delivered from Washington, with both aspects of capacity-building assistance reflected in the IMF's *Regional Strategy Notes*. These plans articulate and prioritize the capacity-building needs of countries in a medium-term framework and in the context of Fund surveillance and lending activities, to ensure appropriate balance between short-term policy needs and medium-term capacity-building requirements.

Participation and support from the key regional bodies and agencies has always been an important facet of all regional centers. This is especially so given the centers' strong familiarity with local circumstances and reform issues. Indeed, in the existing centers, strong support from regional development banks and financial institutions has been a crucial rallying point to attract financing from other donors. Each center will thus work closely with the respective regional bodies to further countries' reform agendas.

Donor representation in the steering committees also improves coordination of IMF assistance with that from other providers. This arrangement has served the existing centers well, as noted by successive independent evaluations.

Importantly, country ownership and support for these bases is increasingly shown by significant financial commitments from beneficiary countries to their respective centers.

The way forward

As a precursor to the institution of the steering committees for each of the new centers, working groups have been established to drive the process. Discussions have been initiated with beneficiary countries on broad assistance needs and priorities that could be addressed, and with donors on possible financing for the new centers. It is expected that, by April 2009, the Central American center will be the first of the new centers to open. ■

IMF to Launch Trust Funds to Support Technical Assistance

The IMF plans to launch a series of trust funds to channel its technical assistance to specific policy topics. The menu-based Topical Trust Funds approach is designed to augment IMF resources already allocated to technical assistance.

Demand for the IMF's technical assistance is rising continuously, particularly from low- and lower-middle-income countries seeking to build the institutions and capacity needed to implement growth-enhancing policies. To meet this rising demand as well as to better coordinate assistance delivery, the Fund seeks to strengthen its partnerships with donors by engaging them on a broader, longer-term, and more strategic basis.

The idea is to pool donor resources in multidonor trust funds that would supplement the Fund's own assistance resources while leveraging the IMF's expertise and experience. The funding model is planned to operate by region and by topic, offering donors various entry points according to their priorities. Complementing the IMF's regional technical assistance centers, topical trust funds will provide global geographical coverage and specialized topical scope.

Supported by a research agenda, these trust funds are intended to be at the vanguard of international best practice in delivering assistance, addressing more advanced or complex issues within their field of specialization. The trust funds would create synergies with the work of the IMF's regional centers, which focus on hands-on implementation of such advice on-site.

Newscom

Possible topics for the trust fund menus include management of natural resource wealth, because volatile revenues can pose problems.

The proposed trust funds have several advantages over more traditional forms of assistance delivery. For recipient countries, they increase the project scope and resources available for capacity building. They promote coordination between donors and assistance providers—as called for in the 2005 Paris Declaration on Aid Effectiveness—and thus avoid costly duplication.

Trust funds also provide donors with a menu of topics to support, depending on their development strategies and priorities, while using the Fund's technical expertise and existing apparatus for assistance delivery and follow up. For the IMF, trust funds enable collective action in areas of common interest and leverage the Fund's own resources in strategic priority areas.

IMF staff have started talks with donors on a range of topical trust funds. Work is most advanced in the preparation of a trust fund covering anti–money laundering and combating the financing of terrorism. The trust fund is expected to become operational in May 2009, and a full trust fund menu of topics is planned over the next few years. Other possible topics include fragile states, data provision, public financial management, management of natural resource wealth, debt sustainability and public debt and asset management, and financial sector stability and development.

African Growth Eases as Region Responds to Price Shocks

Growth in sub-Saharan Africa is projected to slow, reflecting increases in food and fuel prices, slower world growth, and global financial turmoil, according to the IMF's latest regional forecast.

The continent's growth is projected to slow slightly to about 6 percent in 2008 and 2009, down from 6½ percent in 2007, while inflation is set to rise to an average 12 percent, says the IMF's *Regional Economic Outlook* (*REO*) for Sub-Saharan Africa, released October 10.

So far, the report notes, the main effects of the global financial turmoil appear to be indirect, in the form of slower global growth and volatile commodity prices. But recent heightened turbulence raises the risk of a decline in resource flows to Africa in the form of private capital, remittances, and aid.

"The resilience of growth and macroeconomic stability in the continent is being put to a test," Antoinette Sayeh, Director of the IMF's African Department, told the press. "Countries need—more than ever—to be able to respond quickly to unexpected exogenous shocks. In these circumstances, maintaining, if not increasing, aid remains of paramount importance."

Tony Karumba/AFP/Getty Images

Call center in Nairobi, Kenya: The recent heightened turbulence raises the risk of a decline in resource flows to Africa, according to the IMF's latest regional forecast for sub-Saharan Africa.

Growth prospects

Although GDP growth has tapered off somewhat in sub-Saharan African countries, at slightly less than 6 percent, the growth rate for 2008 is still expected to be relatively strong, continuing the healthy growth trend of previous years.

In oil exporters, growth is expected to fall temporarily by half a percentage point, to 8 percent in 2008, reflecting mainly lower-than-expected oil output in the Niger Delta due to recurring violence there; slightly lower-than-expected production in Equatorial Guinea's maturing main oil field; and weaker non-oil growth in Chad. Among oil importers, growth is also projected to decelerate, by half a percentage point, to 5 percent.

In 2009, the *REO* says, overall growth in sub-Saharan Africa is expected to remain above 6 percent.

Price shocks

But the food and fuel price shock has put upward pressure on inflation and current account deficits. The increase in inflation cuts across countries with different exchange rate regimes and different economic structures and levels of development. Overall, sub-Saharan Africa's inflation in 2008 is projected to climb to 12 percent—a noticeably larger increase than in advanced countries.

Despite recent price declines, food and fuel prices are projected to remain substantially above their 2007 levels. As a result, and although some sub-Saharan African countries have benefited from rising prices on their exports of non-oil commodities (such as aluminum, cotton, and gold), most African oil-importing countries are expected to see a significant and lasting decline in their terms of trade relative to 2007.

Reflecting a substantial oil revenue windfall, fiscal surpluses (excluding grants) in oil exporters are projected to rise to 7 percent of GDP in 2008. Oil importers' fiscal balances, on the other hand, are deteriorating because of lower GDP growth and the cost of policy measures to cushion the impact of the food and fuel price shock. Perhaps surprisingly, grant inflows to oil-importing countries have responded little to the food and fuel price shock.

Poverty concerns

The most pressing challenge for policymakers is to adjust to the food and fuel price shock, preserve macroeconomic stability, and shield the poor.

Food and fuel price increases could lead to a substantial increase in poverty rates in a number of countries. In 2008, through July, world market prices for rice rose by 111 percent, those for wheat 89 percent, and those for maize 48 percent, and world market prices for fuel products rose by 64–82 percent, before easing recently. The impact of the food price increases on poverty could be particularly large in sub-Saharan Africa, given that average households there spend about half of their income on food.

The fuel price increases are likely to have a smaller direct impact on poverty than the food price increases because households in sub-Saharan Africa typically spend less than one-tenth of their income on fuel products. Nevertheless, the ultimate effect of the fuel price increases on poverty rates is likely to be substantially greater than the direct effect, because fuel is an intermediate input into most other goods.

Africa outlook

The high growth rates of recent years cannot be taken for granted.

	2006	2007	Proj. 2008	Proj. 2009
	(real GDP growth, percent)			
Oil-exporting countries	7.5	8.9	8.1	8.8
Excluding Nigeria	9.3	12.7	10.4	9.6
Middle-income countries	5.2	5.1	4.0	3.5
Excluding South Africa	3.9	4.8	5.1	4.8
Low-income countries	7.3	7.0	6.0	6.6
Fragile countries	3.0	3.3	5.1	6.0
Including Zimbabwe	2.8	3.0	...	...
Sub-Saharan Africa	6.3	6.7	5.9	6.2

Sources: IMF, African Department database, October 3, 2008; and World Economic Outlook database, October 3, 2008.

Risks

Risks to the outlook for 2009 from the global environment have increased and are tilted to the downside. One important risk is that the global financial market turbulence could slow global growth by more, or for longer, than expected, which would likely reduce demand for Africa's exports and depress its terms of trade. In a more-pronounced global downturn, foreign direct investment, portfolio aid, and remittances inflows could slow as well.

To sustain growth and keep inflation in check, countries need to be prepared to respond to sudden changes in global economic conditions, particularly in commodity prices. They may also need to consider building over time an additional cushion in external reserves to better withstand exogenous shocks.

In addition to risks stemming from unforeseen developments in the global environment, there are domestic risks. The main domestic risk is that policies could fail to preserve the growth and reform momentum of recent years, either by not providing enough cushioning for the poor or by failing to preserve sufficient macroeconomic stability. This risk appears particularly acute in several hard-hit low-income oil importers, but other countries do not seem immune. ■

The IMF's latest *Regional Economic Outlook for Sub-Saharan Africa* is available on the IMF's website at the following address: www.imf.org/external/pubs/ft/reo/208/afr/eng/sreo1008.htm.

IMF Revamps Loans for Countries Facing Price Shocks, Disasters

The IMF has reformed a loan program to help low-income countries cope with emergencies caused by events beyond their control.

Revision of the Exogenous Shocks Facility (ESF) aims to provide assistance more quickly, and in larger amounts, to help low-income IMF members cope with events such as commodity price changes, natural disasters, and conflicts and crises in neighboring countries that disrupt trade.

The revamp, approved by the Executive Board on September 19, also streamlined the conditionality—commitments that borrower governments make on their economic and financial policies—attached to the ESF. The modifications respond to the request from ministers at the IMF's 2008 Spring Meetings.

The ESF was established two years ago to enhance the Fund's ability to help low-income member countries deal with sudden and exogenous shocks. Review of the ESF to make it easier and faster for members to receive the Fund's support has been accelerated in light of experience and the recent worsening of global economic conditions, in particular with the recent episode of surging food and fuel prices that have hit low-income countries particularly hard, an IMF spokesman said.

Jez Aznar/AFP

Shoppers at rice market: The IMF has reformed its loan program for countries facing shocks from events beyond government control.

Key features of the modified ESF include:

Creation of a new rapid-access component, under which a country could access fairly quickly up to 25 percent of its quota for each exogenous shock, with resources normally being provided in a single disbursement. This component could be used on a stand-alone basis or as a first step toward higher access.

A high-access component, along the lines of the current ESF, with access to up to 75 percent of quota for each arrangement in normal circumstances. Resources would be provided in multiple disbursements based on reviews. This component could be used following a rapid-access component, or on a stand-alone basis.

Conditionality and requirements for access to ESF financing have been streamlined. Under the rapid access component, the member would need only to commit to appropriate policies to address the shock, and in exceptional cases, to take targeted up-front measures. Under the high-access component an economic program of upper-credit-tranche quality would be needed.

The ability to be used more flexibly in conjunction with other Fund facilities and instruments, for example, with a Policy Support Instrument.

Maintaining a focus on the impact of the shock and the related policies on the poor in program design, while dropping the requirement for a Poverty Reduction Strategy.

Africa Conference in Tanzania to Share Lessons from Economic Successes

President Jakaya Kikwete of Tanzania and IMF Managing Director Dominique Strauss-Kahn will host a high-level international conference in Dar es Salaam on March 10–11, 2009, to discuss how Africa can meet the challenge of sustaining and building on its recent economic successes.

The conference—built around the theme "Changes: Successful Partnerships for Africa's Growth Challenge"—will provide both senior policymakers and stakeholders an opportunity "to learn from successful economic reforms in Africa and elaborate on the evolving roles of private sector and official partners—particularly the IMF—in supporting African countries," Strauss-Kahn said.

The conference will bring together more than 300 high-level participants—including finance ministers, central bankers, and representatives from partner countries, global and regional private sectors, civil society, media, academics, and private foundations.

Stephen Jaffe/IMF Photo

Michael Spilotro/IMF Photo

Forceful Action Needed to Contain Crisis

"Time is of the essence," said George Soros, chairman of Soros Fund Management. "Right now we are teetering on the brink of panic brought about by the failure of the authorities to anticipate and react. They have consistently been behind the curve. Now they have to get ahead of it."

Soros was one of five leading financial market players participating on a panel to discuss "Turmoil in Global Financial Markets: Prospects and Policies" during the IMF-World Bank Annual Meetings.

Soros and the other financial experts at the October 12 seminar stressed that any policy package should be coordinated and comprehensive.

IMF to Sharpen Assessment of Risks Facing Countries

The IMF has announced a new set of priorities for its surveillance of the global and national economies. The institution will sharpen its risk analysis and focus more on linkages between the financial sector and the real economy as well as cross-country analysis.

The IMF's Executive Board agreed the new priorities as part of a major review of the IMF's surveillance work. The new Statement of Surveillance Priorities, which lays out medium-term objectives and priorities in surveillance, was announced as the world was rocked by an increasingly virulent financial crisis.

Economic priorities identified include resolving financial market distress, strengthening the global financial system, adjusting to sharp changes in commodity prices, and promoting the orderly resolution of global imbalances.

IMF Launches Lending Review

The IMF has launched a review of its financing role in member countries, to make sure it has the right instruments to meet countries' needs in a world characterized by growing—and increasingly complex—cross-border financial flows.

"Although the Fund has a record of adapting to change, the truth is that our lending instruments are based on a model that may no longer be suited to the needs of a large part of the membership," Managing Director Dominique Strauss-Kahn told IMF Executive Directors at the Board's initial discussion of its financing role on September 22.

For the coming year, the study will focus on five broad areas: developing an analytical framework for the IMF's lending; advancing work on a new crisis prevention instrument; reviewing access limits and financing terms for using Fund resources; re-examining the use of conditionality; and considering lending instruments for low-income members.

Making Fiscal Stimulus Effective During Downturns

A new IMF study finds that although fiscal policy is a potentially valuable tool for stimulating growth, it can easily do more harm than good if it is not implemented well. Tax cuts or spending increases that make debt unsustainable are likely to cause output to fall, not rise.

The study, published in the October 2008 *World Economic Outlook*, shows that a key challenge to policymakers is to make sure that discretionary fiscal policy measures—that is, changes in spending and taxation—are delivered quickly and that they do not cause concerns about future debt sustainability.

For the full text of the study, see *www.imf.org/external/pubs/ft/weo/2008/02/index.htm*

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