Chapter 1

IMF Surveillance in Action

The IMF's Articles of Agreement call for it to oversee the international monetary system in order to ensure its effective operation, and to exercise firm "surveillance"—that is, oversight, including monitoring and analysis—over its member countries' exchange rate policies. As decided by the Executive Board, this appraisal of a country's exchange rate policies must involve a comprehensive analysis of the economic situation and policies of the country, including domestic as well as external policies.

The IMF exercises this responsibility of surveillance—over the system and over individual countries' policies—in several ways:

- *Country (or "Bilateral") Surveillance.* As mandated by Article IV of the IMF's Articles of Agreement, the Executive Board holds regular consultations with each of its members on the country's economic and financial policies, including their international repercussions. These "Article IV" consultations, based on staff reports, are known as bilateral or country surveillance. Through this surveillance, the IMF can identify policy weaknesses, signal dangers on the horizon, and advise countries on corrective policy actions. The consultations are complemented by continuous monitoring and analysis of economic and financial developments by IMF staff, informal contacts between staff and national authorities, and informal interim Board discussions as needed.
- *Global (or "Multilateral") Surveillance.* The IMF's Executive Board regularly reviews major global economic and financial market developments. The reviews are based partly on the *World Economic Outlook* reports, prepared by IMF staff usually twice a year, and on the *Global Financial Stability Report*, also prepared twice a year, on the health of the world's financial system. In addition the Board holds frequent, informal discussions about world economic and financial market developments, and all Directors and staff receive a daily report covering key financial developments in mature and emerging markets.
- *Regional Surveillance.* To supplement country consultations, the IMF also examines policies pursued under regional arrangements. It holds regular discussions with such regional economic institutions as the European Union, the European Central Bank, the West African Economic and Monetary Union, the Central African Economic and Monetary Community, and the Eastern Caribbean Currency Union.

IMF management and staff also take part in policy discussions of finance ministers, central bank governors, and other officials in such country groups as the Group of Seven major industrial countries, the Group of 24, the Asia-Pacific Economic Cooperation forum, the New Partnership for Africa's Development, the Gulf Cooperation Council countries, and the Maghreb countries associated with the European Union.

The IMF's approach to surveillance has evolved to keep pace with new challenges. For a comprehensive discussion of steps taken to strengthen IMF's surveillance, see Chapter 2.

Country Surveillance

To conduct country surveillance in accordance with Article IV, an IMF staff team visits the member country to meet government and central bank officials, and collect economic and financial information. The consultations cover recent economic developments and the monetary, fiscal, and relevant structural policies the country is pursuing. The Executive Director for the member country usually participates as an observer. The team generally also meets other groups—such as trade unions, employer associations, academics, legislative bodies, and financial market participants. The IMF staff team normally prepares a concluding statement, or memorandum, summarizing the findings and policy advice of the staff team, and leaves this statement with the national authorities, who have the option of publishing it.

On their return to headquarters, IMF staff members prepare a report describing the economic situation in the country and the nature of the policy discussions with the national authorities, and evaluating the country's policies. The Executive Board then discusses the report. The views of the country's authorities are conveyed to the Board by the country's Executive Director. The views expressed by Executive Directors

during the meeting are summarized by the Chair or Acting Chair of the Board, and a written summing up is produced. Subject to the approval of the member country concerned, the full Article IV consultation report and a Public Information Notice (PIN), containing a summary of the Board discussion and background material, are released to the public. The country authorities may authorize release of a PIN even if they do not wish to release the full report. In FY2003 the Board conducted 136 Article IV consultations with member countries (see Table 1.1). All PINs and the Article IV reports that the authorities have agreed to release are published on the IMF website.

In addition, the Board assesses economic conditions and policies of member countries borrowing from the IMF in the context of its discussions on the lending arrangements that support the member countries' economic programs.

Global Surveillance

The Executive Board's conduct of global surveillance relies heavily on two staff reports—the *World Economic Outlook* and the *Global Financial Stability Report*—as well as on regular sessions on world economic and market developments.

World Economic Outlook

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

In FY2003, the Board discussed the *World Economic Outlook* on two occasions—in September 2002 and in March 2003. (See Box 1.1 for a chronology of key economic developments during FY2003.)

World Economic Outlook: September 2002 Session

At its *September 2002* meeting, the Executive Board noted that economic and financial market developments had been mixed since the spring. Negative developments had occurred on several fronts, Directors noted, including the sharp decline in global equity markets since the end of March 2002; the deterioration in financing conditions facing most emerging market borrowers—notably in Latin America; and weaknesses in a number of current and forward-looking indicators for the United States, Europe, and several other regions. These developments were especially disappointing in light of the strengthening of several global economic indicators, including trade and industrial production, seen since the end of 2001, as well as first-quarter growth that exceeded expectations in several regions.

The world economy and financial market activity had shown considerable resilience in the face of multiple shocks, Directors observed, and, going forward, several factors should support a steady strengthening in global growth—including the continuing stimulus from earlier macroeconomic easing in many regions, the winding down of inventory corrections, and the recent signs of greater stability returning to global financial markets. Nonetheless, Directors expressed concern about the strength and sustainability of the recovery and agreed that the outlook for the remainder of 2002 and for 2003 was likely to be weaker than had been anticipated in the April *World Economic Outlook*.

The risks to the short-term outlook, the Board assessed, were predominantly on the downside. In particular, Directors noted that equity price falls could have a more marked impact on domestic demand than expected—especially in the United States, which had led the global recovery. Movements in major exchange rates would be appropriate from a medium-term perspective, they observed, although in the short term some negative impact on the recovery in Japan and the euro area, which had been led by external demand, should not be ruled out. Many Directors also saw the persistently high U.S. current account deficit and the still high U.S. dollar value as posing some risk of an abrupt and disruptive adjustment. In addition, tight emerging market financing conditions could further weaken growth prospects and increase vulnerabilities in a number of countries. Directors also noted the potential for further volatility in oil prices in the event of a deterioration in the security situation in the Middle East.

World Economic Outlook: March 2003 Session

The pace of the global recovery had slowed by the time of the Board's second session on the *World Economic Outlook* in *March 2003*, amid rising geopolitical uncertainties related to Iraq, the continued adverse effects of the fallout from the bursting of the equity market bubble, and rapidly changing conditions.

The global economy had been resilient, Directors noted, and in many industrial countries the fundamentals remained sound. They agreed that a global recovery should gradually reassert itself, achieving global GDP growth of just over 3 percent in 2003 under the baseline scenario of the *World Economic Outlook*. Such an outcome would be supported by a pickup in confidence, the abating of the headwinds to growth from the bursting of the equity bubble, the policy stimulus in the pipeline, and the inventory cycle. In addition, with corporations in both the United States and Europe having relatively high cash balances, investment could respond relatively quickly. Nonetheless, Directors acknowledged that considerable uncertainties and risks gave cause for concern for the

Table 1.1
Article IV Consultations Concluded in FY2003

Country Name	Board Date	PIN Issued	Staff Report Published
Albania	February 26, 2003	March 7, 2003	March 7, 2003
Algeria	February 24, 2003	March 5, 2003	March 12, 2003
Argentina	January 8, 2003	July 25, 2003	July 25, 2003
Armenia	September 25, 2002	October 9, 2002	October 17, 2002
Aruba	February 24, 2003	March 3, 2003	March 3, 2003
Australia	September 16, 2002	September 18, 2002	September 18, 2002
Austria	August 8, 2002	August 14, 2002	August 14, 2002
Bahrain	May 31, 2002		
Barbados	February 7, 2003	February 21, 2003	March 5, 2003
Belarus	April 16, 2003	April 30, 2003	April 30, 2003
Belgium	February 21, 2003	March 4, 2003	March 4, 2003
Belize	November 1, 2002	November 14, 2002	November 22, 2002
Benin	July 15, 2002	August 5, 2002	August 5, 2002
Bhutan	February 21, 2003	March 31, 2003	
Botswana	October 9, 2002	November 1, 2002	November 5, 2002
Brazil	March 14, 2003	March 24, 2003	
Brunei Darussalam	April 30, 2003		
Bulgaria	July 22, 2002	August 5, 2002	August 7, 2002
Burundi	October 9, 2002	October 30, 2002	November 6, 2002
Cambodia	February 20, 2003	February 28, 2003	March 6, 2003
Cameroon	September 18, 2002	December 24, 2002	November 22, 2002
Canada	January 31, 2003	February 25, 2003	February 25, 2003
Cape Verde	December 16, 2002	June 13, 2003	June 13, 2003
Chile	July 19, 2002	July 31, 2002	July 31, 2002
China	August 5, 2002	September 3, 2002	
Colombia	January 15, 2003	January 23, 2003	January 24, 2003
Comoros	October 30, 2002		
Congo, Dem. Rep. of	March 24, 2003	April 16, 2003	June 16, 2003
Costa Rica	March 3, 2003	March 7, 2003	March 21, 2003
Croatia	August 5, 2002	August 8, 2002	August 12, 2002
Cyprus	January 31, 2003	February 14, 2003	February 14, 2003
Czech Republic	July 26, 2002	August 7, 2002	August 7, 2002
Denmark	May 8, 2002	May 21, 2002	May 21, 2002
Dominica	August 28, 2002	October 9, 2002	October 10, 2002
Dominican Republic	June 7, 2002	June 26, 2002	
Ecuador	March 21, 2003	April 7, 2003	April 7, 2003
Egypt	November 13, 2002		
El Salvador	July 19, 2002		
Estonia	July 1, 2002	July 3, 2002	July 3, 2002
Ethiopia	September 23, 2002	October 3, 2002	October 7, 2002
Fiji	August 9, 2002	September 12, 2002	January 8, 2003
Finland	August 13, 2002	August 15, 2002	August 15, 2002
France	October 28, 2002	November 13, 2002	November 13, 2002
Gambia, The	July 10, 2002	October 8, 2002	
Germany	October 23, 2002	October 31, 2002	October 31, 2002
Grenada	January 27, 2003	February 4, 2003	February 10, 2003
Guatemala	October 2, 2002		
Guinea	July 24, 2002		
Guinea-Bissau	June 26, 2002	July 26, 2002	July 26, 2002
Guyana	September 13, 2002		
Haiti	January 24, 2003	March 3, 2003	
Hong Kong SAR	May 1, 2002	May 15, 2002	May 15, 2002
Hungary	May 22, 2002	June 5, 2002	June 5, 2002
Iceland	June 21, 2002	July 3, 2002	July 3, 2002
India	June 28, 2002	August 29, 2002	
Iran, Islamic Rep. of	September 18, 2002	September 26, 2002	September 27, 2002
Ireland	July 31, 2002	August 7, 2002	August 7, 2002
Israel	March 7, 2003	March 13, 2003	March 17, 2003
Italy	October 21, 2002	October 25, 2002	October 25, 2002
Jamaica	August 7, 2002	September 11, 2002	September 11, 2002
Japan	July 24, 2002	August 8, 2002	August 8, 2002
Korea	March 3, 2003	March 6, 2003	March 19, 2003
Kuwait	December 13, 2002	January 2, 2003	January 21, 2003
Kyrgyz Republic	February 20, 2003	March 7, 2003	March 7, 2003
Lao People's Dem. Rep.	August 26, 2002	October 4, 2002	October 7, 2002
Latvia	April 23, 2003	April 28, 2003	April 28, 2003
Lebanon	February 28, 2003	March 20, 2003	
Liberia	March 5, 2003		
Libya	May 6, 2002		
Luxembourg	June 5, 2002	June 17, 2002	June 17, 2002

Table 1.1 *(concluded)*

Country Name	Board Date	PIN Issued	Staff Report Published
Macedonia, FYR	April 30, 2003	May 20, 2003	May 20, 2003
Madagascar	December 23, 2002	January 9, 2003	January 9, 2003
Malawi	August 5, 2002	August 16, 2002	August 16, 2002
Malaysia	October 16, 2002	December 10, 2002	
Maldives	January 8, 2003	February 19, 2003	
Mauritania	June 7, 2002	October 11, 2002	December 4, 2002
Mauritius	May 24, 2002	July 15, 2002	July 15, 2002
Mexico	September 23, 2002	September 26, 2002	October 30, 2002
Micronesia	January 24, 2003	February 10, 2003	February 10, 2003
Moldova	July 10, 2002	August 26, 2002	August 26, 2002
Mongolia	October 25, 2002	November 14, 2002	November 14, 2002
Morocco	April 28, 2003	May 9, 2003	May 28, 2003
Mozambique	June 17, 2002	July 9, 2002	July 9, 2002
Myanmar	October 23, 2002		
Namibia	April 23, 2003		
Nepal	September 4, 2002	September 12, 2002	September 24, 2002
Netherlands	June 10, 2002	June 19, 2002	June 19, 2002
New Zealand	April 30, 2003	May 2, 2003	May 2, 2003
Nicaragua	December 4, 2002	December 12, 2002	February 10, 2003
Nigeria	December 18, 2002	January 2, 2003	January 3, 2003
Norway	March 7, 2003	March 18, 2003	March 18, 2003
Oman	October 2, 2002	November 6, 2002	
Pakistan	November 1, 2002	November 6, 2002	November 11, 2002
Panama	July 10, 2002	July 18, 2002	
Papua New Guinea	June 5, 2002		
Paraguay	March 10, 2003	March 27, 2003	April 8, 2003
Peru	December 13, 2002	December 23, 2002	March 14, 2003
Philippines	September 25, 2002	November 14, 2002	
Poland	June 7, 2002	June 26, 2002	June 26, 2002
Portugal	March 26, 2003	April 9, 2003	April 9, 2003
Qatar	June 24, 2002	September 10, 2002	
Romania	January 8, 2003	January 17, 2003	January 17, 2003
Rwanda	July 24, 2002	September 20, 2002	September 25, 2002
St. Kitts and Nevis	June 7, 2002	June 14, 2002	
St. Lucia	January 27, 2003	May 9, 2003	May 23, 2003
St. Vincent and the Grenadines	January 27, 2003	February 14, 2003	February 14, 2003
Saudi Arabia	October 9, 2002	October 25, 2002	
Senegal	April 28, 2003	June 19, 2003	June 19, 2003
Serbia and Montenegro[1]	May 13, 2002	May 23, 2002	May 23, 2002
Seychelles	July 31, 2002		
Singapore	December 9, 2002	January 6, 2003	
Slovak Republic	August 9, 2002	August 13, 2002	September 26, 2002
Slovenia	April 16, 2003	April 25, 2003	April 25, 2003
Solomon Islands	January 24, 2003		
South Africa	July 1, 2002	July 19, 2002	January 23, 2003
Spain	February 10, 2003	February 26, 2003	February 28, 2003
Sri Lanka	September 3, 2002	September 11, 2002	September 13, 2002
Suriname	October 16, 2002	November 1, 2002	
Swaziland	December 19, 2002	December 23, 2002	January 31, 2003
Sweden	July 31, 2002	August 7, 2002	August 7, 2002
Switzerland	May 29, 2002	June 3, 2002	June 3, 2002
Syrian Arab Republic	February 24, 2003		
Tajikistan	December 11, 2002	January 3, 2003	January 15, 2003
Tanzania	November 18, 2002	January 6, 2003	January 6, 2003
Thailand	August 2, 2002	August 29, 2002	
Togo	May 17, 2002		
Tonga	February 5, 2003	February 24, 2003	February 27, 2003
Tunisia	June 5, 2002	June 19, 2002	June 19, 2002
Uganda	February 12, 2003	March 20, 2003	March 26, 2003
United Arab Emirates	February 12, 2003	March 11, 2003	March 12, 2003
United Kingdom	February 26, 2003	March 3, 2003	March 3, 2003
United States	July 29, 2002	August 5, 2002	August 5, 2002
Vanuatu	November 22, 2002	December 11, 2002	December 11, 2002
Venezuela	September 11, 2002		
Yemen, Republic of	July 31, 2002	August 12, 2002	
Zambia	November 27, 2002		

[1]Effective February 4, 2003, the Federal Republic of Yugoslavia changed its name to Serbia and Montenegro.

economic outlook, given the fragility of the global recovery and the likelihood that the resiliency of the world economy to shocks might have weakened. Developments in the oil market, in particular, would need to be monitored closely.

The economic impact of a conflict in Iraq was very difficult to quantify, Directors recognized. They considered that the balance of the other risks to the outlook was principally on the downside, and that sluggish growth could persist even in the absence of a war. Three elements underpinned this caution. First, the global recovery remained heavily dependent on the United States, and there was no obvious candidate to take up the slack if growth in the United States faltered. A disorderly adjustment in response to global imbalances—involving a sharp depreciation of the U.S. dollar—remained a risk. Second, the possibility of further declines in mature equity markets could not be ruled out, as earnings expectations remained relatively optimistic, and an adjustment in housing prices in some industrial countries was also possible. Third, despite progress, a number of emerging market countries remained vulnerable to a deterioration in the global environment. Notwithstanding these downside risks, Directors regarded sustained global deflation as unlikely, although they did not rule out price declines in individual countries.

With inflationary pressures in general quite moderate, Directors agreed that monetary policies in major industrial countries would need to remain accommodative. With regard to fiscal policies, the situation differed by country. In the short run, Directors acknowledged that the scope for fiscal tightening was constrained by the cyclical situation. Automatic fiscal stabilizers should generally be allowed to operate, although fiscal consolidation remained a clear medium-term priority in many industrial countries with high levels of public debt and mounting pressures from aging populations. Directors urged an acceleration of structural reforms to boost confidence and domestic demand growth—particularly in Europe and Japan—in order to reduce global dependence on the United States and foster an orderly reduction in global imbalances.

Policymakers would need to remain vigilant to changing circumstances, Directors underscored, and be flexible and ready to adapt to them as events unfold. Close international cooperation and dialogue and concerted efforts would be required to confront global uncertainties and boost global confidence. Directors considered that a strong push to advance multilateral trade negotiations under the Doha Round (see Box 5.7) should be a key ingredient of such efforts.

Major Currency Areas

Directors expected the *United States* to continue to lead the global recovery. They observed that while some U.S. economic fundamentals—notably productivity performance—remained strong, some U.S. economic data had been disappointing, reflecting weakening consumer confidence and spending. Several factors contributed to downside risks to the U.S. outlook. These included uncertainties about conflict in Iraq and about whether the bubble-period excesses had been fully worked out, and the emergence of fiscal deficits alongside the large current account deficit. The current stance of monetary policy was broadly appropriate, Directors observed, but further easing could be necessary if downside risks to growth were to materialize, although several noted that the scope for doing so was becoming increasingly limited. On fiscal policy, Directors viewed the U.S. administration's tax proposals as having some merit from a structural perspective, but believed that if they were implemented they would significantly worsen the medium-term fiscal position, and might be procyclical if the economy picked up as expected under the baseline scenario. They underlined the importance of restoring investor confidence to underpin the recovery, and called for strict enforcement of enhanced corporate governance rules.

While the *euro area* was not experiencing serious imbalances and its fundamentals remained generally strong, Directors viewed developments in the area with concern. Growth continued to disappoint, and forecasts for 2003 had been revised down sharply. The appreciation of the euro, balance sheet strains, and prospective fiscal tightening in a number of countries were all likely to weigh on the regional economy. Within this overall picture, Directors viewed the situation in Germany—where the economy had stagnated and the financial sector had come under increasing strain—with particular concern.

The recent move by the European Central Bank (ECB) to cut interest rates was welcomed, and many Directors saw scope for further monetary easing to reinvigorate growth. In the fiscal area, with budgetary positions in a number of countries in Western Europe having become more difficult over the past year, Directors noted that the challenge in the near term would be to avoid adding unduly to economic headwinds through fiscal retrenchment, while strengthening the credibility of the Stability and Growth Pact (SGP). To achieve this, Directors believed that structural deficits would need to be reduced toward the medium-term norm of a fiscal position close to balance or in surplus. Most Directors supported the full play of automatic stabilizers around the consolidation path, even if this were to result in deficits in 2003 above the 3 percent of GDP deficit limit. An overshooting of the deficit limit in the present circumstances was not warranted, in the view of a few Directors, however, as it might undermine confidence in the fiscal framework without bringing significant short-term benefit to economic activity.

Box 1.1

Key Economic and Financial Developments, April 2002 to May 2003

Global economic growth in 2002 was only modestly higher than in 2001. Relatively strong growth in the first quarter of 2002 was followed by a gradual slowdown extending to the end of FY2003. World trade volume picked up after stagnating in 2001, but its growth was the weakest since the global recession of the early 1980s (see Figure 1.1). Foreign direct investment inflows to developing countries fell during 2002. However, portfolio investment and bank financing exiting from developing countries also slowed, leading to a net gain in private capital flows into developing countries. Several emerging market economies took advantage of improving market conditions and the narrowing of interest rate spreads in the second half of FY2003 to issue sovereign bonds.

Among the industrial countries, the economies of the *United States, euro area,* and *Japan* initially showed improvement—because of private consumption in the United States, net exports in the euro area, and a combination of the two in Japan. But business investment failed to pick up and buttress the recovery. The aftermath of the equity price bubble continued to weigh on the real economy. In the run-up to the war in Iraq in late 2002 and early 2003, geopolitical concerns heightened and oil prices surged. Consumer and business confidence fell steadily throughout the first quarter of 2003, up to the start of the war on March 20. First-quarter 2003 GDP growth was weak in all three economic areas—with activity essentially flat in the euro area and Japan. Labor markets also weakened—unemployment rose across the three areas. The cessation of military conflict in mid-April 2003 lessened geopolitical uncertainty and oil prices fell dramatically, although by the end of FY2003 there was little evidence of a renewal of the recovery.

Emerging market economies grew at quite different rates. Generally, in comparison with the industrial countries, growth was higher and the slowdown occurred a little later and was less pronounced.

Growth in *Latin America* was highly variable, with Argentina starting to pull out of its deepest recession in 20 years, while in Venezuela political turmoil late in 2002 led to a drop in activity. At the end of FY2003, economic growth was generally subdued, but financial conditions were somewhat more stable across the region.

The *emerging market economies of Asia* were a bright spot—registering robust growth throughout 2002, driven primarily by exports. China, in particular, continued to grow strongly, providing an increasingly important destination for exports of other economies in the region. The spread of Severe Acute Respiratory Syndrome (SARS), recognized in early 2003, however, affected the region adversely, especially those economies dependent on tourism-related services and local spending. By the end of FY2003, the rate of increase in new cases of SARS had slowed, but the economic and health effects remained uncertain.

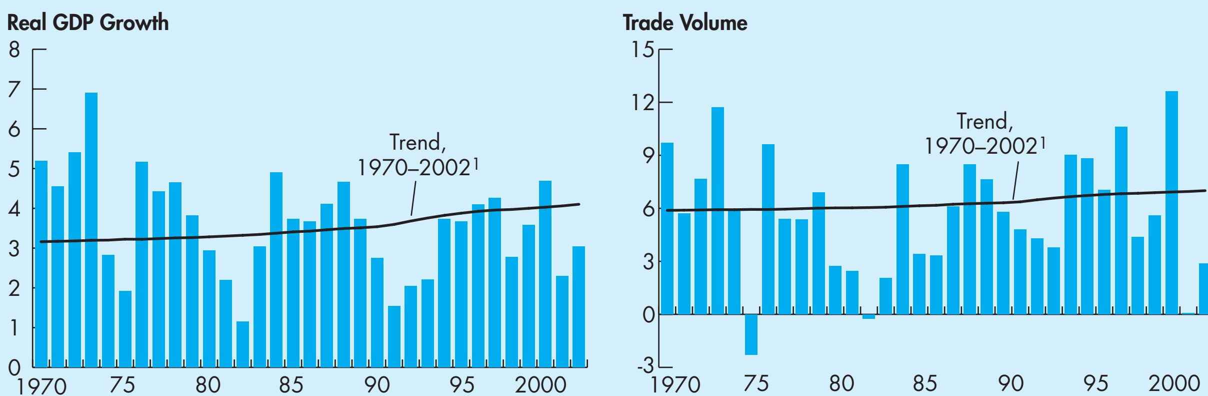
Central and Eastern Europe grew strongly through the second half of 2002, despite a slowdown in the euro area. Activity in many of the countries in the region was boosted by positive foreign direct investment inflows in anticipation of entry into the European Union. Higher oil prices in the latter part of 2002 spurred growth in the oil-exporting countries of the former Soviet Union—Azerbaijan, Kazakhstan, and Russia. The strong increase in demand in these countries supported growth in the other countries in the region.

Before the buildup in tensions surrounding the war in Iraq, activity in the *Middle East* had picked up, with higher oil prices aiding oil exporters' growth in particular. Despite the relatively short duration of the conflict, disruptions in trade and tourism and the dramatic fall in oil prices led to slower

Figure 1.1

World Real GDP Growth and Trade Volume (Goods and Services)

(Annual percent change)



Sources: Haver Analytics; and IMF, *World Economic Outlook* (April 2003).

[1]Average growth rates for individual countries, aggregated using purchasing-power-parity weights; the aggregates shift over time in favor of faster-growing countries, giving the line an upward trend.

growth in early 2003. Continuous geopolitical tensions in the region dampened activity throughout FY2003.

Growth in most *African* countries held up better than in other regions, supported by improved macroeconomic policies and debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative. Serious problems troubled parts of Africa, however—most important, deepening famine and drought in southern and eastern Africa. Economic conditions edged up in early 2003 reflecting developments in nonfuel commodity prices, which did not contract as much as in earlier global slowdowns, as well as debt relief, although the HIV/AIDS pandemic has remained a serious threat, reducing life expectancy and negatively affecting growth prospects.

Inflationary pressures across the globe remained subdued and wage increases were generally moderate. With the run-up to the war in Iraq and associated uncertainties, energy prices rose markedly toward the end of 2002 and at the beginning of 2003, but fell back at the end of the war. In *exchange markets,* the U.S. dollar depreciated during the financial year on a trade-weighted basis, while the euro appreciated.

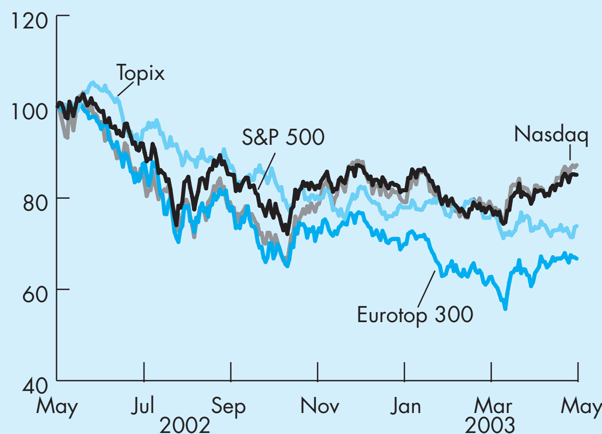
Monetary policies remained accommodative in most industrial countries, with falls in policy interest rates in most cases. The stance of *fiscal policies* varied. Policy was loosened in the United States as a result of tax cuts, but policies were neutral in the euro area.

Regarding developments in *financial markets*, nominal government bond yields in mature markets declined sharply over the financial year, with the U.S. 10-year treasury note reaching a 41-year low of 3.56 percent on March 10, 2003. Slowing growth prospects and low inflation, declining equity prices, geopolitical uncertainty, and declines in central bank policy rates contributed to the fall in yields.

Mature equity markets remained under pressure throughout much of FY2003 (see Figure 1.2). Uncertain prospects for corporate earnings, lingering effects of the bursting of the high-tech bubble, and the war in Iraq weighed heavily on mature equity markets. Record numbers of bankruptcies in the United States, corporate fraud cases, and lapses in corporate governance hurt investor confidence. The S&P 500 lost 15 percent and closed FY2003 down 40 percent from its March 2000 peak, despite a postwar rally and an eventual easing of risk aversion. European equities fared worse. The Eurotop 300 lost 33 percent to close 50 percent below its March 2000 peak. Japanese shares ended FY2003 at a 19-year low. In local currency terms, the Topix lost 26 percent in FY2003, to close 72 percent below its December 1989 high.

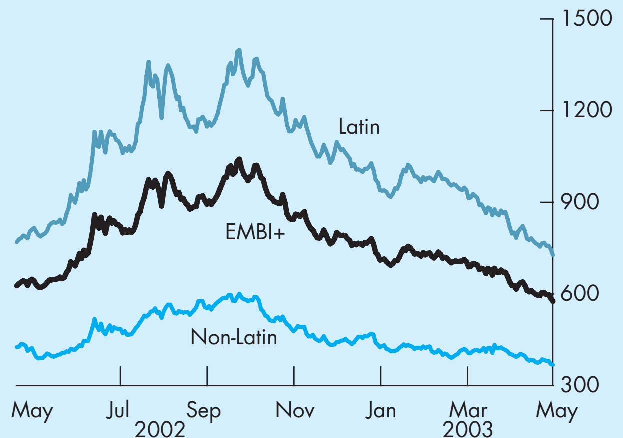
Emerging debt markets recovered in the second half of FY2003—with considerable differences across regions—and bond spreads narrowed to historical lows in many cases. Concerns over policy continuity, especially in Latin America, triggered a pronounced sell-off of emerging debt markets during the first half of the year. Investors regained confidence after elections in Brazil and Turkey and following policy pronouncements and reform initiatives. These developments combining with investors seeking higher-yielding investments in global markets paved the way for one of the longest emerging market bond rallies in history. The EMBI+ spread tightened from a high of 1,040 basis points in September 2002 to 576 basis points by the end of FY2003 (see Figure 1.3). In tandem, primary debt markets reopened in October 2002, after a long period of inactivity, and many emerging market governments met their 2003 market financing targets early in the year.

Figure 1.2
Equity Market Performance
(May 2002 = 100)



Source: Bloomberg L.P.

Figure 1.3
Sovereign Spreads
(In basis points)



Source: J.P. Morgan Chase.

Directors called for a greater sense of urgency by European countries to address structural rigidities in product and labor markets. While a number of important steps had been taken, European unemployment rates generally remained high, and participation rates were much lower than in other advanced countries. Labor market rigidities, most Directors agreed, played an important role in explaining the persistent unemployment in a number of industrial countries. This was shown by the contrasting experiences of countries that had undertaken comprehensive reforms—and observed a steady decline in structural unemployment—and those that had made little progress—and seen further increases in unemployment rates. They called for comprehensive labor market reforms in the euro area that, particularly if complemented with product market reforms, would yield significant gains in the form of lower unemployment and higher output. Proposals recently put forward by the German authorities to improve incentives to work and begin dismantling excessive job protection were welcome. If these measures were bold and implemented in full, Directors considered that they would have a favorable effect on business confidence and job creation.

The economic situation in *Japan* remained difficult, Directors noted. The economy experienced a modest cyclical recovery during 2002, but growth was expected to remain flat in 2003. Moreover, deflation continued, and survey evidence suggested that deflationary expectations were becoming more widespread and persistent. The Bank of Japan, most Directors urged, should be more aggressive in both its monetary policy actions and its communications strategy to arrest deflation. Also, the effectiveness of monetary policy would be improved by measures to strengthen the financial sector. Given the large budget deficit and high public debt levels, Directors emphasized the need for the authorities to establish a credible medium-term fiscal consolidation strategy and to implement key fiscal reforms. Most Directors believed that Japan should make a gradual start toward fiscal consolidation, unless the authorities were to push ahead with a much more aggressive structural reform agenda. Reforms to strengthen banks and corporations were welcomed, although Directors underscored that the reforms did not go far enough to resolve the long-standing problems in these sectors.

On asset price bubbles, Directors observed that the busts in equity markets of the past few years had been quite similar to earlier episodes in terms of magnitude, length, and cross-country synchronization of the price declines. The stock market booms in Europe and North America in the late 1990s led firms to borrow and invest well ahead of demand, thus increasing corporate vulnerability to a decline in stock prices and aggregate demand. Directors also noted concerns about the high levels of corporate debt compared with equity, especially in Europe, which could dampen investment spending during the recovery.

Emerging Markets

Growth prospects in emerging market countries generally remained relatively favorable, Directors observed, although performance and prospects varied significantly within this group. Many countries were implementing disciplined fiscal and monetary policies and advancing with structural reforms, and were in a better position to withstand external shocks. Nevertheless, downside risks remained, given the weaker outlook in industrial countries and uncertainties related to the situation in Iraq.

Recent signs of a pickup in activity in much of *Latin America* and the improvement in market sentiment were welcome, although Directors noted that the situation in a number of countries remained difficult. In Argentina, the economy might be over the worst, but policy continuity would be fundamental, and the market signals sent by presidential candidates would be crucial in shaping expectations. In Brazil, the new government's decisive actions to maintain macroeconomic stability and fiscal discipline had helped reduce uncertainties in financial markets. Chile and Mexico were relatively more sheltered from deterioration in external financing conditions, reflecting their strong policy record and relatively high degree of integration with the world economy. For the region as a whole, Directors emphasized the importance of sustained efforts to lower public sector debt levels and improve the maturity structure of the debt. Directors identified other key policy priorities for the region, including orienting monetary policy to achieve low inflation with exchange rate flexibility, deepening domestic financial intermediation, and introducing reforms to liberalize trade, improve social safety nets, and increase labor market flexibility.

Directors commended the impressive economic performance in *emerging Asia* underpinned by both exports and domestic demand, with countries moving most vigorously to implement structural reforms generally seeing the most robust growth, and noted that growth in emerging Asia will remain reliant on the global economic environment. The continuation of accommodative monetary policies was generally appropriate, in the Board's view, and automatic fiscal stabilizers should be allowed to operate in most countries. Further progress with structural reform, particularly in the financial sector, was seen by Directors as necessary to underpin stronger domestic demand and help contribute to a reduction in global imbalances, and the generally comfortable external sector positions in the region provided the foundation for pressing ahead with the unfinished agenda of structural reforms. In the near term, the oil-exporting countries faced the difficult task of managing very large balance

of payments inflows. Directors encouraged the authorities to permit flexibility in the exchange rate and target monetary policy on achieving a further reduction in inflation. Over the medium term, they noted, the challenge would be to manage the oil wealth appropriately.

In *Central and Eastern Europe*, strong foreign investment continued to underpin growth in some countries, as European Union accession grew nearer. Significant challenges lay ahead, Directors noted, as governments looked beyond accession to the requirements associated with adoption of the euro. They observed that, although the picture varies across countries, the need for fiscal restraint would likely remain a central focus of policy for most countries in Central and Eastern Europe to underpin market confidence and bolster growth. In Turkey, following a better-than-expected performance last year, economic and financial conditions had deteriorated in early 2003, and Directors underscored the urgent need for the government to pursue fiscal restraint and structural reforms to sustain confidence.

Growth in oil-exporting countries of the *Commonwealth of Independent States* (CIS) had been buoyed by rising energy prices. Slowing structural reforms could dampen investment spending, particularly in Russia, Directors cautioned, and could weaken medium-term prospects. Directors called upon the authorities in the CIS countries to reinvigorate the reform process, including by strengthening banking systems. They suggested that the seven low-income CIS countries (Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan) give priority to accelerating structural reforms to strengthen the investment climate in order to ensure the sustainability of the uptick in growth seen in many of the countries and to help address the high public debt levels that threaten fiscal sustainability in several of the countries.

Growth in the *Middle East* weakened in 2002, although countries where reforms had progressed fastest experienced more rapid growth. Many countries in the region were benefiting from the increase in oil prices, Directors observed, but the regional security situation was weighing on foreign investment and tourism. The key policy challenge over the medium term across the region, Directors noted, would be achieving sustained high GDP growth in order to reduce unemployment and absorb the rapidly growing labor force. Efforts to energize the private sector, liberalize trade, and develop human resources should remain at the core of the reform agenda.

Macroeconomic policy and structural reform implementation had improved in many African countries. Nevertheless, growth in *Africa* slowed in 2002 owing to poor weather and continuing political turmoil affecting several countries. The central challenge in Africa, in Directors' view, was putting in place the conditions to reach the Millennium Development Goals (see Chapter 5). As stressed in the New Partnership for Africa's Development (NEPAD), this would require a substantial improvement in the climate for private investment, which in turn would depend on actions to restore peace and political stability; improve governance, infrastructure, health, and education; liberalize markets and trade; and address the HIV/AIDS pandemic. Achieving these goals, Directors underscored, would require the financial support of the international community and greater market access for the exports of African countries.

Impact of Institutions on Economic Performance

Directors observed that improvements in institutional quality are found to raise the level and growth rate of GDP per capita, and lower the volatility of growth. On the basis of these findings, Directors agreed that developing countries would significantly build up their economic performance if they improve the quality of their institutions, while maintaining sound macroeconomic policies. In the Board's view, some general principles might frame the strengthening of institutions. For example, successful market-based economies need institutions that protect property rights, uphold the rule of law, provide appropriate regulation of markets, support macroeconomic stability, and promote social cohesion and stability.

Institutional design and reform would inevitably have significant country-specific elements requiring adaptation and innovation to suit local conditions, Directors stressed. Some key elements of institutional reform include greater competition, including through trade openness, which can help rein in the power of vested interests, and broader information flows and transparency, which can improve policy choices and reduce the scope for corruption. In addition, external "anchors," such as those associated with the EU accession process, have also proved effective for strengthening institutions. In the final analysis, Directors felt, firm domestic ownership and commitment remain the most vital ingredients for institutional reform.

Global Financial Stability Report

The *Global Financial Stability Report* (GFSR) was introduced in March 2002 to provide timely and comprehensive coverage of both mature and emerging financial markets and to identify potential fault lines in the global financial system. The Executive Board discussed four issues of the report during FY2003, with the last discussion occurring in March 2003. Discussions covered both recent developments and topics of special interest.

Key Developments

At their *May 2002* discussion, Directors noted that, in the context of an improved global economic outlook,

no imminent threat to global financial stability was evident. Stock prices were broadly unchanged in the United States and Europe in the first quarter of 2002, even as concerns over the recovery and quality of reported earnings weighed heavily on the stock prices of highly leveraged firms and of firms that had been active in mergers and acquisitions. At the same time, emerging market bond and equity markets had rallied, reflecting new inflows from dedicated investors and increased interest from crossover investors. Bond market flows to emerging markets had increased during the first quarter of 2002, Directors noted, which, in spite of decreased overall capital flows, had allowed many governments to satisfy substantial portions of their 2002 financing needs.

Conditions in global financial markets had deteriorated significantly by the time of the Board's second session on the GFSR in *August 2002*, reflecting eroding investor confidence and heightened risk aversion. A combination of corporate earnings disappointments, increased investor pessimism and uncertainty about the earnings outlook, and further corporate accounting scandals had triggered repricings and volatility in a range of markets. Higher-risk borrowers, including those in emerging markets, faced tighter terms of market access as investors had reduced their appetite for risk. In addition, portfolio rebalancing by international investors appeared to have contributed to downward pressure on the U.S. dollar and on U.S. asset prices.

At their *November 2002* meeting, Directors noted that global investor sentiment in the third quarter had continued to be weighed down by concerns over the strength and durability of the global economic recovery, the prospects for corporate profits, and geopolitical conditions, and that this contributed to the tiering by credit quality and to continued difficult financing conditions for higher-risk corporate and sovereign borrowers. Emerging market countries had continued to face a difficult environment, characterized by unusually high financial market volatility and increased risk aversion, Directors observed. This environment, coupled with earlier concerns over policy continuity in some key emerging markets, resulted in a continuation of sharply reduced flows and tight external financing to emerging markets as a group, affecting in particular noninvestment-grade issuers. Although in the primary markets unsecured access had been effectively closed to noninvestment-grade issuers in Latin America, broad-based contagion had nevertheless been limited, with investment-grade issuers and Asian and Eastern European issuers benefiting from relatively open access.

In the *March 2003* session, Executive Directors observed that the global financial system had remained resilient, despite significant geopolitical uncertainties and a hesitant and uneven global economic recovery. Markets continued to work off the excesses of the equity asset price bubble, and the bursting of the bubble had revealed underlying structural weaknesses, which required carefully crafted policy responses.

In an unsettled international environment, Directors noted, consumers, businesses, and investors had remained on the sidelines. They felt that this uncertainty could persist for some time. In this difficult environment, policies to improve market confidence on a sustained basis would remain of critical importance. Directors underlined their endorsement of continued supportive macroeconomic policies and wide-ranging measures in the structural area to address underlying market vulnerabilities.

Major Financial Centers

In the March session also, Directors noted that a gradual improvement of financial conditions in mature markets had begun to take hold, and, in particular, U.S. household and corporate sectors' balance sheets had strengthened somewhat. This progress was still fragile, they cautioned, and underlying vulnerabilities would require continued vigilance and policy attention. The corporate sector in a number of countries faced growing funding gaps in defined-benefit pension plans, as a result of lower equity prices and higher present values of pension liabilities owing to lower interest rates. Directors observed that improvement in the U.S. household sector's balance sheet rested crucially on continued strength in the housing market.

The financial sector in the mature economies presented a mixed picture, Directors considered. While banks with a strong retail franchise had performed reasonably well, wholesale and investment banks had been hard hit. Despite the authorities' renewed initiative to tackle the situation, the persistent weaknesses of Japanese banks remained a matter of concern. A number of Directors also highlighted the difficult situation facing the German banks in a context of low earnings, high costs, a deterioration in loan quality, and an erosion of hidden reserves as a result of the decline in the German equity market. Close monitoring of the deteriorating financial condition in the insurance sector in several European countries was also needed. Directors noted that the protracted weakness of equity markets had resulted in lower returns on assets and prompted sales of equity holdings, in some cases, to comply with solvency regulations.

The tendency of investors to remain on the sidelines had resulted in a significant accumulation of high-quality, short-term cash balances by retail and institutional investors. Directors saw the potential for deployment of these balances into more productive assets once investor sentiment recovers as a generally positive factor in the outlook. At the same time, a number of Directors cautioned that a sudden shift in asset preferences and prices could expose the unhedged

positions of commercial banks and broker-dealers to considerable interest rate risk. Still others expressed concern about the capital strength of the government-sponsored mortgage agencies in the United States. A number of Directors also pointed to the increased sensitivity to interest rate differentials resulting from the sizable reallocation of net capital flows to the United States away from equities and direct investment toward fixed-income securities.

Emerging Market Financing

An unsupportive external environment, together with investor concerns over the risk of policy discontinuity in key emerging market borrowers, had limited the availability and raised the cost of capital for most emerging market borrowers throughout most of 2002. Directors were encouraged that the easing of global financial market conditions in the fourth quarter had led to a reopening of capital markets to many issuers, and that investor concerns about the direction of future polices in some major emerging market economies had abated. However, this recent development should be seen against the backdrop of the longer-term decline in capital flows to emerging market borrowers, which deserved further attention. The continued "feast or famine" dynamic in the primary market for emerging market bonds highlighted the importance of self-insurance to mitigate— through sound economic frameworks and institutions—externally induced market volatility.

Recent market developments provided evidence, Directors noted, that more discriminating investors were responding positively to the sustained pursuit of sound policies. Nevertheless, it would remain important to consolidate this encouraging development and further reduce risks of contagion. In particular, Directors highlighted the importance of further efforts, including by the IMF, to help investors distinguish among borrowers, and of policies aimed at promoting financial stability. They welcomed the improvements in banking sector regulation and capitalization in many emerging markets. Progress had varied by region, however, and they noted that further measures were needed to bolster domestic banking systems. Directors welcomed the recent issuance by Mexico of a bond that included collective action clauses (CACs; see Chapter 3), and encouraged other issuers to include CACs in future bond placements. They encouraged IMF staff to provide members with the necessary advice to further this aim.

Promoting Stability

The GFSR's primary purpose is to point to weaknesses and vulnerabilities in the global financial system so that policymakers can take steps to prevent crises. During FY2003, the GFSR suggested a variety of policy actions, and Directors highlighted several policy measures that, taken together, should help ward off an excessive cutback in risk taking, rebuild investor confidence, and strengthen the markets' self-correcting mechanisms. At the *August 2002* Board meeting, Directors stressed the importance of continued financial surveillance by the IMF, including through such instruments as the Financial Sector Assessment Program (FSAP) and Reports on the Observance of Standards and Codes (ROSCs). They called on financial regulators to be vigilant for signs of further weakness in key institutions and markets. In advanced countries, policies should continue to support economic activity and an orderly reduction of imbalances over the medium term. In addition, Directors emphasized that strong implementation and enforcement of steps to improve corporate governance, accounting, disclosure, and transparency, together with close monitoring by national authorities and the IMF, would be helpful to strengthen markets' self-correcting forces. In emerging market countries, strong policies to bolster macroeconomic and financial stability would help investors to discriminate more clearly between countries as investment destinations. National authorities should also encourage the development of sound and diversified domestic financial systems.

In *November 2002,* Directors emphasized that macroeconomic policies in the advanced economies should remain responsive to any signs that economic recovery might be faltering. Speedy conclusion of the Doha trade negotiations and implementation of other trade liberalization moves would improve confidence in economic prospects, and provide emerging market countries with an opportunity to increase their export earnings and, ultimately, strengthen their debt-servicing capabilities. Supervisors of nonbank financial institutions, particularly insurance companies—and, in a number of cases, pension funds—should be vigilant for signs of significant capital erosion stemming from falling asset prices. Furthermore, the increased reliance of financial institutions upon credit risk transfer instruments to manage their risks warranted enhanced disclosure and regulatory scrutiny.

The continued ability of some emerging markets to tap international capital markets in the then-current environment, in Directors' view, illustrated the importance of strong commitment to the continued implementation of policies aimed at maintaining macroeconomic and financial stability and strengthening institutional frameworks. More generally, Directors stressed that firm commitment to the preservation of property rights, the rule of law, transparency, and stability in the legal and regulatory frameworks were key to fostering investor confidence and building a stable investor base.

In *March 2003,* Directors saw a continued need for strong confidence-building measures. In the structural area, Directors highlighted the need for legal and regula-

tory frameworks to support corporate and financial sector restructuring. In the case of Japan, the low profitability of Japanese financial institutions and the problem of non-performing loans were in need of urgent corrective action. German banks, Directors also observed, would need to address their low earnings through cost reduction measures, including consolidation.

Directors observed that the "feast or famine" dynamic in emerging market financing and persistent credit tiering underscored the need for the consistent implementation of sound macroeconomic policies. In addition, they encouraged continued measures to deepen local securities markets, which could help provide a buffer against changing global financial conditions.

Financial Market Activities of Insurance and Reinsurance Companies

Another major theme highlighted by the GFSR was the role of insurers and reinsurers in global financial markets. At the *May 2002* Board meeting, Directors noted that such companies had become an increasingly important class of institutional investors and financial intermediaries, which conveyed important benefits to international financial markets by adding to market liquidity and the diversity of market participants. In this context, more information would need to be made available on the market activities of insurance and reinsurance companies, by category of insurance (such as life and non-life insurance), and particularly in newer market segments such as credit derivatives. In addition, Directors suggested that the regulatory and supervisory frameworks might need to be modified to reflect these companies' expanding asset-market activities and any attendant implications for financial stability.

The international systemic risks associated with insurers' financial markets activities, Directors broadly agreed, seemed relatively limited compared with those of the major internationally active investment and commercial banks. Nevertheless, uncertainties remained about whether insurers' capitalization and risk management systems fully reflected the risks associated with their expanding financial market activities. There were also questions about whether these activities contributed to a migration of financial risks from the banking to the insurance sector. These issues complicated an assessment of the potential systemic risks associated with the expanding financial markets activities of insurance and reinsurance companies, and underscored the importance of improved disclosure and transparency.

Promoting Local Securities Markets

In their *May 2002* meeting, Directors also noted that the experience with the banking crisis and the loss of access to international capital markets during the Asian crisis of the late 1990s had emphasized the need to develop local securities markets to provide a more stable source of sovereign and corporate funding. Directors considered that the relatively low dollar equivalent returns on *emerging market equities* over the past decade underlined the need both for more stable macroeconomic conditions and for an adequate domestic and international investor base for this asset class. The migration of top-quality emerging market corporates to major mature market financial centers, Directors noted, had taken a toll on the liquidity of emerging equity markets, and they emphasized that improvements in the trading infrastructure in emerging markets would be crucial for expanding emerging market equities as an asset class.

At the Board's *August 2002* discussion, Directors endorsed the development of *local bond markets* as an alternative source of financing, and were encouraged by progress made in this area since the Asian crisis. While by no means a panacea, local bond markets could mitigate the adverse effects of lost access to international capital markets or bank credit, while widening the menu of instruments to deal with inherent currency and maturity mismatches faced by emerging markets borrowers. Well-developed primary and secondary markets, and the roles of foreign investors in these markets, were important, Directors emphasized.

Despite their rapid growth, emerging local bond markets remained a small part of the increasingly global bond market. Directors stressed that the deepening of the local government bond market should not come at the expense of depth in the corporate bond market, where progress had often been slower in part as a result of crowding out by the government sector.

At the *November 2002* meeting, Directors welcomed the discussion of *financial derivatives in emerging market economies*, noting that the rapid expansion of these instruments over the past decade was among the key factors facilitating the increase in global cross-border capital flows. Emerging derivatives markets present opportunities as well as certain risks, they observed. While derivatives could play a positive role in contributing to a more efficient allocation of risks in financial markets, these instruments could also be used to avoid prudential safeguards and take on excessive leverage. In some of the recent emerging market crisis episodes, Directors noted, the rapid unwinding of derivative positions had accelerated capital outflows and exacerbated the crisis dynamics, although it was stressed that derivatives were not the ultimate cause of the crises. Moreover, deep and liquid local derivatives markets could help market participants to price and manage the risks associated with investing in emerging markets more efficiently.

Measures to *ensure the smooth functioning of local securities markets*—through, among other moves,

improving market infrastructure and transparency, strengthening corporate governance, developing liquid benchmarks, and promoting a domestic institutional investor base—were highlighted at the *March 2003* session. Directors stressed that steps to develop local securities markets needed careful sequencing, with the development of money markets typically being a crucial first step in developing bond and derivatives markets.

Directors cautioned against heavy resort to bonds indexed to foreign currencies, which could increase vulnerability to external shocks and contribute to unstable debt structures. However, inflation-indexed bonds could be a useful instrument to deepen local bond markets. While local derivatives markets could facilitate the management of financial risk, Directors stressed that the development of such markets needed to be based on a strong supervisory and regulatory foundation.

Although local securities and derivatives markets had grown substantially over the last years, Directors observed that they had not yet developed enough to provide full insurance against the closure of banking or international markets, which in many cases may remain a remote prospect. Directors supported continued efforts to develop these markets given their potential to improve emerging markets' resilience.

Finally, the Executive Board agreed with IMF Management's suggestion to shift the GFSR from a quarterly to a semiannual publishing schedule beginning in March 2003.

Regional Surveillance

Central African Economic and Monetary Community

In June 2002, the Board discussed developments in the Central African Economic and Monetary Community (CAEMC), whose members are Cameroon, the Central African Republic, Chad, the Republic of Congo, Equatorial Guinea, and Gabon. Directors commended the authorities of the CAEMC countries for their continued efforts to intensify regional economic integration and surveillance and to harmonize macroeconomic policies. Directors welcomed, in particular, the adoption of new convergence criteria and of a framework for surveillance over macroeconomic policies—while noting the need to build on this progress by strengthening aspects of implementation. The IMF's dialogue with CAEMC, in Directors' opinion, was a valuable complement to its bilateral surveillance over the member countries of the region.

Developments in world oil markets had permitted CAEMC countries to sustain satisfactory—albeit somewhat uneven—economic growth, and to increase their international reserves substantially. Nonetheless, Directors considered that domestic demand had been allowed to grow too strongly—reflecting a rapid expansion in credit granted by the regional central bank and a procyclical fiscal policy. This had led to a rise in inflation and a deterioration in the external balance. Directors believed that the international reserve position and external competitiveness of the region remained broadly adequate. However, they stressed that the macroeconomic situation warranted a tightening of financial policies.

Discipline in the public finances must be the foundation of price and exchange rate stability, Directors underscored. While recognizing that the current fiscal position is strong, they considered that the management of the public finances could be improved. In particular, they urged that the relevant convergence criteria be adjusted to take into account the importance of oil revenues for most of the economies in the region: at present, a significant increase in the world oil price resulted in a procyclical rise in public expenditure. They suggested, for example, that fiscal goals could be based on a longer-term trend of oil prices, instead of the current price.

There was potential merit, Directors observed, in the planned establishment of an oil revenue stabilization fund, which could serve as a buffer against oil price fluctuations. For such a fund to be effective, regional surveillance over fiscal policy must be geared to avoiding procyclical spending and take into account developments in the non-oil deficit. There was support for the creation of a long-term savings fund as one of the routes available to benefit future generations—provided it were set up with appropriate safeguards and offered adequate returns.

Turning to monetary policy, Directors welcomed the plan to phase out statutory central bank financing of government deficits, although it was questioned whether 10 years was not too long a time frame for doing so. Regional financial markets were not well developed, Directors noted, and this inhibited the use of open market operations and other indirect monetary policy instruments. The sale of government bonds to substitute for central bank financing would help develop domestic money and capital markets and thus further strengthen monetary control. However, this reform would require a number of legal and institutional changes and would need to be prepared carefully. Directors supported the increase of commercial bank reserve requirements, provided these were adequately remunerated, as an important step to enhance the effectiveness of monetary policy by reducing excess liquidity. Changes along these lines would allow the regional central bank to pursue its goals more effectively and counter the recent unduly rapid growth of credit.

Regional financial integration requires a well-functioning banking system, Directors noted. Progress had been made in strengthening bank soundness in

recent years, but there was scope for further improvement. They commended the authorities for their efforts to put in place an efficient regional payments system. Nonetheless, they stressed the need to go further in making effective the common banking license and developing a well-functioning interbank market—thereby creating a fully fledged regional monetary zone. The authorities' determination to address problems of the arbitrary attachment of bank deposits was welcome, but Directors urged further steps to strengthen the financial framework and infrastructure, and they called for additional resources to be provided to the regional supervisory agency (the Central African Banking Commission, or COBAC) to enable it to work effectively.

Much remained to be done to implement fully the goal of a single market in the region, Directors noted. Thus, they welcomed the member countries' decision to further liberalize trade through a simplification of the structure of the common external tariff and a reduction of average tariff rates. Directors stressed the importance of reducing barriers to trade in order to achieve an outward-looking customs union, and they welcomed a project to take stock of remaining regional barriers, with the help of donor countries. Member countries needed to fully implement the agreements they had reached, and thus demonstrate their commitment to putting regional integration goals above sectoral interests. Several Directors also noted that the region's exports of cotton were adversely affected by subsidies in advanced economies.

Technical assistance to CAEMC members—especially in the areas of trade reform and monetary management—was important to strengthen the regional integration process, Directors underscored. They welcomed the amendment of the CAEMC Treaty to create an action group to combat money laundering and the financing of terrorism, and urged speedy passage and implementation of the proposed regional law addressing these activities.

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

In October 2002, the Board discussed the monetary and exchange rate policies of the euro area and the trade policies of the European Union.

With regard to the *monetary and exchange rate policies of the euro area,* Directors congratulated the authorities for the smooth and successful changeover to euro notes and coins at the beginning of the year, which marked another milestone in European integration. However, overall economic performance in the euro area had been disappointing, with growth weaker and inflation higher than had been expected. While unanticipated shocks—including oil price increases, animal diseases, the external slowdown, and financial market turmoil—contributed to this setback, the euro area showed a greater-than-anticipated vulnerability to shocks. In particular, structural rigidities were underlying factors responsible for the continued dependence of activity on foreign demand and for the persistence of inflationary pressures despite weak domestic demand.

In Directors' estimation, the recovery would be rather gradual, with indicators pointing to continued tepid growth in the near term. The recovery was expected to pick up in 2003, led by consumption, as past price shocks dissipated, and in step with global developments. This would be helped by the overall sound economic fundamentals and the progress achieved on structural reform, as reflected in the relative robustness of the labor market. Nevertheless, Directors noted considerable downside risks, including those related to the fragile external environment and the impact of the recent turbulence in financial markets. Policies should focus on increasing both the pace and robustness of the area's performance, Directors agreed, thus helping to strengthen world growth and facilitate an orderly adjustment of international payments imbalances. Macroeconomic policy in the period ahead would need to take account of possibly heightened uncertainty, and decisive action on structural reforms would be key to lifting the euro area's growth potential and reducing its vulnerability to shocks.

Monetary policy had continued to strike the right balance between the risks of inflation stemming from adverse one-off supply shocks and the ongoing weakness of activity, Directors considered. With the recovery expected to be gradual and inflation expected to move back below the European Central Bank's 2 percent upper limit for price stability, Directors agreed that monetary policy should maintain an accommodative stance. In view of the predominance and recent increase of downside risks to the recovery, they considered that a clear bias toward further monetary easing would be appropriate.

The steps taken by the ECB to further clarify to market participants the relationship between the monetary framework and the policies that issue from that framework were welcomed by Directors. They saw the de facto narrowing of the range of desired inflation outcomes to the upper half of the 0–2 percent official definition of price stability as a useful step toward balancing the benefits of an ambitious inflation objective against the benefits of providing for easier adjustment to shocks and guarding against the risks of deflation. Directors also welcomed the ECB's move toward integrating broader financial market and real developments into its analysis of monetary developments. However, a number of Directors considered that developments in the monetary aggregates are useful for predicting inflation only in the longer term. Therefore, these Directors suggested that less emphasis be placed on the role of

developments in monetary aggregates, which should be used primarily as long-term information variables to support policy decisions. Several Directors highlighted, in this context, that money and credit developments can provide valuable signals of emerging financial imbalances that could lead to asset price bubbles.

The appropriateness of the Stability and Growth Pact (SGP) as a fiscal framework for the euro area was discussed by the Board, and in particular how it should best guide the adjustment of members that had not yet met the Pact's consolidation objectives. Directors generally considered the SGP to be basically in line with the requirements of both the area members and the fiscally decentralized monetary union and to provide a forward-looking framework that is reasonably well-tuned to the long-term pressures and debt sustainability issues stemming from the costs of aging populations. However, several Directors considered that the SGP's standing had been hurt by public perceptions that countries were held accountable for achieving nominal balance targets regardless of cyclical developments, resulting in procyclical fiscal policy responses. Therefore, these Directors welcomed recent announcements emphasizing the focus on structural balances, although a few Directors cautioned that these may be more difficult to explain to the public.

The recent collective reaffirmation by the euro area authorities of their commitment to avoid excessive deficits and to uphold the SGP objective of achieving and maintaining budgetary positions close to balance or in surplus over the economic cycle was welcomed by the Board. A coordinated consolidation approach would be helpful for further enhancing the credibility of the Pact. Directors also noted the positive role that the Pact had played in supporting most members of the euro area in achieving an underlying fiscal position that was close to balance or in surplus. They welcomed these fiscal consolidation efforts, and urged that fiscal policies in these countries allow the automatic stabilizers to operate fully, as envisaged by the Pact.

In several countries, most notably the three largest, fiscal adjustment had lagged, in particular during periods of strong growth. These countries, Directors suggested, faced the particular challenge of striving to maintain the ambitious medium-term target of achieving fiscal balance while being cognizant of the shorter-term fragility of the cyclical outlook and the demand implications of adjustment. Meeting this challenge would require choosing a path of adjustment to medium-term fiscal targets that both signals credible adherence to SGP rules and maintains a sustainable pace of consolidation. In light of this, Directors endorsed the view that the best way forward would be a concerted and credible commitment by the three largest countries to adjust their underlying fiscal positions by at least ½ of 1 percent of GDP per year over the next several years until they reached close-to-balance structural positions. Such an approach would impart needed fiscal credibility at both the national and area-wide levels, which could significantly lessen the short-term negative demand effects of the adjustment, particularly if fiscal consolidation is anchored in expenditure reforms. They also saw a need for a comprehensive understanding that—provided the 3 percent limit is not breached—the automatic stabilizers should be allowed to play fully around those adjustment paths.

The scope for raising the area's potential through structural reforms remained large, Directors stressed, and it had become increasingly urgent to implement the remaining reform agenda with perseverance, in particular to support the reabsorption of labor. Directors welcomed the "new European paradigm" of employment-intensive growth, but noted that as the employment-generating effects of past reforms wear off, further labor market reforms—together with continued wage restraint—would become an increasingly pressing priority to maintain the paradigm and bolster the area's resilience. Priority should be given, Directors also emphasized, to the further integration of product markets—a long-standing rationale for the EU's existence that continues to be hindered by the slow progress in liberalizing trade in services. The new impetus to, and awareness of gains from, financial sector integration was welcomed, and, in this context, Directors noted, in particular, the agreement on the Lamfalussy process for speeding up the implementation of the Financial Services Action Plan in securities markets, and the recent agreement on its extension to the banking and insurance sectors.

Directors acknowledged that area-wide statistics were adequate for surveillance purposes but called for improving the timeliness of quarterly national accounts data, and the quality of labor market and short-term business cycle statistics.

With respect to *trade policies of the European Union* (EU), Directors emphasized that, given its prominent role in world trade, the EU has a special responsibility to pursue liberal trade and agricultural policies, improve access to developing country exports, and advance the agenda of multilateral trade liberalization. They welcomed the leading role played by the EU in the successful launch of the Doha round of trade negotiations and the priority given by EU trade policy to further liberalization and better trade rules in the multilateral context. They were encouraged by the fact that further escalation over transatlantic trade disputes, which could have undermined progress under the Doha round, had so far been avoided. Reform of the Common Agricultural Policy (CAP) should be a key policy priority for the EU, Directors considered, given the costs it imposes on EU consumers, trading part-

ners, and agricultural markets. The proposals under the mid-term review of the CAP, which involve delinking financial support from production, were seen as a first crucial step in this direction. Directors called for determined political leadership in order to pursue reform comprehensively, including elimination of agricultural export subsidies.

The EU's commitment to increase developing countries' access to its market was welcomed by Directors, and they urged the EU to go further by being prepared to eliminate or reduce tariff peaks and tariff escalation, especially on exports of developing countries. In textiles and clothing trade, quota removals should be accelerated in order to help smooth the adjustment in both EU industries and in those developing country suppliers currently protected by the quota system.

Eastern Caribbean Currency Union

In January 2003, the Board discussed recent economic and policy developments in the Eastern Caribbean Currency Union, which comprises Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

The region had faced a series of harmful shocks, Directors observed, including natural disasters, repercussions from the events of September 11, 2001, and the global economic slowdown. In particular, the weakness of the tourism sector had contributed to an unprecedented overall decline in GDP in both 2001 and 2002. These developments had worsened the region's difficult economic challenges, but Directors stressed the urgency of addressing these challenges with determination. Priority would need to be given to correcting the deepening fiscal imbalances and to safeguarding the stability of the currency board arrangement and the financial system. At the same time, structural reforms should aim at strengthening the region's competitiveness and growth potential.

Efforts at fiscal consolidation and stabilizing public debt ratios, Directors noted, require a range of actions. Expenditure measures should include wage restraint, improved public expenditure management (informed by World Bank public expenditure reviews), and greater focus on public sector investment projects that are geared to growth and poverty reduction and funded largely by grants and concessional loans. To strengthen the revenue effort, Directors urged an early reduction in tax exemptions and discretionary concessions, and a broadening of the tax base, preferably on a regional basis and through the introduction of a VAT-type tax and reduced reliance on trade tariffs. Strengthened public debt management will also play a crucial part in improving fiscal outcomes and lessening vulnerabilities.

The ongoing work coordinated by the Eastern Caribbean Central Bank (ECCB) in the tax, expenditure, and debt management areas was welcomed by Directors. They commended the ECCB for its efforts to support fiscal reforms in the region, particularly in the context of stabilization programs, and saw the fiscal benchmarks being developed as a useful commitment mechanism to improve fiscal performance. The fiscal authorities needed to take full ownership of these regionally coordinated initiatives, Directors stressed, and their full and determined implementation would be key to ensuring fiscal sustainability. Peer review and the regular monitoring of members' performance against the benchmarks would help ensure that all members achieve—at a minimum—the benchmarks over the medium term. Directors also underscored the need to improve fiscal transparency and governance in the region, and suggested that fiscal ROSCs for the members of the ECCB would be helpful in this regard.

Directors noted the mixed assessment of the health of the financial systems in the member countries, and called for measures to ensure bank soundness going forward. They welcomed plans to strengthen the domestic bank supervisory and regulatory regime in accordance with the Basel Core Principles, as well as the amendments to the Banking Act and the ECCB Agreement Act, and looked forward to their early enactment. Establishing uniform agencies in each jurisdiction to regulate nonbank financial institutions and the offshore financial sector was a matter of urgency, Directors stressed. Problem banks needed to reduce their nonperforming loans and would, in some cases, have to be recapitalized.

Recent progress toward strengthening regulation and supervision in the offshore financial sector was welcomed by Directors, but prospects remained dim for sustaining a vibrant offshore industry over the medium term in the region. While efforts to raise supervision to international standards needed to continue, it would also be important to work toward mechanisms to prevent the cost of supervision from outweighing the overall economic benefits of the sector. Directors encouraged the authorities to keep up the momentum in their efforts to strengthen the mechanisms to combat money laundering and the financing of terrorism. They supported the provision of IMF technical assistance for this purpose, and looked forward to the FSAP exercise, to be conducted later in 2003.

The monetary and exchange rate system operated by the ECCB had generally served the region well in the past, Directors considered, and they noted the ECCB's high currency backing ratio and comfortable level of international reserves. They cautioned, however, that preserving the exchange rate peg going forward would require sustained fiscal consolidation and a decline in public sector debt, a sound and well-regulated financial sector, and strengthened efforts to increase the region's competitiveness. Some Directors encouraged the

authorities to keep the currency peg under review. The authorities were also encouraged to abolish the floor on savings deposit rates in order to increase the responsiveness of interest rates to liquidity conditions.

Determined efforts to strengthen external competitiveness and achieve sustainable growth were important, Directors underscored. This would require strong wage restraint, and efforts to increase the flexibility of the labor market and enhance the skill composition of the labor force. Directors also highlighted the benefits that members of the currency union would obtain from deeper structural reforms to improve efficiency as they advanced toward greater regional and global integration. They supported the goal of creating an economic union by 2007, and encouraged the authorities to accelerate integration plans that would position the region to take full advantage of the anticipated Free Trade Area of the Americas and facilitate adjustment to the prospective loss of EU trading preferences for key agricultural products. Stronger efforts toward privatization, trade liberalization, civil service and public sector reforms—including pension reform—and improvements in the business environment were also needed, Directors noted. The region would need appropriate technical assistance to support its integration efforts.

Directors underscored the importance of strengthening economic statistics and addressing remaining weaknesses that hamper the quality of economic analysis. Improvement is most urgent in the national accounts and labor statistics, while further efforts are required to improve the quality, transparency, and timeliness of economic data.

West African Economic and Monetary Union

In March 2003, the Board discussed the recent economic developments and regional policy issues with the West African Economic and Monetary Union (WAEMU), which comprises Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo.

The strong economic expansion in the WAEMU region in the aftermath of the 1994 devaluation of the CFA franc had slowed, Directors observed. The continued uncertainties posed by the unsettled political and economic situation in Côte d'Ivoire (the largest economy in the WAEMU), the delayed global economic recovery, and the possibility of high oil prices resulting from war in the Middle East, along with persistent structural and institutional rigidities across the WAEMU membership, weighed on the region's growth prospects. An early economic recovery and reestablishment of political stability in Côte d'Ivoire would be essential for regional GDP growth to resume at a pace consistent with poverty reduction in the region, Directors recognized. They considered that the WAEMU was at a crossroads: member governments needed to match their political commitment to WAEMU with strong actions to deepen the regional integration process in the face of the serious uncertainties about the economic outlook.

Directors commended the authorities of the WAEMU for the progress achieved in regional integration since 1994, including the establishment of a customs union and an economic union. However, some important regional reforms remained to be implemented. Directors therefore concurred with the decision to extend the timetable for economic convergence of the member states to 2005. They stressed that determined further fiscal consolidation by all the WAEMU members over the next few years would be necessary to meet the ambitious timetable. The strengthening of regional institutions and greater political commitment on the part of member countries would also facilitate the removal of the remaining obstacles to intraregional trade and the creation of a full-fledged customs union and a single market.

The prudent monetary policy of the Central Bank of West African States (BCEAO) had kept inflation low and the coverage of base money by foreign reserves adequate, Directors noted, despite the weakening of economic performance of the WAEMU member countries. They considered that further steps would be required to streamline monetary policy instruments and to improve the functioning of the regional interbank market. They urged the authorities to pursue a more flexible interest rate policy, and to lay the basis for replacing the current differentiation of reserve requirements with a uniform reserve requirement ratio for all members at the appropriate time. The shift in government budget financing from central bank direct advances to the issuing of securities on the regional capital market was welcomed by Directors, but they noted that for the market to work optimally, close coordination of monetary and fiscal policies across the WAEMU members, as well as strict observance of the fiscal convergence criterion, would be called for. Development of a deep and effective regional capital market would greatly enhance the efficacy of monetary policy, Directors considered.

Directors noted the moderate improvement in the financial position of the WAEMU banking system and emphasized the importance of further improvement. Measures to ensure the observance of prudential ratios by banks, and to strengthen loan recovery mechanisms and the judicial environment, would help to raise the standard of banks' portfolios. Reinforcement of the authority of the Regional Banking Commission would be essential to ensure the effectiveness of bank supervision and the adherence by financial institutions to prudential norms.

The adoption by the WAEMU Council of Ministers of an anti-money-laundering directive and a draft com-

munity regulation on the freezing of funds linked to terrorist activities was supported by Directors, who also urged member states to enforce strictly the relevant laws and regulations.

Directors welcomed the initiatives undertaken in the past few years to harmonize taxation, budget laws, and government accounts, and they noted that these initiatives and the steadfast implementation of the remaining reform agenda will be crucial if the full benefits of economic integration are to be reaped. The authorities were encouraged to pursue the harmonization of exemptions and the adoption of a common investment code, which would help level the playing field and remove residual distortions. Directors welcomed the establishment of structural funds, which should help reduce regional disparities. They also encouraged the establishment of a regional solidarity bank, which should complement rather than compete against the lending activities of microfinance institutions in the context of poverty reduction efforts.

The external competitiveness of the WAEMU economies is so far adequate, Directors agreed, but these economies remained vulnerable to fluctuations in the terms of trade. To maintain the region's external competitiveness and its share in export markets, Directors recommended policies aimed at broadening the productive base and diversifying the economies, improving factor productivity, and reducing high nonlabor domestic costs, along with continued sound macroeconomic policies. The authorities were also urged to pursue regional sectoral policies aimed at addressing the underlying structural rigidities of the WAEMU economies.

The steps taken toward the implementation of a common trade policy by WAEMU members and the encouragement of intraregional trade were welcomed by the Board. A common external tariff (CET) was being set in place in all members. Directors also welcomed the increase in volume in intraregional trade resulting from the internal trade liberalization undertaken so far. At the same time, considerable scope for further liberalization remained, and Directors encouraged the authorities to eliminate nontariff barriers to intraregional trade, as well as the exceptions to the CET.

Directors recalled the decision by the Heads of State of the Economic Community of West African States (ECOWAS) to create a large single regional market, and ultimately to establish a common monetary framework. Achievement of this objective would require a high degree of macroeconomic convergence among the member countries, which at present was lacking. Directors acknowledged the strong political support underpinning the integration process within ECOWAS, and considered that the goal of achieving a single monetary union in West Africa could serve as a useful anchor for economic policy, even though convergence remained an ambitious objective and would take time. Member countries of the WAEMU and the ECOWAS were encouraged to intensify their cooperation in the areas of macroeconomic and sectoral policies and trade in order to set a firm foundation for monetary and economic union at the appropriate juncture.

CHAPTER 2

Strengthening Surveillance and Crisis Prevention

Surveillance lies at the heart of the IMF's efforts to help prevent economic and financial crises. The Fund has taken a variety of measures in recent years to strengthen its surveillance, reflecting the changing global environment, including the increased importance of international capital flows, and drawing on the lessons of international financial crises. These initiatives aim to encourage members to adopt policies and institutional reforms that make their economies more resilient to potentially harmful developments and financial stress, support sustained and balanced global growth, and contribute to a more stable international financial system.

Issues related to economic and financial globalization were the subject of two IMF conferences and an informal Board seminar in FY2003 (see Box 2.1).

During FY2003, the IMF reviewed several of these key measures and took a number of additional steps to enhance its surveillance and contribution to crisis prevention:

- The Board undertook reviews of the IMF's *strategy for enhancing the effectiveness of its surveillance*, and determined ways to carry the agenda forward.
- Management and staff continued to develop a system for *assessing crisis vulnerabilities* in countries that are potentially exposed to capital account shocks. This system enables the staff to pull together, for internal use, information on global economic and market developments, analyses of vulnerabilities and financing scenarios, early warning indicators, financial soundness indicators, information on vulnerabilities in specific sectors, and market intelligence to judge the likelihood of incipient crises and consider policies to forestall them.
- The Board proposed several improvements to assessment exercises under the IMF's *standards and codes initiative* and the joint IMF–World Bank *Financial Sector Assessment Program (FSAP)*.
- Executive Directors broadly supported proposals to enhance *data provision for surveillance purposes.*
- A new analytical framework for *debt sustainability assessments* was adopted in June 2002 and by end-April 2003 was being used in surveillance reports for members with significant capital market access, as well as in reports on members' requests for use of the IMF's general resources.
- In April 2003, the Board endorsed further measures to strengthen *surveillance in program countries*, partly in response to the Independent Evaluation Office's report on the prolonged use of IMF resources. (See Chapter 4 for more details on the IEO report.)
- The IMF took steps to *clarify the signals it conveys to official and private creditors* about the strength of a member's policies.
- The IMF significantly advanced its contribution to *combating money laundering and the financing of terrorism*, including through the start of a 12-month pilot program in October 2002.

Follow-Up to 2002 Biennial Surveillance Review and Steps Forward

The financial year saw two follow-up discussions by the Executive Board of the 2002 Biennial Review of Surveillance. The first, in July 2002, led to several conclusions: endorsement of a new guidance note for staff on surveillance, agreement on a first step toward enhanced assessment of the impact of the IMF's policy advice, and measures to strengthen surveillance in program countries. The second discussion, in March 2003, was a more comprehensive follow-up: the Board revisited the conclusions of earlier reviews, took stock of the range of initiatives already undertaken to strengthen surveillance, and discussed a number of areas where further work would be helpful.

Past reviews, Directors noted, pointed to five key ingredients of effective surveillance:

- timely, comprehensive, and accurate information;
- focused, high-quality analysis;
- openness to different perspectives to minimize the risk of "tunnel vision";
- effective communication of assessments to the authorities and the public; and
- desired impact on members' policy decisions.

They observed that, building on the lessons learned from the Mexican and Asian crises of the 1990s, a range of steps has been taken in recent years to shape

Box 2.1
Research on Globalization

The debate continues on globalization's benefits and costs and about the policies that can best ensure that its net benefits are maximized and shared by all. During the financial year, research on issues directly related to globalization was discussed at three meetings at the IMF.

The IMF held its *Third Annual Research Conference* in November 2002. The theme was *Capital Flows and Global Governance*. The conference provided a forum for economists from the Fund and elsewhere to exchange views on recent research related to globalization and the IMF's work. All research papers presented at the conference can be found at *www.imf.org/external/pubs/ft/staffp/2002/00-00/arc.htm*.

A *Global Linkages Conference* was held in Washington, D.C., in January 2003, to explore how economic linkages across countries have changed in recent years and what implications these changes have for policymakers in advanced and developing economies. The presentations and the discussions are available at *http://web.mit.edu/kjforbes/www/GL-Website/index.htm*.

In March 2003, the Executive Board discussed in an informal seminar a paper by the staff on the *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence*, which was subsequently published on the IMF website. The document is available at *www.imf.org/external/np/ res/docs/2003/031703.htm*.

IMF surveillance to better meet these criteria. Nevertheless, there is scope for further progress in these ongoing efforts, including the following:

- improving data provision to the IMF and data dissemination to the public;
- achieving more systematic financial sector surveillance—in particular, through the Financial Sector Assessment Program (FSAP); and
- strengthening assessments of policy frameworks and institutions against internationally recognized standards and codes.

In addition, vulnerability assessments have been significantly bolstered, with better analyses of debt sustainability and capital account developments, and more consideration of market participants' perspectives. Surveillance in program countries is being strengthened by ensuring that economic conditions and policies are reassessed from a fresh perspective. Moreover, regional surveillance is being reinforced by the multilateral surveillance missions to major emerging market financial centers conducted by the International Capital Markets Department to gather market participants' views on the vulnerabilities facing emerging market economies.

Agenda for Further Improvement

Directors were generally of the view that the strengthened architecture of surveillance put in place in recent years remains a sound framework for the conduct of the IMF's surveillance activities. The priority now was to take full advantage of the potential of the present framework by ensuring that progress with implementation was sustained and that the various surveillance outputs were adequately linked. In addition, Directors identified six areas in which further work and reflection would be useful.

First, while a broad consensus has emerged on the types of policies that help to provide buffers against outside shocks, questions remain about the appropriate *calibration of the IMF's policy advice in these areas.* For instance, recent experience in some emerging market countries suggests that prudent debt levels are lower than previously thought, and has focused new attention on the size of risks in highly dollarized economies. The IMF will be working to improve the analytical basis for policy advice in such areas, and to identify criteria for gauging the soundness of policies. However, many Directors saw considerable difficulty in developing such criteria without falling into a one-size-fits-all approach, and cautioned against allowing such criteria to transform Article IV consultations into a rating exercise. They also observed that this approach should apply to the whole membership as relevant.

Second, in order to strengthen policy advice, the IMF will be looking at ways to integrate *insights from cross-country experiences more systematically* into surveillance.

Third, experience in a number of recent crises suggests that whether a country can implement policies that reduce vulnerabilities depends on the robustness of its political institutions and capacity to mobilize political consensus in favor of needed adjustment measures. Given the importance of these political factors—reiterated in the IEO's evaluation of prolonged use of IMF resources—the Board encouraged the staff to enhance its *analysis and reporting of political economy issues.* This effort is to proceed in an evolutionary manner, based on close dialogue with member countries and building on treatment already accorded to such issues in post-conflict cases and in countries facing severe governance issues. Many Directors cautioned, however, that the staff has limited expertise in political analysis and that political economy considerations should not undermine the technical quality of its policy advice.

Fourth, policy initiatives on transparency, global and regional surveillance, and surveillance over systemic effects of members' trade policies have been designed, in part, to *enhance the impact of the IMF's advice to systemically and regionally important countries*—particularly the major industrial countries, whose trade,

macroeconomic, and financial policies have major repercussions on other members and the system as a whole. However, in view of the widespread concern that the views of the IMF on such members' policies are still not taken sufficiently into account, Directors saw scope for further efforts to draw attention to the positive and negative effects of systemically and regionally important countries' policies, including the global impact of their trade policies.

Fifth, the IMF must continue to grapple with the *trade-offs between the goals of transparency and candor* in the IMF's policy assessments and prescriptions. Directors agreed that a key challenge is to preserve full candor in the staff's diagnoses and prescriptions to the Board. Subject to that overriding objective, efforts should be made to continue boosting rates of publication of staff reports.

Sixth, Directors supported the ongoing efforts to *enhance the role of surveillance in program countries*, including through a special guidance note to staff that will bring together the various steps taken to help ensure an independent assessment of economic conditions and policies and to present this fresh perspective at a time when it is most beneficial.

Several steps are already planned to move the policy agenda forward, Directors noted. These include the review of the framework for debt sustainability assessments; work on the feasibility and desirability of adapting the Contingent Credit Line (CCL) eligibility framework for possible use in surveillance; the review of progress on financial soundness indicators as well as a seminar discussion on the balance sheet approach to financial crises; the review of the IMF's transparency policy; and implementation of the conclusions of the review on prolonged use of IMF resources.

Building on the Success of the Standards and Codes Initiative and the FSAP

The Executive Board conducted reviews of both the *Standards and Codes Initiative* and the *Financial Sector Assessment Program* in March 2003 (see Box 2.2). These initiatives were significantly enriching IMF surveillance, Directors found, and member countries indicated that they had benefited from participation in the initiatives.

For the standards and codes initiative, Directors agreed that going forward, coverage should be more selective, focusing on the countries and standards expected to have the highest payoff in improving domestic and international financial stability and strengthening institutional capacity. In addition, Reports on the Observance of Standards and Codes (ROSCs) will be expected to focus more sharply on main conclusions and recommendations, with greater attention to follow-up.

In the case of the FSAP, Directors observed that there is scope for streamlining the assessment exercises. In addition, priority should continue to be given to industrial countries and emerging market economies of systemic importance, while maintaining a balanced coverage of countries. The program remained the foundation for strengthened financial sector surveillance, Directors agreed, but it should be complemented with other tools—such as FSAP updates, more participation of specialized financial sector staff in Article IV missions, and off-site monitoring, including through financial soundness indicators—to achieve more continuous surveillance, especially of systemically important countries. To make resources available for these activities, Directors proposed a moderate reduction in the annual number of FSAP assessments and reassessments—while continuing to expect that the entire membership would participate in the program over time—coupled with greater variation in the scope of FSAP assessments according to country circumstances. The proposed greater focus on medium-term and structural issues in low-income countries with small financial systems was welcomed by Directors. It was also noted that for least developed countries with nascent diversified financial systems, the more immediate need might be technical assistance to develop the financial sector, rather than a resource-intensive detailed FSAP.

Data Provision for Surveillance Purposes

The IMF's member countries supply the data that the Fund needs to oversee their economic policies. Members are required to provide such data under the IMF's Articles of Agreement. Crises in emerging market economies since the mid-1990s have made clear the importance of comprehensive, timely, and accurate economic and financial data—including on international reserves, external debt, and capital flows—for assessing countries' external vulnerabilities and as an essential element of surveillance.

To guide members in disseminating their economic and financial data to the public, the IMF created data standards, the Special Data Dissemination Standard (SDDS) and the General Data Dissemination System (GDDS); see Box 2.2. These standards contribute to the pursuit of sound macroeconomic policies and the smooth functioning of financial markets.

In May 2002, the Board met to discuss the *provision of data to the IMF for surveillance purposes.* Directors welcomed recent improvements in members' data provision to the IMF for surveillance purposes. They reaffirmed the IMF's policy on data provision whereby all members are required to provide a minimum set of core data, consistent with their capacity. Beyond this, member countries are expected to supply the data

Box 2.2

The Standards and Codes Initiative and Financial Sector Assessment Program

In 1999–2000, the IMF, with the World Bank, introduced two initiatives as part of the international community's strategy to improve the stability of the global financial system. Under the standards and codes initiative, the Fund and Bank assess member countries' adherence to internationally recognized standards and codes of good economic and financial practices that contribute to sound national and international economies. *Reports on the Observance of Standards and Codes (ROSCs)* are a key output of the initiative. Work under the second initiative, the Financial Sector Assessment Program (FSAP), examines a country's financial sector institutions, policies, and vulnerabilities in a comprehensive manner, including possible systemic risks. These are detailed in a *Financial Sector Stability Assessment* report.

Typically, in both programs, which are interrelated, joint teams of IMF and Bank staff—supported by experts from a range of national agencies and international standard-setting bodies—make at least one in-country visit and work with government authorities and/or the representatives of the private sector. Countries' participation in the programs is voluntary.

Reports on the Observance of Standards and Codes (ROSCs)

A ROSC is an assessment of a country's observance of one of 12 areas and associated standards useful for the operational work of the Fund and Bank. The reports—about 70 percent of which are subsequently published—examine three broad areas: transparency, financial regulation and supervision, and market integrity (including corporate governance, accounting, auditing, and insolvency).

Transparent government operations and policymaking: *Country reports on Data Dissemination, Fiscal Transparency, and Monetary and Financial Policy Transparency.* The underlying assumption is that better-informed publics are more likely to hold their governments accountable for their policies and that investors, armed with better data and a standard against which to evaluate them, are more likely to invest wisely. Key tools are the IMF's statistical initiatives (SDDS and GDDS) and codes of transparency in monetary, financial, and fiscal policies.

Special Data Dissemination Standard (SDDS). Created in 1996, the SDDS is a voluntary standard whose subscribers—countries with market access or seeking it—commit to meeting internationally accepted levels of data coverage, frequency, and timeliness. Subscribers also agree to issue calendars on data releases and follow good practices with regard to data quality and integrity. Information on subscriber data dissemination practices is posted on the IMF's website on the Data Standards Bulletin Board, which is linked to subscriber websites.

General Data Dissemination System (GDDS). For countries that do not have market access but are eager to improve the quality of their national statistical systems, the GDDS offers a "how to" manual. Voluntary participation allows countries to set their own pace but provides a detailed framework that promotes the use of widely accepted methodological principles, the adoption of rigorous compilation practices, and ways in which the professionalism of national systems can be enhanced. Participating countries post their detailed plans for improvement on the Data Standards Bulletin Board, thus permitting both domestic and international observers to view their progress.

Financial sector standards: *Country reports on Banking Supervision, Securi-*

appropriate to their individual characteristics and circumstances.

Directors broadly supported IMF staff proposals to enhance the provision of data needed by the Fund for surveillance purposes. Highlights of the discussion included:

Issues regarding moving to weekly dissemination of data on international reserves under the SDDS. Frequent and timely disclosure of reserves data to the public is emerging as a best practice for many countries, Directors remarked. However, increasing frequency and timeliness in the data requirements of the SDDS is not now necessary, most Directors considered, noting also that moving to weekly data would raise technical and resource constraints for most subscribers and could deter new subscribers. Directors will have an opportunity to return to this issue later in 2003.

Improving provision of fiscal data. Directors stressed the critical importance of the IMF's being provided with adequate fiscal data, and asked the staff to continue working on improving the provision of these data. They welcomed the recent completion of the *Government Finance Statistics Manual*, which represents a major advance in the development of an analytical framework for fiscal data, and they supported giving IMF technical assistance to countries to help them adopt the practices set out in the new manual.

Identifying gaps in data for vulnerability assessments and national policymaking. Recent improvements in Article IV report discussions of countries' vulnerabilities, particularly for countries with access to international capital markets, were welcomed by the Board. Nevertheless, data deficiencies in many cases continued to hamper vulnerability analysis, and most Directors agreed that staff reports should more clearly identify gaps in data and technical assistance priorities during Article IV consultations and discuss progress in compiling data needed for vulnerability assessments, as relevant.

ties Regulation, Insurance Supervision, Payments Systems, and Combating of Money Laundering and Terrorist Financing. The IMF and the World Bank each year undertake at members' requests a certain number of financial system "health checkups" under the Financial Sector Assessment Program (see below). As part of this checkup, staff prepare detailed assessments of the country's observance of relevant financial sector standards and codes such as the Basel Core Principles for Effective Banking Supervision; summaries of these assessments may be issued as individual ROSCs as well as included in a comprehensive *Financial Sector Stability Assessment* report on the country.

Market-integrity standards for the corporate sector: *Country reports and assessments on Corporate Governance, Accounting and Auditing, and Insolvency and Creditor Rights.* With the private sector serving as the engine of growth in most economies, the health of the corporate sector is a critical concern. The World Bank typically takes the lead in assessing the quality of corporate governance, the adequacy of accounting and auditing standards, and the state of insolvency procedures and creditor rights.

The standards initiative has attracted growing participation from members and attention from financial market participants and ratings agencies. By end-April 2003, over 388 ROSCs had been prepared for 91 countries. Most systemically important countries are participating in ROSCs, though country coverage of the assessments remains uneven across regions.

Financial Sector Assessment Program (FSAP)

The FSAP is a comprehensive health checkup of a country's financial systems. Financial systems comprise the whole range of financial institutions, such as banks, mutual funds, and insurance companies, as well as the financial markets themselves—that is, securities, foreign exchange, and money markets. Also included are the payments system and the regulatory, supervisory, and legal frameworks that underlie the financial institutions and markets.

The Checkup. FSAP teams (IMF and Bank staff and experts from central banks, national supervisory agencies, and international standard-setting bodies) seek to alert member countries to likely vulnerabilities in their financial sector and to help the IMF and the Bank—and the international community—formulate the appropriate assistance. Teams use a variety of analytical tools (including stress tests and financial soundness indicators) to review financial sectors, evaluate how risks are managed, weigh possible technical assistance needs, and help countries prioritize policy responses. The FSAP assessment is an important input to IMF surveillance. By end-April 2003, reports under the program had been completed for 48 countries or regions, another 22 were under way, and a further 31 countries had committed to future participation.

Offshore Financial Centers

The IMF uses many of the diagnostic tools developed for the FSAP in its work on offshore financial centers. This work helps members to identify gaps and reduce potential vulnerabilities in their financial systems and improves the statistical coverage of the activities of offshore financial centers. Assessments of offshore financial centers evaluate financial regulation and supervision in jurisdictions with significant offshore financial activity to help safeguard the stability and integrity of their financial systems.

The Board noted that the cost implications of these enhancements for member countries as well as for the IMF will require careful prioritization and sequencing. They stressed that efforts to increase the frequency of data provision should not come at the expense of quality.

Signaling Assessments of Members' Policies

The IMF's interactions with member countries can have an important signaling function. Most of these interactions take place in the context of IMF surveillance and the IMF's financial support of policy programs. However, on occasion the IMF has responded to requests from member countries for special monitoring that goes beyond surveillance but does not involve an IMF financial arrangement. Some of these monitoring mechanisms were specifically intended to provide signals to official or private creditors. In recent years, such monitoring has mainly taken the form of staff-monitored programs (SMPs), under which no funds are lent but IMF staff follow a member's economic program and meet regularly with the country's authorities to discuss economic developments and policies.

During the discussion of the 2002 Biennial Review of the IMF's Surveillance, Directors expressed concerns about certain aspects of these programs. A follow-up discussion took place in January 2003 based on a paper entitled *Signaling Assessments of Members' Policies.* Experience with another signaling mechanism—assessments of members' policies provided in response to ad hoc requests from various official creditors or donors—was also discussed.

Concerns about SMPs relate mainly to SMPs that are used to convey signals on a member's policies to official and/or private creditors, Directors agreed. Given the close formal resemblance to IMF-supported programs, these "signaling" SMPs risk being misinterpreted as carrying the IMF's seal of approval. Moreover, relatively lax standards for reporting on perfor-

mance have allowed members to use the positive signal of initiating an SMP without adequate follow-up on implementation.

In light of these concerns, Directors felt that the existing framework for SMPs is not well suited to situations where members see a need for monitoring by IMF staff to provide assessments of their economic policies to official and/or private creditors. Consequently, they supported a proposal to discontinue such "signaling" SMPs. However, Directors concluded that the SMP framework remains suitable for circumstances where members need to establish a policy track record based on strong ownership before moving to an IMF arrangement or after an arrangement has gone off track.

Views differed, however, on establishing a new mechanism for this purpose. Given their differences on the matter, Directors agreed that, for the time being, the IMF will use existing mechanisms, including the Article IV consultation process and precautionary arrangements, for signaling purposes. If later it becomes evident that there is a demand for a more specific signaling mechanism, the staff will come back to the Board with a new proposal.

On the future role of SMPs, Directors were of the view that, in cases where SMPs are used to build a policy track record toward an IMF arrangement, the risk of misinterpretation is relatively low. In these cases, Directors concluded, the SMP framework remains suitable.

IMF staff also provide assessments of members' macroeconomic conditions and policies in response to various ad hoc requests from other international financial institutions, creditors, or donors. While recognizing the need for flexibility in meeting such demands, Directors nevertheless saw merit in general guidelines for the preparation of these assessments. They stressed that these assessments should be sufficiently nuanced to take account of different country circumstances, but written clearly so that the boards of other international financial institutions or other donors would be able to distinguish between countries with strong macroeconomic policies and those without. The assessments should also provide a brief history of the IMF's relationship with the member country.

Review of the Contingent Credit Line

The IMF designed and introduced its Contingent Credit Line (CCL) in 1999 as a way to enhance incentives for sound policies and provide a better safety net for good performers. It offers precautionary short-term financing under a Stand-By Arrangement primarily to help a member overcome the balance of payments financing need arising from a sudden and disruptive loss of market confidence due to contagion, and largely generated by circumstances beyond the member's control. At the end of FY2003, Directors were engaged in a review of the CCL, addressing reasons why it had not been used to date, especially:

- Concerns by members that a CCL request could be viewed as a sign of weak, rather than strong, policies;
- The possibility that a country's withdrawal from the CCL (or a determination that it no longer met the requirements) might trigger adverse market reactions; and
- An impression that the CCL might not provide greater assurances of timely financing than other IMF facilities and policies.

Besides its consultations with members and Directors, the staff has engaged in extensive outreach with market participants on these and other issues related to the CCL. The Board expects to continue its discussions in the period prior to the scheduled expiration of the facility in November 2003. In the interim, it has asked the staff to explore ways in which it might be possible to use strengthened IMF surveillance and precautionary arrangements to achieve the goals of the CCL in helping member countries with sound policies to confront the challenges of globally integrated capital markets.

Improving Sustainability Analysis

Assessments of the sustainability of a country's external and public debt are a key element in the IMF's work with many member countries. Judgments about debt sustainability—whether the debt can be serviced without an unrealistically large correction to the balance of income and expenditure—underpin the IMF's decisions in program contexts, in particular by helping to determine when financing is appropriate and, if so, the appropriate amount of financing to provide. These judgments become critical—and in many cases, particularly finely balanced—in cases of emerging market countries that are highly integrated into global capital markets and may have large financing needs.

In June 2002 the Board discussed and endorsed a new framework for judging debt sustainability. The new framework provides a reality check on the baseline projections on the basis of which sustainability is assessed, by clarifying the underlying assumptions regarding key variables including growth, real interest rates, exchange rates, and primary fiscal or external imbalances, and by highlighting their implications. It introduces a set of standardized parameters for stress-testing the program baseline, to identify the extent to which sustainability hinges on the assumption of a macroeconomic outcome more favorable than experienced in the past and to help ensure the robustness of the program in the face of plausible shocks.

In their discussion, Directors noted that assessments of sustainability are necessarily based on judgment,

given that they depend upon a complex assessment of the interrelationships among several factors—including macroeconomic developments, political and social constraints on adjustment, and the availability and cost of private and official financing. The new framework helps strengthen the analytical basis for making these judgments. It does not provide a mechanistic approach, which would be inappropriate given the wide variation in the debt-bearing and adjustment capacities of different economies over time. Rather, it is a framework for informing these judgments and expressing them in a transparent manner. As greater experience is gained, efforts will continue on further refining the framework.

Combating Money Laundering and the Financing of Terrorism

In July 2002, the Board discussed proposals to advance the IMF's contribution to international efforts to combat money laundering and the financing of terrorism (AML/CFT). The IMF had begun a new chapter in its work on this subject, Directors noted, by taking two key steps:

- conditionally adding the Financial Action Task Force (FATF) 40 Recommendations and the 8 Special Recommendations (FATF 40+8) to the list of areas and associated standards and codes useful to the operational work of the IMF (see Box 2.3); and
- endorsing a 12-month *pilot program* of AML/CFT assessments and accompanying ROSCs that would involve participation of the IMF and the World Bank, the FATF, and FATF-Style Regional Bodies (FSRBs).

Governing Principles

In moving forward, Directors emphasized that four key principles should guide the IMF's role in AML/CFT assessments and accompanying reports:

- the IMF staff's involvement in assessing non-prudentially regulated financial sector activities should be confined to those that are macroeconomically relevant and pose a significant risk of money laundering or terrorism financing;
- all assessment procedures should be transparent and consistent with the mandate and core expertise of the different institutions involved, and compatible with the uniform, voluntary, and cooperative nature of the ROSC exercise;
- the assessments should be followed up with technical assistance, if requested by a member, to build its institutional capacity and develop its financial sectors; and
- the assessments would be conducted in accordance with the comprehensive and integrated methodology being developed jointly by IMF and World Bank staff and the FATF.

Box 2.3

Money Laundering and the FATF

Money laundering is the hiding or hidden movement of assets resulting from criminal activity to muddy the connection between the crime and the assets. In turn, this laundered money is sometimes used to finance terrorism.

The harmful effects of money laundering on countries could include a range of severe macroeconomic consequences, such as unpredictable changes in money demand, risks to the soundness of financial institutions, and contamination effects on legal financial transactions. And money laundering can inhibit foreign direct investment if a country's commercial and financial sectors are perceived as being under the influence of organized crime. From a wider perspective, the financing of terrorism threatens the stability of individual countries and of the international financial system. Because financial market integrity is closely linked to financial stability, setting out guidelines for financial sector supervision is an important role for the IMF, which has expertise in assessing and providing technical assistance in financial sectors and overseeing members' exchange systems.

Financial Action Task Force

The Financial Action Task Force on Money Laundering (FATF) is an intergovernmental body established by the G-7 summit in Paris in 1989 to develop and promote policies, at national and international levels, against money laundering. The task force monitors its members' progress in carrying out anti-money-laundering measures, reviews money-laundering techniques and countermeasures, and promotes the global adoption of anti-money-laundering measures, collaborating with other international bodies. In April 1990 the task force issued a set of "40 Recommendations," which provide a comprehensive blueprint of the actions needed to fight money laundering. After the terrorist attacks of September 11, 2001, the scope of the FATF was expanded to include terrorist financing. At a Plenary on the Financing of Terrorism, the task force issued 8 Special Recommendations on Terrorism Financing to supplement the original 40. The recommendations are now referred to as the FATF 40+8.

The IMF's Executive Board agreed in April 2001 that the FATF 40 Recommendations be recognized as the appropriate standard for combating money laundering and that work should be conducted to determine how the Recommendations could be made operational in the IMF's work. In July 2002 Executive Directors conditionally approved adding the FATF 40+8 to the IMF list of standards and codes (see text); they were formally added in November 2002.

Pilot Program

A 12-month pilot program of AML/CFT assessments was initiated in October 2002, with participation of the IMF, World Bank, FATF, and many of the FSRBs. The Fund and the Bank are undertaking the assessments of

the FATF 40+8 and accompanying ROSCs in the context of the Fund/Bank Financial Sector Assessment Program and the Fund's Offshore Financial Center assessments. They are following the AML/CFT assessment methodology endorsed by the FATF in October 2002 and also approved by the IMF Executive Board as part of the pilot project's launch. (This methodology was reviewed by the Board in July 2002.) About 50 assessments using the methodology could be undertaken under the pilot program, including up to 8 by the FATF, 12 by the FSRBs, and at least 36 by the IMF and the World Bank.

The FSRBs are generally cooperating in the pilot program, although there is still some uncertainty about how many assessments they will undertake. Three regional bodies have endorsed the methodology, and two others are expected to do so shortly. The Caribbean FATF, while not fully endorsing the methodology, has acknowledged that it will be used in assessments of member countries during the pilot project in IMF/World Bank assessments.

The assessments are identifying weaknesses in AML/CFT regimes, and technical assistance has been significantly stepped up in response. Areas of weakness include legislative drafting and review, especially in combating the financing of terrorism, and the effectiveness of supervisory arrangements. The IMF and the World Bank have completed, initiated, or agreed to 52 AML/CFT technical assistance programs, comprising direct technical assistance to 40 jurisdictions and 12 regional technical assistance projects. In March 2003, they published a Joint Interim Progress Report. The participating parties will undertake a full review of the pilot program early in 2004.

CHAPTER 3

A Better Framework for Crisis Resolution

While crisis prevention has been the main focus of the IMF's reform agenda, the Fund has also been working to improve the management and resolution of the financial crises that do occur, where it also has a central role. Indeed, a stronger and clearer framework for crisis resolution should make an important contribution to crisis prevention in addition to lessening the number and severity of crises. Evolving reforms of the framework for crisis resolution have been designed to reinforce incentives for countries and their creditors to reach voluntary, market-oriented solutions to their financing problems. To this end, the IMF has sought to combine a clearer policy on access to Fund resources and greater selectivity in its lending with an examination of possible approaches to strengthening the mechanisms for the restructuring of sovereign debt. This chapter describes progress made in these areas during the past financial year.

Access Policy in Capital Account Crises

Increasing international integration of financial markets in recent decades has facilitated the financing of investment and economic activity in emerging market countries but has also exposed these countries to the risk of crises caused by rapid reversals of capital flows. In some cases, the IMF has supported members' efforts to resolve such crises by providing large amounts of financing. Beginning with Mexico in 1995, during the Asian crises of 1997–98, and subsequently, the IMF has in several cases provided financing in amounts that have been well above the access limits normally applying to Stand-By Arrangements and arrangements under the Extended Fund Facility (EFF).

The Executive Board held discussions on access policy in the context of capital account crises in September 2002 and January/February 2003. Most of the programs supported by exceptional access have been quite successful in helping the member achieve external viability, resume growth with limited vulnerability, and regain access to private markets, Directors noted, although in some cases more slowly than at first expected. But in a few cases, the combination of adjustment and exceptional access in the context of the associated political and external environment was insufficient to avoid a restructuring of obligations. However, in all cases, the borrowing members have remained current on their repayment obligations to the IMF. From a broader perspective, Directors also observed that, while some moral hazard is bound to be present in IMF lending, there is little empirical evidence that the use of exceptional access in general has had large moral hazard effects by increasing investor or country risk taking.

During the Board discussion in September 2002, Directors agreed that more clearly defined criteria for exceptional access in capital account crises were needed to help shape the expectations of members and markets, set up benchmarks for difficult decisions about program design and access, safeguard IMF resources, and ensure uniform treatment of members. Directors generally considered that (at a minimum) the following criteria would need to be met to justify exceptional access for members facing a capital account crisis:

- The member is experiencing exceptional balance of payments pressures on the capital account, resulting in a need for IMF financing that cannot be met within the normal limits.
- A rigorous and systematic analysis indicates there is a high probability that debt will remain sustainable.
- The member has good prospects of regaining access to private capital markets within the time IMF resources would be outstanding, so that the Fund's financing would provide a bridge.
- The policy program of the member country provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.

During the January/February 2003 discussions, Directors agreed on stronger procedures for decision making on all exceptional access proposals. These procedures include a higher burden of proof in program documentation, early consultations with the Board on program negotiations in exceptional access cases based on a concise staff note outlining the considerations, and ex post evaluation of programs with exceptional access within a year of the end of the associated arrangement. The ways in which these criteria and

procedures are applied in practice in reaching judgments about access will, however, be decisive, and an assessment of implementation is planned by early 2004.

Policy on Lending into Arrears to Private Creditors

When a member is experiencing difficulties in servicing its debt obligations to its external private creditors, discussions on the restructuring of its debt may be a difficult and protracted process, and an agreement may not be reached before the emergence of arrears. The IMF stands ready to provide resources to members that are in arrears to private creditors when prompt support is essential for the success of the member's adjustment policies and the member is making a good-faith effort to reach a collaborative agreement with its creditors.

In September 2002, the Board reviewed recent experience gained with the restructuring of sovereign bonds and the application of the good-faith criterion under the policy on lending into arrears. Greater clarity about the good-faith dialogue between a debtor and its creditors during the restructuring process, Directors agreed, could better guide the application of the lending into arrears policy and, more generally, promote a better framework for the engagement of debtors and creditors in the restructuring of sovereign debt.

Greater clarity on the framework for possible debt restructuring would strengthen the capacity of investors to assess recovery values under alternative scenarios, thereby facilitating the pricing of risk and improving the functioning of the capital markets. At the same time, however, Directors stressed the need for continued flexibility in applying the good-faith criterion to accommodate the characteristics of each specific case; to avoid putting debtors at a disadvantage in the negotiations with creditors; and to avoid prolonged negotiations that could hamper the ability of the IMF to provide timely assistance. Indeed, any clarification of the good-faith criterion should serve primarily to support the difficult judgments that will continue to have to be made in each case, and should be made operational in a manner that does not impair market discipline.

The following principles would strike an appropriate balance, Directors considered, between clarity and flexibility in guiding the dialogue between debtors and their private external creditors:

- When a member has reached a judgment that a restructuring of its debt is necessary, it should engage in an early dialogue with its creditors, which should continue until the restructuring is complete.
- The member should share relevant, nonconfidential information with all creditors on a timely basis.
- The member should provide creditors with an early opportunity to give input on the design of restructuring strategies and the design of individual instruments.

Although, as a general premise, the form of the dialogue would be left to the debtor and its creditors, Directors expected that a member in arrears would initiate a dialogue with its creditors before agreeing on an IMF-supported program, consistent with the above principles. In cases in which an organized negotiating framework is warranted by the complexity of the case and by the fact that creditors have been able to form a representative committee on a timely basis, there would be an expectation that the member would enter into good-faith negotiations with this committee, though the unique characteristics of each case would also be considered. By the same token, in less complex cases, where creditors have not organized a representative committee within a reasonable period, or where for other reasons a formal negotiation framework would not be effective, the member would be expected to engage creditors through a less structured dialogue.

In assessing whether the member is making good-faith efforts to negotiate, judgments would continue to be required in a number of important areas. These include a consideration of the complexity of the restructuring case, the extent to which a creditor committee is sufficiently representative, and whether a reasonable period has elapsed to allow for the formation of a representative committee. Directors also noted that, to the extent that negotiations become stalled because creditors are requesting terms that are inconsistent with the adjustment and financing parameters that have been established under an IMF-supported program, the Fund should retain the flexibility to continue to support members notwithstanding the lack of progress in negotiations with creditors.

Finally, all loans made while a member has outstanding arrears to private creditors will continue to be subject to financing reviews, which will provide an opportunity for the IMF to monitor relations between a debtor and its creditors, and for the Board to be kept informed about developments in this area at an early stage.

Dealing with Unsustainable Sovereign Debt

The IMF has also been engaged in an active debate on how best to deal with the relatively rare cases in which sovereign debts have become unsustainable. The challenges to a successful restructuring are several. Sound macroeconomic and structural policies are clearly critical. Transparency and predictability in the restructuring process are also important, to permit better-informed due diligence and decision making, and ease the task of achieving adequate intercreditor equity. Another challenge is effective collective action by creditors. In particular, there is a danger that individual creditors

will decline to participate in a voluntary restructuring in the hope of recovering payment on the original contractual terms, even though creditors as a group would be best served by agreeing to a restructuring.

The IMF has been working with its members and other representatives of the international financial community on possible approaches to improving the framework for the resolution of sovereign restructuring cases, and in particular on:

- The inclusion of *collective action clauses* (CACs) in sovereign bond contracts; and
- The establishment of a statutory framework through a *sovereign debt restructuring mechanism* (SDRM).

These approaches could be complemented through the development of a *voluntary code of conduct*—a set of standards for transparency and best practices—that could help guide the conduct of debtors and their creditors across a broad spectrum of circumstances, ranging from relative tranquility to acute stress. The IMF welcomes the private and public sector initiatives in this area and supports their development. It is clear, in this context, that a code could be effective only to the extent that it is able to attract broad support among debtors and their creditors.

Collective Action Clauses

CACs in international sovereign bond instruments are designed to facilitate more orderly and rapid debt restructuring in the rare cases when a sovereign needs to restructure its debt. CACs are provisions in bond contracts that enable the sovereign and a qualified majority of its bondholders to make decisions that become binding on all bondholders within the same issuance.

The IMF has long recognized the role of CACs in helping to resolve the collective action problem. This financial year, the Board held two discussions on CACs. In June 2002, Directors discussed two staff papers focusing on the design and effectiveness of CACs and ways to encourage their greater use. The discussion was advanced during April 2003, when Directors considered a staff paper reviewing issues and developments in promoting the use of CACs more actively.

The IMF's most effective strategy, Directors reiterated, is to promote the more widespread use of those types of provisions that already exist in many international sovereign bond contracts. Perhaps the most important provision is the *majority restructuring provision*, which enables a qualified majority of bondholders within the same issuance to bind all bondholders to the terms of a restructuring agreement, either before or after default. In addition, *majority enforcement provisions* enable a qualified majority of bondholders to prevent individual creditors from taking disruptive legal action before a restructuring agreement is reached. While majority restructuring provisions currently exist in sovereign bonds that are governed by English law, bonds governed by New York law (which represent the largest portion of the emerging market sovereign bond market) have not traditionally included these provisions.

Developments over the past year were encouraging, Directors noted, with respect to both the design of majority restructuring and majority enforcement clauses, and the incorporation of such clauses into bonds governed by New York law, which represents an important breakthrough in this area (see Box 3.1). However, given the outstanding stock of bonds that do not include CACs, Directors acknowledged that it will take some time before CACs are included in most international bonds. Moreover, because of the contractual nature of CACs, any decision as to the inclusion and design of CACs will ultimately be made by the debtor and its creditors.

The IMF should more actively promote the use of CACs through its bilateral and multilateral surveillance, Directors emphasized, and all member countries, both advanced and developing, should be encouraged to include CACs in their international bond instruments. Directors welcomed the proposals to continue several forms of outreach to encourage the use of CACs. They strongly encouraged the staff to hold a more active dialogue with emerging market issuers, with a view to encouraging the use of CACs in the New York market as well as in other markets, such as Germany, where CACs are not yet the norm. Progress by mature market economies in the use of CACs in international bond issuance, such as with recent issuance by Italy and the United Kingdom, would further strengthen these efforts. In addition, as part of a more concerted effort to encourage the use of CACs, Directors encouraged the staff to hold workshops with key issuers and legal practitioners later in 2003 on ways to promote CACs.

Sovereign Debt Restructuring Mechanism

The second approach pursued by the IMF for resolving unsustainable sovereign debt situations—a proposal for a sovereign debt restructuring mechanism (SDRM)—differed from the CAC approach in two key ways. First, an SDRM would create a legal framework that allows for collective action for all instruments, including those that required unanimity to restructure the financial terms. The adoption of such a legal framework would require an amendment of the Fund's Articles of Agreement. Second, the votes of similarly situated creditors holding participating debt instruments would be aggregated, allowing a single vote to restructure *multiple debt instruments.*

The period after the 2002 Annual Meetings witnessed a vigorous debate regarding the need for, and design of, an SDRM. A Board discussion in December

Box 3.1

Collective Action Clauses: Latest Developments

Collective action clauses (CACs) in debt instruments allow a qualified majority of lenders to amend key financial terms of the debt contract and bind a minority to these new terms. Incorporating CACs in bonds, as is the norm under English law, contributes to more orderly and rapid agreement on restructuring terms, ensures that the rights of the majority are respected, and prevents a minority of dissident creditors from pursuing disruptive litigation.

There have been several important developments in the design and use of CACs in the past financial year.

Proposals on the Design of Model Clauses

In June 2002, the official community through a G-10 working group consulted with market participants, issuers, and legal experts to recommend improvements to the debt-restructuring process. In its September 2002 report, the working group proposed a set of clauses based on existing practices with respect to bonds governed by English law that reflect the principles of fostering early dialogue, ensuring effective recontracting, and minimizing litigation by minority creditors. In early 2003 the group published its work on a set of model clauses that are designed to illustrate that these recommendations could be implemented. A group of private sector capital trading associations also published proposals for developing model clauses.

CACs and Recent International Sovereign Bond Issuance

A number of mature market countries have taken steps to introduce CACs in their international sovereign bonds. In September 2002, European Union (EU) finance ministers stated that their member countries intended to include CACs in new sovereign bonds issued under a foreign jurisdiction. Although such bonds represent a small part of the overall bonds issued by EU countries, the EU represents a sizable portion of the global bond market and, thus, could influence market practice in the jurisdictions of New York and Germany, which traditionally have not included majority restructuring provisions.

At the end of 2002, international sovereign bonds with CACs issued by emerging markets amounted to about 30 percent of total sovereign bonds issued by these markets. In March and April 2003, amid much discussion within the official and capital markets communities about the use of CACs, Mexico twice issued bonds governed by New York law that included both majority restructuring provisions and majority enforcement provisions. (Lebanon (2000), Qatar (2000), and Egypt (2001) had preceded Mexico in issuing bonds with majority restructuring provisions governed by New York law, but at the time the inclusion of these clauses went unnoticed by the markets.) Mexico's issuances were successful in that they were oversubscribed, and an analysis of the Mexican sovereign yield curve provided no evidence that the price, either at the launch or in secondary market trading, reflected a yield premium for the inclusion of CACs.

Also in April 2003, a global bond issuance by Brazil—governed by New York law and including CACs—was heavily oversubscribed and again showed no evidence that there was a cost associated with the use of CACs. Shortly after the end of the financial year, South Africa, Korea, Belize, and again Brazil followed with new international bond instruments that were governed by New York law and included CACs. In addition, CACs were included in Uruguay's new bonds following its debt exchange operation.

2002 reviewed issues associated with a possible design of an SDRM. In January 2003, the Board discussed a broad range of economic policy issues that might arise in connection with a member's decision to restructure its unsustainable sovereign debt obligations. A Board discussion in March 2003 further advanced the issue, in particular by considering a first draft of the Proposed Features of an SDRM that the International Monetary and Financial Committee had requested in September 2002 for consideration at its April 2003 meeting. The formulation of this proposal involved an extensive dialogue with private market participants, debt-restructuring practitioners and other workout specialists, academics, and members of the official community, and benefited from inputs received during a workshop and conference organized at the IMF in January 2003 (see Box 3.2). In addition to contributing to the design of an SDRM, this debate provided fresh impetus to efforts to promote the adoption of CACs in sovereign bonds, as well as proposals for a voluntary Code of Good Conduct.

While most Directors supported the establishment of an SDRM, not all were convinced of the need for, or the desirability of, such a mechanism. Moreover, views among Directors that supported an SDRM continued to differ on a number of design issues.

Directors who expressed support for an SDRM agreed that its objective should be to provide a framework that strengthens incentives for a sovereign and its creditors to reach a rapid and collaborative agreement on a restructuring of unsustainable debt in a manner that preserves the economic value of assets and facilitates a return to medium-term viability, thereby reducing the costs of the restructuring process. To achieve this objective, the SDRM must not only address collective action problems among creditors, but also catalyze an early and effective dialogue and exchange of information between the debtor and its creditors. By creating greater predictability in the restructuring process, the SDRM should also be expected to improve the working of international capital markets. Although a number of issues remained

Box 3.2

Sovereign Debt Restructuring Mechanism Conference

The IMF hosted a conference in January 2003 on its Sovereign Debt Restructuring Mechanism (SDRM) proposal to exchange views with country officials, representatives of the private sector, nongovernmental organizations, legal experts, and academics. In his opening remarks, Managing Director Horst Köhler stated the conference objectives as (1) to "remind ourselves" of the problem that a sovereign debt restructuring mechanism is trying to address; (2) clarify the state of the discussion, and the nature of the proposals that have been made; and (3) bring that work to a provisional close embodied in a single, clear, and understandable design.

The main topics discussed were the IMF proposal for sovereign debt restructuring; the context and content of the SDRM; the role of creditors and the IMF under the SDRM as well as its implications for the impact on capital markets; and ensuring integrity in the process.

Most speakers agreed that the sheer diversity of creditors and debt instruments had made the negotiation process between the sovereign and its creditors more complex, leading to delays in restructuring. However, they differed on the extent of the collective action problem and the design of the solution. Anne Krueger, IMF First Deputy Managing Director, underscored the need to establish a system that would promote a transparent, orderly, and expeditious debt restructuring. Some speakers thought that holdout creditors were only a minor problem, and called for more voluntary approaches to reaching a solution.

IMF staff argued that the scope of debt brought under the SDRM would generally be broad enough to ensure the future sustainability of debt and intercreditor equity, but that some carve-outs would be required to avoid undermining domestic insolvency procedures and protect secured financing. Other participants argued for wider coverage of debt under the SDRM, in order to better ensure economic viability of the sovereign following debt restructuring as well as fairer treatment of all creditors.

IMF staff also argued that the use of a stay on creditor litigation was not proportionate to the relatively low risks of such litigation. Moreover, an automatic stay would not be appropriate in the absence of a general cessation of payments. Staff maintained that other aspects of the SDRM—including the "hotchpot" rule to neutralize any benefits received by a litigating creditor following activation—would effectively discourage disruptive litigation. While some participants supported this view, others noted that the specter of early litigation could arise in response to changes in capital markets, and some feared that debtors would be forced to use up scarce resources in fighting litigation.

open, Directors expressing support for an SDRM viewed the Proposed Features as providing a balanced response to key questions. The main elements of the proposal included:

- A qualified majority of creditors across aggregated claims could vote to accept new terms under a restructuring agreement, thereby binding all affected creditors.
- The mechanism would contain provisions that would prevent creditor enforcement actions from disrupting the negotiating process, or delaying agreement on a restructuring that could be acceptable to a broad majority of creditors.
- An independent dispute resolution forum would be established to verify claims, ensure the integrity of the voting process, and adjudicate disputes that might arise following activation of the SDRM.

The International Monetary and Financial Committee considered a Report by the Managing Director on a Statutory SDRM at its April 2003 meeting. The IMFC emphasized in its Communiqué that the extensive analysis and consultation undertaken in developing the SDRM proposal have served to promote better understanding of the issues to be addressed in bringing about orderly resolution of crises. While recognizing that it was not feasible at that time to move forward to establish the SDRM, the Committee agreed that work should continue on issues raised in its development that are of general relevance to the orderly resolution of financial crises. These issues include intercreditor equity considerations, enhancing transparency and disclosure, and aggregation issues. The Managing Director will report on progress at the Committee's meeting in September 2003.

Chapter 4

Improving Lending Policies and Practices

The IMF provides financial support to member countries under a variety of policies and lending instruments (see Table 8.1). Most forms of IMF financing are made conditional on the recipient country's adopting policy reforms to correct the underlying problems that gave rise to its need for support.

During FY2003, the Executive Board concluded a comprehensive, two-year review of conditionality (that is, the conditions related to IMF-supported programs) and approved new guidelines for the design and implementation of conditionality in IMF-supported programs. The new guidelines aim to streamline and focus IMF conditionality to promote the success of member countries' reform programs.

In the context of this major review of conditionality, the Board emphasized the need to establish a clear division of labor with other international institutions, especially the World Bank. In September 2002, Directors discussed the progress made on strengthening IMF–World Bank collaboration on country programs and conditionality under a new collaboration framework for the two institutions.

Also in September 2002, the IMF's Independent Evaluation Office (IEO) issued an evaluation report on the prolonged use of IMF resources by some member countries. Subsequently, the Board discussed the conclusions of a staff task force set up to make recommendations on how issues raised in the report might best be addressed.

New Conditionality Guidelines

To ensure continued effectiveness, the IMF regularly reviews developments in conditionality (see Box 4.1). In September 2002, the Board adopted new guidelines

Box 4.1

How IMF Conditionality Has Evolved

When the IMF commits its financial support to a member country, the country is expected to carry out policy adjustments and reforms to correct the underlying problems that gave rise to its balance of payments difficulties and its need for assistance. To this end, the IMF has attached conditions to its lending, focusing initially on monetary, fiscal, and exchange rate policies. Unsurprisingly, these conditions have evolved over the IMF's history as the circumstances and challenges facing its members have changed.

Structural Conditionality

Beginning in the late 1980s, the IMF increasingly emphasized the need to achieve adjustment through structural improvements in the economy. As a result of the greater focus on structural measures, the average number of structural conditions in a program, which was only 2 or 3 in the mid-1980s, climbed to 12 or more by the second half of the 1990s. Much of the increase was in the transition economies where, almost by definition, the programs had large structural content.

The increase in the number of conditions raised concerns that the IMF might be overstepping its mandate and expertise. Excessively detailed policy conditions can undermine a country's sense that it is in charge of its own reforms. Without such "ownership," reform is less likely to happen. Moreover, poorly focused conditionality can overburden countries attempting to implement nonessential reforms at the expense of reforms truly needed for achieving the program's objectives.

New Guidelines

In September 2000, the IMF's Managing Director issued interim guidelines on streamlining structural conditionality that set out general principles. From March 2001, papers prepared by IMF staff were posted on the IMF website to invite public comment on the principles and issues related to conditionality. Country officials, academic experts, and representatives of other organizations also added their views. Among their suggestions were the need to pay attention to the sequence and pace of policy implementation and the importance of a clear and coherent strategy for assistance from the international community.

In April 2002, the IMF's Executive Board agreed on the general principles to be embodied in new conditionality guidelines, and in September 2002 the Board approved the new conditionality guidelines, the first revision since 1979.

to encapsulate ongoing efforts to streamline and focus IMF conditionality. (The guidelines can be found on the IMF website.) An important objective of the new guidelines is to enhance country ownership and improve the prospects for sustained implementation of Fund-supported programs, most importantly by concentrating the IMF's policy conditions on areas that are critical to their success. The wholehearted implementation of these guidelines has also been identified in the IEO evaluation report on prolonged use of IMF resources as one of the key steps in avoiding the failure of Fund-supported programs.

The guidelines emphasize the need to focus conditionality on policies that are critical to achieving the macroeconomic objectives of Fund-supported programs. They also aim to establish a clearer division of labor with other international institutions, especially the World Bank. The guidelines are based on an increasing recognition of the importance of several interrelated principles:

- national ownership of policy reforms;
- parsimony in the application of program-related conditions;
- tailoring of programs to the member's circumstances; and
- clarity in the specification of program-related conditions.

The new guidelines introduce specific criteria for deciding whether conditions are appropriate in each case. Structural conditionality is regarded as an important element of Fund-supported programs, as long as it is critical to achieving the objectives of the program.

Box 4.2
A Framework for Bank-Fund Collaboration

In July 2001, Directors discussed the strengthening of IMF– World Bank collaboration on country programs and conditionality (see *Annual Report 2002*, page 41), and adopted a strengthened collaboration framework between the two institutions. The framework, which was also endorsed by the Executive Board of the World Bank, is based on three key principles:

- clarity about responsibilities,
- early and effective consultation, and
- the accountability of each institution for its own financing.

To implement the new framework, in the spring of 2002 the managements of both institutions issued a Guidance Note on *Operationalizing Bank-Fund Collaboration in Country Programs and Conditionality* to their staffs. Later in the year, the staffs of both institutions prepared a progress report examining their experience with collaboration under the Guidance Note.

The guidelines also spell out the roles of different types of program-related conditions, including performance criteria, structural benchmarks, and prior actions. A note by IMF staff providing additional explanation and context for the conditionality guidelines was released along with the guidelines.

An essential aspect of the IMF view of conditionality is that the member country will take primary responsibility for its own policies, and that documents setting out the country's reform agenda will be drafted by the authorities with the cooperation and assistance of Fund staff. The Board agreed during the course of its review that properly designed conditionality can complement and reinforce national ownership.

Strengthening IMF–World Bank Collaboration

In September 2002, the Progress Report on Strengthening IMF–World Bank Collaboration on Country Programs and Conditionality, prepared jointly by the staffs of the IMF and the World Bank, was discussed by the Board.

The progress report examined the experience with collaboration in relation to a Guidance Note issued in April 2002 (see Box 4.2). The report highlighted a survey of staff in the two institutions—World Bank country directors and IMF mission chiefs—examining their experience of collaboration. The survey found that, although collaboration was seen as satisfactory with no major problems indicated in most cases, a number of institutional factors were impeding fully effective collaboration—such as differences in working structures, time frames for achieving goals, and lending arrangements and instruments. These results con- firmed the need for continued efforts to strengthen collaboration.

In their discussion, Directors reaffirmed that close collaboration is indispensable for providing effective support to member countries, and forms an integral part of efforts to streamline and focus conditionality to enhance national ownership of reform programs. The move to strengthen collaboration in country programs is taking place against the background of progress achieved in a number of other areas, including the PRGF/HIPC framework and systematic joint analytic work such as that being done in the Financial Sector Assessment Program (FSAP) and Report on the Observance of Standards and Codes (ROSC) exercises.

The central principles of collaboration on country program design and conditionality, Directors noted, clearly designate one of the two institutions as a lead agency in particular policy areas and systematic information sharing between the two institutions. At the same time, they considered it essential that each institution retain ultimate responsibility for its own lending decisions.

The Guidance Note on *Operationalizing Bank-Fund Collaboration in Country Programs and Conditionality*

was beginning to play a positive role in strengthening collaboration, Directors observed, while noting the limited basis for assessing progress at this stage.

Effective collaboration with the World Bank is critical for the success of efforts to streamline and appropriately focus IMF conditionality, Directors emphasized: it is needed to ensure that important measures are adequately covered as the IMF applies conditionality more sparingly outside its core areas. At the same time, Directors generally considered that structural measures that do not fall in the core areas of the IMF, but are critical for macroeconomic stability, should remain part of the IMF's conditionality.

For the low-income countries, Directors noted that the PRSP process provides a natural framework for ensuring collaboration between the staffs of the two institutions in support of a country-led strategy for addressing poverty and fostering sustainable growth. For middle-income countries, collaboration has been more varied and based on a less formal approach, depending in part on the circumstances of the country, and stronger efforts are needed to ensure an effective approach in these cases also.

Looking forward, Directors encouraged the staff of both institutions to move ahead on the basis of the Guidance Note and the approach set out in the progress report, subject to another review no later than the end of 2003. They stressed that the views of the country authorities need to be taken into account in evaluating the effectiveness of collaboration, and they also suggested seeking input from donors, as well as a wider sample of IMF and World Bank staff.

Prolonged Use of IMF Resources

In March 2003, the Board concluded its discussions on prolonged use of IMF resources, based on the report of the IMF's Independent Evaluation Office (IEO) and the conclusions of a staff task force (see Box 4.3).

Directors appreciated the work of the task force as a key step in following up on the IEO's candid and comprehensive analysis. Thorough implementation and review of the measures proposed by the task force—

Box 4.3

Evaluation of Prolonged Use of IMF Resources

The Independent Evaluation Office (IEO) was set up by the IMF's Executive Board in July 2001 to provide objective and independent evaluation on issues related to the IMF. It operates independently of IMF management and at arm's length from the Executive Board. In September 2002 the IEO issued its first evaluation report—on the prolonged use of IMF resources.[1] Shortly afterward, the Managing Director issued a statement to the Executive Board welcoming the IEO's report, agreeing with many of its findings, and indicating that the IMF's management would establish a staff task force to recommend how issues raised in the report could best be addressed, building on the recommendations made by the IEO. Directors welcomed both the IEO report and the Managing Director's proposal. After receiving the conclusions of the staff task force, the Board discussed them in detail, concluding its discussion in March 2003.

Financial support from the IMF is intended to assist members in overcoming temporary balance of payments difficulties. Particularly under Stand-By and Extended Arrangements, IMF-supported programs aim to attain external viability, after which the IMF's financial support should no longer be needed. At times, prolonged use of IMF resources may signal a failure to achieve this key objective—which can impose costs on the member country, damage the IMF's credibility, and make it more difficult for the member to meet its external obligations (including its obligations to the IMF). In past discussions of prolonged use, the Executive Board has stressed the importance of distinguishing between countries that are making adequate progress toward achieving their program objectives and those that are not.

The IEO report concluded that prolonged use of IMF resources was substantial and could be associated with a number of problems. These included:

- risks to the revolving character of IMF resources;
- the possibility that prolonged use may be the result of weak program design and implementation;
- unwarranted intrusion on the development of domestic policies and institutions; and
- a possible blurring of the IMF's role and mandate, especially in relation to the work of the World Bank and other development institutions.

Follow-Up

The follow-up to the IEO report focused more generally on improving the prospects for successful implementation of all IMF-supported programs, through the adoption of policies and procedures that promote better program design and strong country ownership, along with accountability for outcomes. It also included measures aimed specifically at cases of prolonged use of IMF resources. The follow-up was aimed as well at ensuring that the Board's decisions on whether to provide Fund financial support for a member's adjustment program are taken transparently and with a clear understanding of the risks and constraints.

In its work, the staff task force benefited not only from the IEO report but also from comments received by the IEO through a process of external outreach, including seminars in Berlin, Cambridge, London, Manila, and Tokyo.

[1] The IEO's report on Evaluation of Prolonged Use of IMF Resources is available on the IMF's website at *http://www.imf.org/external/np/ieo/2002/pu/index.htm*.

along with timely attention to the IEO's future reports—would be critical to ensure that the work of the IEO makes its maximum contribution to enhancing the listening and learning culture within the IMF.

In their March discussion, Directors generally reaffirmed their observations during the Board's discussion of the IEO report, in September 2002, regarding the extent and nature of problems posed by the prolonged use of IMF resources. Under proper circumstances, most Directors agreed, long-term IMF financial engagement could be an appropriate response to help member countries address deep-seated problems that, by their nature, required many years to resolve. These problems have been particularly prevalent in low-income countries and countries in transition. Directors also observed, however, that at times prolonged use can be associated with inadequate progress in dealing with a country's key economic problems, and that, in some cases, prolonged use and the associated policy conditionality can hinder the development of domestic institutions.

The financial implications of prolonged use for the IMF's regular resources and for PRGF resources also were a possible concern. Directors broadly endorsed a number of measures aimed specifically at cases of prolonged use while stressing that attention should also focus on improving the prospects for successful implementation of all IMF-supported programs. This would be achieved through the adoption of policies and procedures that promote better program design and strong local ownership, along with accountability for outcomes. In that context, Directors also supported the recommendation that Board decisions on the provision of IMF financial support be transparently based on candid assessments by the staff of the risks and constraints involved.

The strategy outlined by the task force received the Board's broad support. This would entail:

- the rigorous implementation of IEO recommendations to improve surveillance, conditionality, and program design (including the need for greater realism in program objectives and assumptions);
- additional measures to strengthen "due diligence" for prolonged users (including more systematic ex post assessments) and enhance information for decision making; and
- further substantive consideration of issues raised by the IEO in the context of future discussions on surveillance, program design, and the role of the IMF in low-income countries.

As for the priority accorded by the IEO and the task force to making surveillance more effective, Directors felt the diligent implementation of the conclusions of the recent surveillance review (see Chapter 2) would be key to identifying economic weaknesses and building domestic support for sound policies. Directors stressed the need for the staff to combine clarity and candor with a recognition of the social and political realities that shape economic policy; to complement sound advice on economic objectives with discussions of alternative ways of achieving those objectives; and to reach out more broadly, including to legislative bodies.

In addition, Directors noted that the linkage of some forms of donor assistance to the existence of an IMF-supported program, and the IMF's catalytic role with respect to private financing sources, can result in pressures for IMF lending decisions that contribute to prolonged use. In that context, Directors confirmed the conclusions of their recent discussion on mechanisms for signaling the IMF's assessment of members' policies (see Chapter 2).

Systematically monitoring the timely implementation of the various elements of this strategy, in the context of the IMF's reviews of conditionality, would be important, Directors stressed.