

IMF Surveillance— Promoting Growth and Stability



One of the core responsibilities of the International Monetary Fund is to maintain a dialogue with its member countries on the national and international consequences of their economic and financial policies. This process of monitoring and consultation, referred to as surveillance, is mandated under Article IV of the IMF's Articles of Agreement and lies at the heart of the Fund's efforts to prevent crises.

The IMF exercises this responsibility of surveillance in several ways (see Box 1.1). Highlights of its surveillance activities during financial year 2004 follow.

- As part of the Fund's surveillance of the global economy, the Executive Board conducted its twice-yearly comprehensive assessments of the *World Economic Outlook* in August 2003 and March 2004. Against the background of prospects for a gradual—albeit moderate—global economic recovery, Directors in August 2003 called for macroeconomic policies to remain appropriately supportive and for reinvigorated structural reform efforts. By March, the nascent recovery had strengthened and broadened, and Directors agreed that the focus of policy efforts should be on medium-term measures that would underpin the sustainability of the recovery while rebuilding room for maneuver to respond to possible future shocks. In addition, they observed that managing the transition to a higher interest rate environment would be a key challenge.
- Also in August 2003 and March 2004, the Board discussed developments in financial markets worldwide, based on *Global Financial Stability Reports* prepared by the staff. In August 2003, Directors noted that financial markets had remained resilient, notwithstanding continued lackluster economic growth, but expressed their concern about several downside risks, with a focus

on the policy implications of these market developments. By March 2004, with the prospects for financial stability appearing brighter, Directors stressed, among other things, that relatively benign conditions in mature and emerging markets provided a window of opportunity to focus policy attention on several key structural reforms.

- The Board completed 115 consultations with individual member countries as mandated under Article IV of its Articles of Agreement.
- Executive Directors discussed regional developments on several occasions. In particular, they discussed euro area policies (September 2003), the adoption of the euro by central European members (February 2004), and developments and policies in the Central African Economic and Monetary Community (November 2003).

Country Surveillance

To conduct surveillance in accordance with Article IV, an IMF staff team visits each member country to meet government and central bank officials and collect and analyze economic and financial information. The consultations cover recent economic developments and the exchange rate, 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 with other groups—such as members of legislative bodies, trade unions, employer associations, academics, 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.

Box 1.1 Forms of IMF Surveillance

With its nearly universal membership of 184 countries, the IMF serves as an international forum where members can monitor global, country, and regional economic developments. IMF surveillance takes three main forms:

- **Country (“Bilateral”) Surveillance.** As mandated by Article IV, the Executive Board holds regular consultations with each member country on its economic and financial policies, and the international repercussions of these policies. Through these “Article IV” consultations, which are based on staff reports, the IMF aims to identify policy strengths and weaknesses, indicate potential vulnerabilities, and advise countries on appropriate and corrective policy actions. The IMF also conducts bilateral surveillance through the Financial Sector Assessment Program, or FSAP (see Section 2).
- **Global (“Multilateral”) Surveillance.** The IMF’s Executive Board regularly reviews global economic and financial market developments. The reviews are based partly on the staff’s *World Economic Outlook*

reports and the *Global Financial Stability Reports*, both of which are prepared twice a year. In addition, the Board holds more frequent, informal discussions about world economic and financial market developments. Activities in mature and emerging financial markets are monitored continuously, including in a daily internal report prepared by the staff.

- **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 Commission, the European Central Bank, the Central African Economic and Monetary Community, the Eastern Caribbean Currency Union, and the West African Economic and Monetary Union.

The IMF also takes part in policy discussions of finance ministers, central bank governors, and other officials in a variety of groups, such as the Group of Seven major industrial countries, the Group of 24, and the Asia-Pacific Economic Cooperation Forum. (See also Section 6 on governance.)

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 the 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 FY2004, the Board conducted 115 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 the economic conditions in, 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. The Board also holds frequent informal meetings to

monitor and discuss developments in individual countries.

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 Board’s twice-yearly reviews of the *World Economic Outlook* are an integral part of the Fund’s ongoing surveillance of economic developments and policies in its member countries and of the global economic system. These surveys of prospects and policies are the outcome of a comprehensive review of world economic developments and analyze short-term and medium-term prospects for the world economy as well as for individual countries and

country groups. They draw for the most part on information gathered through the staff’s consultations with member countries and provide a framework for assessing the relationships among the economic policies of Fund members.

In FY2004, the Board discussed the *World Economic Outlook* on two occasions—in August 2003 and in March 2004. (See Box 1.2 for a chronology of key economic developments during FY2004.)

World Economic Outlook, August 2003

At the time of the August 2003 *World Economic Outlook* discussion, economic data in some countries and forward-looking indicators, particularly in financial markets, pointed to a strengthening of global growth in the second half of 2003 and 2004, and Executive Directors noted the prospects for a gradual—albeit moderate—recovery.

Given this environment, Directors called for macroeconomic policies to remain appropriately supportive and for reinvigorated structural reform efforts to strengthen confidence and reduce vulnerabilities over the medium term. In particular, monetary policies in industrial countries should remain supportive for the time being, and—

Table 1.1 Article IV Consultations Completed in FY2004

Country	Board Date	PIN Issued	Staff Report Published
Afghanistan, Islamic State of	November 21, 2003	December 22, 2003	December 22, 2003
Algeria	January 14, 2004	January 29, 2004	February 10, 2004
Angola	July 25, 2003	September 10, 2003	September 10, 2003
Antigua and Barbuda	October 24, 2003		
Australia	October 22, 2003	October 29, 2003	October 29, 2003
Austria	November 24, 2003	November 26, 2003	November 26, 2003
Azerbaijan	May 14, 2003	June 4, 2003	June 6, 2003
Bahamas, The	July 2, 2003	July 23, 2003	July 23, 2003
Bangladesh	June 20, 2003	July 11, 2003	July 11, 2003
Belgium	February 13, 2004	February 27, 2004	February 27, 2004
Belize	March 24, 2004	April 16, 2004	April 16, 2004
Bolivia	July 7, 2003	August 20, 2003	August 20, 2003
Bosnia and Herzegovina	February 25, 2004	March 5, 2004	March 16, 2004
Botswana	March 24, 2004	July 30, 2004	July 30, 2004
Burkina Faso	June 11, 2003	June 30, 2003	June 30, 2003
Burundi	January 23, 2004	February 10, 2004	February 20, 2004
Canada	February 18, 2004	March 10, 2004	March 10, 2004
Central African Republic	April 2, 2004	April 14, 2004	June 10, 2004
Chad	March 19, 2004	April 29, 2004	April 29, 2004
Chile	August 18, 2003	August 20, 2003	September 26, 2003
China	October 31, 2003	November 18, 2003	
Comoros	April 30, 2004	May 14, 2004	
Congo, Republic of	June 13, 2003	June 30, 2003	June 30, 2003
Côte d'Ivoire	March 31, 2004	April 21, 2004	
Czech Republic	August 22, 2003	September 5, 2003	January 9, 2004
Djibouti	January 7, 2004	March 19, 2004	March 19, 2004
Dominican Republic	August 29, 2003	October 14, 2003	
El Salvador	July 18, 2003	December 22, 2003	
Equatorial Guinea	November 12, 2003	December 9, 2003	December 9, 2003
Eritrea	May 2, 2003	July 1, 2003	July 1, 2003
Estonia	October 22, 2003	October 27, 2003	October 27, 2003
Finland	October 8, 2003	October 17, 2003	October 17, 2003
France	October 8, 2003	October 29, 2003	October 29, 2003
Gabon	November 10, 2003	November 20, 2003	February 5, 2004
Gambia, The	March 8, 2004	May 18, 2004	May 18, 2004
Georgia	October 17, 2003	November 7, 2003	November 7, 2003
Germany	November 3, 2003	November 6, 2003	November 6, 2003
Ghana	May 9, 2003	May 16, 2003	May 21, 2003
Greece	May 16, 2003	June 11, 2003	June 11, 2003
Guinea	July 16, 2003	August 14, 2003	August 14, 2003
Honduras	May 5, 2003		
Hong Kong SAR	May 16, 2003	May 30, 2003	May 30, 2003
Hungary	May 2, 2003	May 9, 2003	May 9, 2003
Iceland	August 22, 2003	August 29, 2003	August 29, 2003
India	July 18, 2003	August 21, 2003	
Iran, Islamic Republic of	August 25, 2003	September 5, 2003	September 5, 2003
Ireland	July 30, 2003	August 5, 2003	August 6, 2003
Israel	April 19, 2004	April 29, 2004	June 3, 2004
Italy	November 7, 2003	November 13, 2003	November 13, 2003
Jamaica	June 9, 2003	March 23, 2004	March 23, 2004
Japan	August 20, 2003	September 5, 2003	September 5, 2003
Jordan	April 2, 2004	April 28, 2004	May 4, 2004
Kazakhstan	May 28, 2003	June 17, 2003	July 18, 2003
Kenya	May 2, 2003	July 9, 2003	July 9, 2003
Kiribati	June 16, 2003	July 7, 2003	
Korea	February 20, 2004	February 25, 2004	February 25, 2004
Kuwait	February 9, 2004	February 25, 2004	July 12, 2004
Lesotho	January 21, 2004	February 5, 2004	February 5, 2004
Libya	August 18, 2003	October 23, 2003	October 23, 2003
Lithuania	September 5, 2003	September 9, 2003	September 11, 2003

Table 1.1 (concluded)

Country	Board Date	PIN Issued	Staff Report Published
Luxembourg	April 28, 2004	May 4, 2004	May 5, 2004
Malaysia	February 9, 2004	March 24, 2004	
Mali	December 15, 2003	January 12, 2004	January 12, 2004
Malta	August 18, 2003	September 3, 2003	September 3, 2003
Marshall Islands	January 26, 2004	February 13, 2004	
Mauritania	July 18, 2003	August 13, 2003	October 10, 2003
Mauritius	June 30, 2003	August 6, 2003	October 14, 2003
Mexico	October 15, 2003	October 30, 2003	
Moldova	January 26, 2004	February 2, 2004	February 18, 2004
Mozambique	December 10, 2003	December 22, 2003	March 5, 2004
Myanmar	March 17, 2004		
Nepal	August 22, 2003	September 5, 2003	September 5, 2003
Netherlands	July 30, 2003	August 8, 2003	August 8, 2003
Netherlands Antilles	June 4, 2003	June 13, 2003	June 13, 2003
New Zealand	April 30, 2004	May 5, 2004	May 5, 2004
Norway	March 22, 2004	March 31, 2004	April 2, 2004
Oman	October 6, 2003	October 22, 2003	
Palau	February 27, 2004	March 2, 2004	April 1, 2004
Panama	March 22, 2004	March 26, 2004	
Papua New Guinea	June 4, 2003	June 25, 2003	June 25, 2003
Peru	February 23, 2004	May 28, 2004	May 28, 2004
Philippines	March 5, 2004	March 30, 2004	
Poland	June 9, 2003	June 19, 2003	June 25, 2003
Portugal	March 15, 2004	March 22, 2004	March 22, 2004
Russian Federation	May 2, 2003	May 9, 2003	May 30, 2003
St. Kitts and Nevis	October 24, 2003	November 4, 2003	
Samoa	June 2, 2003	June 30, 2003	June 30, 2003
São Tomé and Príncipe	March 17, 2004	April 2, 2004	January 19, 2004
Saudi Arabia	October 10, 2003	December 5, 2003	
Seychelles	February 20, 2004		
Singapore	March 15, 2004	April 26, 2004	April 26, 2004
Slovak Republic	July 23, 2003	August 5, 2003	August 5, 2003
South Africa	August 20, 2003	July 1, 2004	July 1, 2004
Spain	March 19, 2004	April 2, 2004	April 2, 2004
Sri Lanka	March 5, 2004	March 12, 2004	March 16, 2004
Sudan	October 31, 2003	December 19, 2003	December 19, 2003
Suriname	October 17, 2003	November 19, 2003	November 19, 2003
Swaziland	February 9, 2004	May 25, 2004	
Sweden	July 25, 2003	August 5, 2003	August 5, 2003
Switzerland	May 23, 2003	June 2, 2003	June 2, 2003
Syrian Arab Republic	April 30, 2004		
Thailand	August 25, 2003	September 17, 2003	
Timor-Leste	July 14, 2003	July 28, 2003	July 28, 2003
Togo	April 28, 2004	May 13, 2004	
Trinidad and Tobago	June 23, 2003	July 10, 2003	August 4, 2003
Tunisia	July 25, 2003	August 7, 2003	August 21, 2003
Ukraine	May 14, 2003	June 13, 2003	June 19, 2003
United Kingdom	March 3, 2004	March 5, 2004	March 5, 2004
United States	July 30, 2003	August 5, 2003	August 5, 2003
Uruguay	July 11, 2003	August 4, 2003	August 7, 2003
Uzbekistan	May 19, 2003		
Vietnam	October 3, 2003	December 1, 2003	December 5, 2003
Yemen, Republic of	December 22, 2003		
Zambia	April 7, 2004	July 16, 2004	July 21, 2004
Zimbabwe	June 6, 2003	July 28, 2003	July 28, 2003

with inflationary pressures very moderate—Directors considered that most regions had scope for further monetary easing if the recovery faltered or inflation significantly undershot policy objectives. The orderly depreciation of the dollar was generally welcomed. Going forward, most Directors agreed that the cooperative approach, which would be needed to underpin the global adjustment process, would be helped by currency adjustments that were more broadly spread, with several emerging Asian economies being relatively well placed to handle greater upward exchange rate flexibility.

Directors agreed that fiscal policy would have much less room for maneuver. While automatic stabilizers should generally be allowed to operate, they stressed that greater priority would need to be given to credible, high-quality fiscal consolidation to address both the recent deterioration in the fiscal outlook of the largest economies and the impending pressures of population aging. Directors also called on industrial and emerging market economies to make sustained further progress in vigorously implementing ongoing structural reforms.

Directors underscored the particular importance of a successful outcome of the World Trade Organization (WTO) Cancún Ministerial meeting in September 2003 in curbing protectionist pressures and achieving further trade liberalization, which would help strengthen confidence in the economic recovery. Progress with agricultural reforms—especially in the largest industrial economies—would be critical for boosting the growth prospects of developing economies and making progress with poverty reduction. In this context, Directors expressed strong support for the initiatives being taken by the IMF and the World Bank to strengthen their support for developing countries' efforts to liberalize their trade regimes.

World Economic Outlook, March 2004

The nascent recovery apparent in mid-2003 had begun to spread by the time of the Board's second meeting on the *World Economic Outlook*. Directors welcomed the strengthening and broadening of the global economic recovery, noting especially rapid upturns in the United States and emerging Asia; a sharp pickup in industrial production and global trade; strengthened business and consumer confidence; and positive investment growth in most regions. A broad-based rally in financial markets, including a rise in equity prices, a further drop in bond spreads, and a rebound in private financing flows to emerging markets, supported the recovery. Although growth had picked up and oil and commodity prices had moved up, worldwide inflation remained subdued—a reflection of continued excess capacity, still-weak labor markets, and competitive pricing in both domestic and global markets.

Directors noted the significant upward revision to the global growth forecasts for 2004 and 2005, with the strength of the ongoing recovery pointing to upside risks in the short run. However, Directors also highlighted a number of downside risks. The terrorist attacks in Madrid of March 11, 2004, and developments in the Middle East were sobering reminders of the continuing geopolitical uncertainties under which the global outlook was being shaped. Although recent exchange rate adjustments had been helpful given the large global current account imbalances, most Directors cautioned that these imbalances would still remain large, thereby posing risks of potentially disorderly currency movements and increased protectionist pressures. Most Directors also pointed to possible increased market volatility and adverse consequences for private consumption in countries with buoyant housing markets that could result from an abrupt increase in interest rates from their currently very low levels.

Against the backdrop of the improved global outlook, Directors agreed that the focus of policy efforts should be on medium-term measures that would underpin the sustainability of the recovery while rebuilding room for maneuver to respond to possible future shocks. Managing the transition to a higher interest rate environment in most countries where growth was strengthening was a key challenge facing monetary policy in the period ahead. While the situation was likely to vary significantly among countries, depending on the evolving pace and nature of the recovery, Directors expected that, as the recovery continued, interest rates in most countries would need to rise toward more neutral levels. In this context, they considered it especially important that central banks communicate their policy intentions clearly to the financial markets to reduce the risk of abrupt changes in expectations, and that rate increases, when they actually occur, be well anchored on fundamentals.

To support an orderly resolution of the global imbalances in the context of sustained growth in the world economy, Directors called for the membership to adopt a credible and cooperative strategy that would facilitate the medium-term rebalancing of demand across countries and regions. The main pillars of this strategy should be a credible medium-term fiscal consolidation effort in the United States; an acceleration of structural reforms in the euro area; further banking and corporate reforms in Japan; and a gradual shift toward more exchange rate flexibility, combined with additional structural reforms to support domestic demand, in most of emerging Asia. Reiterating the critical importance of open markets for supporting broad-based global economic growth and poverty reduction in low-income countries, Directors called for a timely resumption and successful conclusion of multilateral trade negotiations under the Doha Round.

Box 1.2 Key Economic and Financial Developments, May 2003–April 2004

The global economic recovery gained traction during 2003, with growth nearly reaching its long-term trend rate (Figure 1.1). With accommodative policy stances in the industrial countries and renewed confidence beginning in the second quarter of 2003, economic growth strengthened and broadened. Growth in world trade volume also picked up, buttressed by increases in intra-regional trade in Asia, involving especially China and Japan. Net private capital flows to emerging market and developing countries increased as portfolio investment rebounded, and foreign direct investment (FDI) also picked up. Emerging market bond spreads narrowed and many emerging market sovereigns took advantage of the low interest rates to issue debt.

Although the recovery became increasingly broad-based, its pace and nature varied significantly. During the financial year, growth was most rapid in the emerging market countries of Asia, particularly China, and the United States, and least well established in the euro area. The recoveries in the *United States and Japan* gained steam—spurred by the growth of private consumption and a rebound in business investment in the United States, and the growth of net exports, business investment, and consumption in Japan. More than in the corresponding stage of most previous cycles, employment growth in the

United States was subdued during much of the financial year, turning up only toward the end.

The *euro area* showed some signs of recovery beginning in the second half of 2003, but growth remained well below its potential and domestic demand growth was lackluster. Cyclically induced job losses were less pronounced in the euro area, but the gradual recovery was insufficient for unemployment to fall from its nearly 9 percent rate.

In FY2004, the recovery broadened to include improved GDP growth in all emerging market regions. In many cases, the recoveries were export-led, but, gradually, the strengthening of domestic demand began to contribute to growth.

Growth improved in most countries of *Latin America*. There was a sharp rebound in economic activity in Argentina following its deepest recession in 20 years. Brazil's growth picked up during the financial year, but in a number of other countries, notably Venezuela and Bolivia, political uncertainties continued to undermine growth. As of end-FY2004, economic activity, initially spurred by exports, was becoming more reliant on domestic demand.

Emerging Asia continued to experience the fastest growth, with those countries affected early in the financial year by the Severe Acute

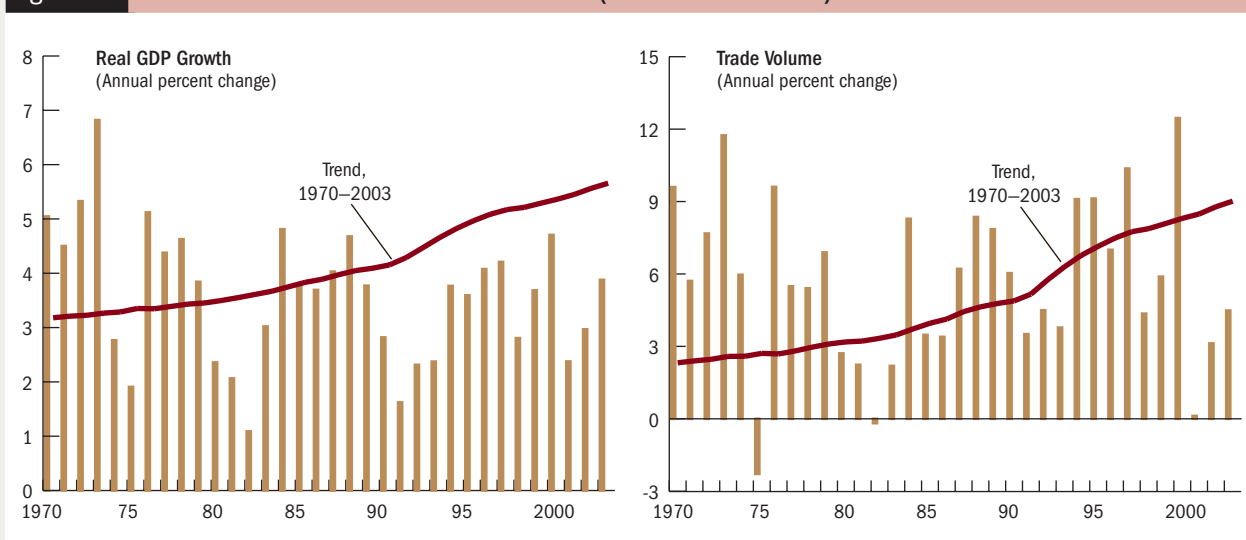
Respiratory Syndrome (SARS) epidemic rapidly recovering. The region accounted for about half of world output growth in 2003, demonstrating its importance as an engine of global expansion. China continued to grow strongly, exhibiting incipient signs of overheating toward the end of the financial year. India's growth accelerated, reflecting both cyclical and structural factors.

Central and eastern Europe maintained relatively strong growth despite the sluggish performance of its largest trading partner, the euro area. In some countries, current account deficits widened as rapid credit growth and expansionary fiscal policies fueled imports. Net FDI inflows contributed less to growth than in the previous year, but, in most countries, the risks of a capital flow reversal were held in check. Higher global oil prices, as well as positive domestic factors, increased growth in the oil-exporting countries of the former Soviet Union. Oil importers in the region also experienced strong GDP growth on the back of robust domestic demand.

The *Middle East* also benefited from rising oil prices and increased oil production (including restored capacity in Iraq). Toward the end of FY2004, however, the intensification of hostilities in Iraq raised the prospect of renewed disruptions in oil supply.

Growth in *Africa* strengthened during FY2004, supported by improved macroeconomic poli-

Figure 1.1 World Real GDP Growth and Trade Volume (Goods and Services)



cies, favorable weather, the abatement of conflicts, and debt relief under the HIPC (Heavily Indebted Poor Countries) Initiative. Higher oil and non-fuel-commodities prices also helped sustain higher growth rates in a number of exporting African countries.

With the firming recovery, producer and non-fuel-commodities prices rose. Oil prices surpassed levels seen before the Iraq war, owing to increased demand as well as to uncertainties about supply stemming from geopolitical risks. Consumer price inflation remained relatively subdued, in part reflecting substantial excess capacity and moderate wage increases. The dollar depreciated during the financial year on a trade-weighted basis. Toward the end of the financial year, however, the dollar steadied, and the euro fell back from its peak. Emerging Asian currencies also depreciated on a trade-weighted basis, accompanied by a further significant buildup in official reserves in countries with relatively inflexible exchange rate regimes.

Monetary policies remained accommodative in most countries, although in some cyclically advanced countries (including the United Kingdom) interest rates were raised, and, in others, policymakers were readying markets for such an event. *Fiscal policies* were varied. Looser fiscal policy in the United States helped to spur growth during much of the year, but the Stability and Growth Pact con-

strained the use of fiscal policy in some euro area countries.

In the *major financial markets*, nominal bond yields reached a four-decade low in the United States in mid-2003. Encouraged by abundant global liquidity, broadening economic growth, and the improving credit quality of both mature and emerging market borrowers, investors increasingly favored riskier assets. As a result, credit spreads on mature and emerging bond markets narrowed, and the cost of default protection fell. Toward the end of the financial year, as expectations of an upturn in policy rates in the United States gathered, market participants began to unwind carry trades and to reduce risk exposures.

Global equity markets rallied strongly on expectations of continued strong global growth and associated improvements in corporate earnings, as well as low interest rates (see Figure 1.2). The S&P 500 rose 45 percent from its March 2003 lows before retracing part of those gains as interest rate expectations changed near the end of the financial year. European equities followed a similar pattern, rising 50 percent from their mid-March 2003 trough before surrendering part of those gains by the end of the financial year. In Japan, stocks rallied almost 60 percent, as the growth of the Japanese economy strengthened, before falling back slightly, along with other mature market indices.

A rise in risk appetite and a search for yield fueled strong inflows into *emerging markets*. Driven by improving fundamentals and abundant liquidity, the spread on the EMBI+ fell precipitously from 756 basis points in late January 2003 to a near-record low of 384 basis points in early January 2004 (see Figure 1.3). Low nominal yields and strong investor demand facilitated increased bond issuance by emerging market borrowers, as many sought to lock in attractive financing costs by prefinancing their future funding requirements. Emerging market bond issuance in the primary market touched a record monthly high in January 2004 and totaled some \$40 billion in January–April, covering more than half of the calendar year's financing needs. Some 56 percent of total issuance during this period was from nonsovereign entities. Brazilian debt experienced one of its longest rallies in history, with continually narrowing spreads for 15 straight months. Similarly, having peaked at over 1,100 basis points in March 2003, the spread on Turkey's EMBI+ sub-index fell by almost three-fourths in less than a year. However, by the end of the financial year, spreads on emerging market bonds had started to rise again as bond yields in the United States rose in anticipation of an increase in policy rates. Primary issuance of equities in emerging markets was also strong during the financial year, although investor appetite dimmed as the year came to a close.

Figure 1.2 Equity Market Performance

(May 2003 = 100)

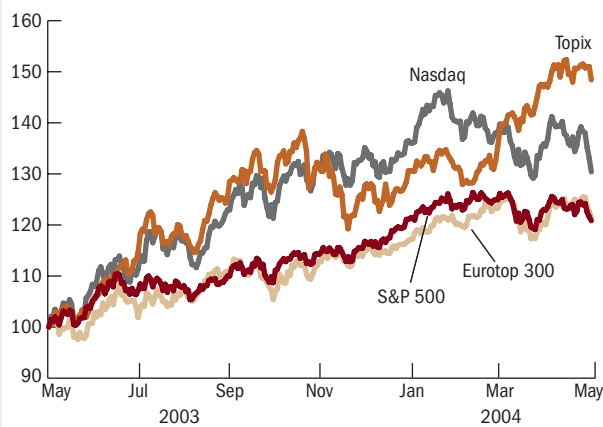
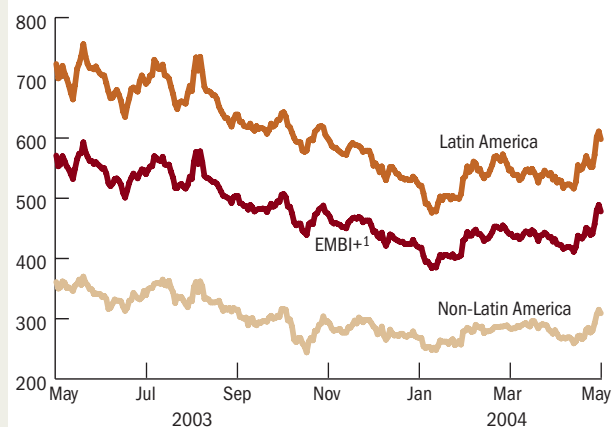


Figure 1.3 Sovereign Spreads

(In basis points)



1.J.P. Morgan Emerging Markets Bond Index Plus.

Directors emphasized that the relatively benign economic outlook provides an advantageous window of opportunity to address vulnerabilities. In particular, efforts to restore sustainable medium-term fiscal positions should be pursued vigorously. In most industrial countries, these will need to involve, in addition to timely fiscal consolidation, credible and high-quality measures to reform pension and health care systems. In addition, for emerging market and other developing countries the priority should be to address remaining public debt sustainability concerns through tax reforms to reduce revenue volatility, steps to strengthen fiscal institutions, and measures to improve the structure of debt.

Major Currency Areas

Directors welcomed the recent strong growth in the *United States*. With the impact of past fiscal and monetary stimulus gradually waning, they considered that the sustainability of the recovery would increasingly depend on continued solid investment and productivity growth and a pickup in employment, which had so far been lagging. In view of the weak labor market and low inflation, Directors supported the U.S. Federal Reserve's decision to maintain a very accommodative monetary policy stance. In the future, Directors observed, the ground should continue to be laid for a move toward a more neutral monetary policy stance. While recognizing that the expansionary fiscal policy pursued by the U.S. authorities in recent years had supported U.S. growth and had had a positive impact on global output, Directors underscored that the priority henceforth would be sustained fiscal consolidation. On the basis of the IMF staff's analysis of the global impact of U.S. fiscal policy, most Directors supported the conclusion that a more ambitious fiscal consolidation path than currently envisaged would produce significant benefits, in particular by containing the risk that higher real interest rates would crowd out productive investments. Accordingly, these Directors urged the U.S. authorities to establish a viable fiscal framework with the objective of returning the budget to balance (excluding Social Security) over the medium term and to undertake reforms to strengthen the financial position of Social Security and health care programs.

The recovery in the *euro area* remained subdued. While prospects for stronger domestic-led growth were being supported by an expected pickup in fixed investment, Directors saw the pass-through effects of euro appreciation, the ongoing balance sheet restructurings, and the Madrid bombings' possible impact on confidence as factors that had the potential to dampen the outlook. In view of this fragile environment, Directors supported the continuation of the current monetary policy stance until convincing signs of a self-sustaining recovery in domestic demand

emerged. Regarding fiscal policy, countries with weak budget positions should aim for a sustained adjustment of underlying imbalances, to achieve fiscal consolidation within the Stability and Growth Pact framework. Directors welcomed the recent progress on structural reforms, including the Agenda 2010 initiative in Germany and pension reforms in France. They considered, however, that to increase sustainable long-term growth and improve the euro area's ability to adjust to shocks, more would need to be done. In particular, in anticipation of future demographic changes, Directors observed that product and labor markets should be strengthened further, and labor force participation and productivity growth increased.

In *Japan*, the strength of the recovery had continued to exceed expectations substantially, with welcome signs of a pickup in private consumption to complement exports and business investment as the main engines of growth. Deflationary pressures had also eased, and the authorities had made progress in strengthening the bank and corporate sectors. Directors encouraged the Japanese authorities to build on these achievements by making further strong efforts to sustain the recovery. In this context, they recommended continued quantitative monetary easing to bring a decisive end to deflation, adoption of a well-defined fiscal consolidation plan to tackle the very difficult budgetary situation, and further reforms of the financial and corporate sectors, particularly of smaller banks and enterprises.

Directors discussed the IMF staff's analysis of the industrial countries' experiences with structural reforms, which provided useful insights on how to move forward. While reforms had, in general, progressed fastest in areas that yielded the most immediate benefits, the experience over the past two decades showed that the end of a protracted period of slow growth provided a particularly favorable environment to embark on more difficult reforms. In such an environment, policymakers and voters remain aware of the costs of weak growth; at the same time, the economic recovery under way mitigates any short-term adjustment costs. Directors accordingly encouraged policymakers to take advantage of the recovery to press ahead with their structural reform agendas, including by carefully exploiting the complementarities between different reform areas.

Emerging Market and Other Developing Countries

Turning to *emerging market and other developing countries*, Directors welcomed the recovery, which had been aided by improved fundamentals, strong private capital inflows, and historically low spreads. GDP growth was expected to strengthen in most regions, although the outlook—particularly in countries where public debt remains high—could be affected by a deterioration in external financing conditions—for example, as a result of an abrupt or unex-

pected increase in interest rates. Directors acknowledged that, in addition to abundant liquidity in global financial markets, the decline in emerging market bond spreads also reflected the considerable progress being made by many countries in strengthening their fundamentals and improving the structure of their public debt.

The Board was encouraged by the improved outlook for *Latin America*, with stronger domestic demand beginning to contribute to an initially export-led recovery. To sustain the prospects for a further firming of the recovery, countries would need to continue making strong efforts to reduce their vulnerabilities to a possible deterioration in the global financial market environment and to further strengthen investor confidence. A number of countries in the region face a challenge in addressing pressing social needs against a backdrop of still high public debt levels. In this context, Directors stressed the importance of implementing broad-based reform strategies aimed at achieving strong and sustained growth. These strategies should be combined with well-targeted social programs and investments.

Directors highlighted the exceptionally strong growth in *emerging Asia*, which was underpinned by accommodative macroeconomic policies, growing domestic demand, competitive exchange rates, and the recovery in the information technology sector. Economic activity in the region was supported by buoyant growth in China. With growth accelerating and some financial imbalances emerging, many countries in the region would need to gradually tighten macroeconomic policies in 2004–05. In a number of countries, accelerated fiscal consolidation may be warranted, along with strengthened prudential oversight of the banking system to ensure that lenders appropriately evaluate and manage risks. Most Directors considered that timely, gradual steps by China toward greater exchange rate flexibility—combined with progress on developing the exchange markets and strengthening the banking sector—would contribute to price stability over the longer term by containing the continuous buildup of international reserves. Such steps would also facilitate similar moves by other countries in the region facing a need for monetary tightening and allow the region as a whole to contribute to more balanced growth globally. Directors discussed the implications of China’s rapid growth and integration for the global economy, and they noted that, while China itself clearly stands to gain the most from this process, the rest of the world will also continue to enjoy long-term benefits from China’s economic emergence, as already evidenced by dynamic productivity gains. To maximize these gains, Directors underscored the importance of continued further efforts by all countries to increase the flexibility of their economies to foster the mobility of resources among sectors.

The robust economic performance in most other emerging market countries was welcomed by the Board. Prospects for continued strong growth remain favorable across regions, provided timely actions continue to be taken to address vulnerabilities and further strengthen the foundations for private-sector-led growth. For many countries in *central and eastern Europe*, it was important to press ahead with fiscal consolidation efforts, in particular in those countries where a sharp widening in the current account deficit calls for firm action to reestablish budgetary discipline. In the *Commonwealth of Independent States* (CIS) countries, the priority should be to continue with reforms to improve the investment environment, strengthen banking systems and judicial frameworks, and dismantle intraregional trade barriers. Directors highlighted the importance of fiscal consolidation in most oil-exporting countries in the *Middle East* to reduce their vulnerability to oil price fluctuations. For the region as a whole, a more stable security situation and reduced geopolitical tensions will—along with employment-generating reforms—be key to accelerating medium-term growth.

Credit booms in emerging market economies, particularly the risk that such booms may presage sharp economic downturns and financial crises, were also examined by Directors. Credit booms are difficult to foresee, and authorities need to remain vigilant, especially in situations where rapid credit growth is accompanied by other signs of macroeconomic imbalance, such as current account deficits, investment booms, and increases in the relative prices of nontradables. Containment of credit booms usually requires strengthened surveillance of the banking system and close scrutiny of corporate borrowing during periods of rapid growth.

Directors were encouraged by the continued improvement in *Africa’s* economic performance, and the expectation that growth will accelerate further in the period ahead. A sustained further effort to accelerate growth and reach the Millennium Development Goal of halving poverty by 2015 remains nevertheless a pressing priority. This will require promoting stronger private sector activity and investment; reducing vulnerability to exogenous shocks; developing infrastructure; and strengthening institutions, governance, and transparency; as well as strong efforts to avoid the resurgence of civil conflicts. Directors welcomed recent regional initiatives to accelerate progress in these areas, including the African Peer Review Mechanism and the African Union’s adoption of a Convention on Preventing and Combating Corruption. They also emphasized that additional assistance from the international community would remain critical for Africa’s development and called for increased aid, continued debt relief, and—most important—greater access to industrial country markets.

Iraq



Iraq was one of the founding members of the International Monetary Fund in 1946. Between 1980 and 2002, however, because of internal political developments, three wars, and international sanctions, the IMF had little official contact with the government of Iraq. With the fall of Saddam Hussein's government in March 2003, the IMF reestablished contact with Iraqi officials working with the Iraqi Governing Council. A number of missions were fielded to Baghdad until the bombing of the UN compound in August 2003 led to the suspension of IMF travel to Iraq. The dialogue between the Fund and Iraq has since continued at locations outside Iraq. Fund staff have concentrated their work in two areas: (1) developing a macroeconomic framework and (2) providing technical assistance. In addition, the Fund's Managing Director is represented on the International Advisory and Monitoring Board (IAMB), which was set up according to the directives of the UN Security Council to oversee the audits of the Development Fund for Iraq, the oil-export proceeds that go into the Development Fund, and the financial controls in place in the spending ministries.

Early work on the macroeconomic framework served as input into the initial needs assessment that was prepared for the donors conference in Madrid in October 2003. During this conference, which was attended by representatives from 73 countries and 20 international organizations, donors pledged some \$33 billion in grants and

loans in support of the reconstruction of Iraq in 2003–07. In April 2004, the Fund participated in a meeting at the U.S. State Department in Washington at which the core group of donors and institutions began preparations for the International Reconstruction Fund Facility for Iraq.

Fund staff worked on a debt sustainability analysis in consultation with Iraqi officials and representatives of the Coalition Provisional Authority (CPA). After contacting 50 countries that are not members of the Paris Club to get information about any outstanding loans to Iraq, the Fund estimated that debt to non-Paris Club creditors is probably about \$60–\$65 billion, compared with about \$42 billion to Paris Club creditors and \$15 billion to commercial creditors. This analysis was provided to the Paris Club in late May 2004 for their consideration of possible debt relief for Iraq. The G-8 summit in June declared that an agreement on debt relief based on the IMF's work on the debt sustainability analysis should be reached by the end of 2004, after the G-8 and Paris Club members have consulted among themselves and with non-Paris Club creditors. On June 8, 2004, the UN Security Council endorsed the formation of the interim government of Iraq, which assumed power upon the dissolution of the CPA on June 28. The interim government is intended to serve until an elected transitional government takes office, which should happen by December 31, 2004, or, at the latest, January 31, 2005. The UN endorsement should pave the way for international recognition of the interim government and make possible the normalization of Iraq's relations with the Fund.

The IMF has been a lead provider of technical assistance in Iraq since the summer of 2003. It has provided extensive technical assistance in a number of areas, including the introduction of a new currency, central bank and commercial bank legislation, the payments system, budget execution and public expenditure management, tax policy, revenue administration, and the compilation and dissemination of economic statistics. Training programs for Iraqi officials have also been provided in the macroeconomic, fiscal, monetary, and statistical areas.

Global Financial Stability Report

Another key tool for the IMF's monitoring of global economic activity is the *Global Financial Stability Report* (GFSR), which, like the *World Economic Outlook*, is published twice a year. The GFSR focuses on the world's financial markets, covering developments in both mature and emerging markets and analyzing topical structural issues relating to the global financial system. The report aims to identify potential fault lines in the global financial system, in an effort to help head off systemic crises. The Executive Board discussed two reports—one in August 2003 and another in March 2004.

Global Financial Stability Report, August 2003

At their August discussion, Directors noted that financial markets had remained resilient during the first half of 2003,

notwithstanding continued lackluster economic growth, geopolitical uncertainties, and high market volatility. However, some concerns remained, associated with risks related to the macroeconomic outlook, rising long-term bond yields, the potential for weak corporate earnings, and the vulnerability of emerging bond markets to a correction.

Several policy implications of market developments were noted by Board members. They urged authorities in major financial centers to persist in reforms to shore up market foundations, including strengthening corporate governance to restore investor confidence; bolstering the regulation and supervision of insurance companies; and improving the accounting practices and regulation of defined-benefit pension funds.

Although the external financing climate for emerging market countries improved somewhat in 2003, Directors

cautioned that public sector debt in these countries remained high and that there was no room for complacency by borrowers. They urged countries to take advantage of enhanced access to international capital markets to press ahead with the implementation of sound policies and improve the structure of their liabilities, including extending maturities and reducing the dependence on dollar-linked debt. Directors noted that several countries had undertaken successful liability-management operations. They also welcomed the use of collective action clauses (CACs) in recent sovereign bond issues.

The discussion in the *Global Financial Stability Report* of the volatility of capital flows to emerging markets was welcomed by Board members, and they agreed that foreign direct investment should be encouraged. However, Directors pointed out that, while capital flows were inevitably somewhat volatile, sound economic policies and transparency could help countries make flows more stable. There was also much that emerging market countries could do to “self-insure” against the effects of volatility, including managing assets and liabilities; adapting exchange rate arrangements to the degree of capital account openness; strengthening domestic financial institutions; enhancing supervision and regulation; and developing local securities markets. Directors noted that developing efficient and stable local sources of finance had become all the more relevant since emerging markets as a group had become net exporters of capital in recent years. Directors also discussed the implications of increased holdings of international reserves by some countries.

Global Financial Stability Report, March 2004

Financial market conditions had strengthened by the time of the Executive Board’s GFSR discussion in March 2004, and the prospects for global financial stability appeared brighter. Directors noted that the improved outlook was supported by a firming of the global economic recovery, rising corporate earnings, and a strengthening of corporate balance sheets. Emerging market borrowers, many of which had taken steps to put their public finances on a sounder footing and improved the structure of their domestic and external debt, were benefiting from higher export demand and commodity prices.

Global Financial Market Surveillance

In response to this improved outlook and the exceptionally low short-term interest rates, Directors noted, global financial markets had staged a strong, broad-based rally in 2003. While low short-term interest rates were continuing to influence investor behavior and were, in some cases, encouraging increased risk taking in search for yield, most mature and emerging market indices appeared to be point-

ing to a period of consolidation, with investors showing renewed caution and increased discrimination.

The improved outlook for financial stability was not without risks, Directors emphasized, noting that risks would require vigilant monitoring, not least because of their interconnected nature. A first set of risks stemmed from the environment of prolonged low interest rates and abundant liquidity. In this environment, asset valuations may be pushed beyond levels justified by fundamental improvements, eventually necessitating a transition to higher interest rates in mature markets. Such an outcome may have broader ramifications, including increased bond market volatility if investors were to revise their interest rate outlook abruptly—as they did during the 1994 sell-off in global fixed-income markets—or if asset valuations that were predicated on an unusually low level of risk-free rates were corrected abruptly. To guard against these risks, Directors encouraged policymakers to develop timely and forward-looking communication strategies that encourage investors to base their decisions on fundamentals rather than on the expectation that interest rates will be kept indefinitely at very low levels. Directors noted that the potential effects of higher interest rates on emerging market economies were being mitigated owing to the progress that many of them have made in reducing vulnerabilities, while stronger world growth would also help offset the impact of higher interest rates.

The potential for market instability arising from large global external imbalances, including the possibility that adverse developments in the currency markets might spill over into other asset markets, was also discussed. The depreciation of the U.S. dollar against other major currencies had so far been orderly. Most Directors considered that, in view of the substantial capital flows that the U.S. economy will continue to need to attract, the risk of a pronounced currency depreciation—possibly resulting in higher U.S. dollar interest rates and a correction in asset valuations—can nevertheless not be dismissed. A strong and sustained cooperative effort—aimed at ensuring a smooth adjustment of global imbalances over the medium term—would remain a key policy priority for the international community.

Turning to the improved external financing environment for emerging market borrowers, Directors observed that the improved credit quality of many emerging market borrowers and low interest rates in the major financial centers contributed to the impressive compression of spreads on emerging market bonds in 2003. Directors commended many emerging markets for steps taken in the current favorable market environment to meet a substantial part of their borrowing needs, improve their debt structures, and extend maturities. The correction in 2004 of the downward

exchange rate overshooting that occurred in 2003 in many Latin American economies was expected to enhance debt sustainability in these countries. Directors also welcomed the trend toward making the inclusion of collective action clauses in sovereign bond issues an industry standard. Notwithstanding the encouraging performance of the region as a whole, some countries appear to have relaxed their fiscal and structural reform efforts. Unless they take timely corrective action, Directors cautioned, these countries face a heightened risk of exposing their underlying vulnerabilities in the event of a turnaround in the current favorable external financing environment.

Board members welcomed the continued strengthening of the balance sheets of the household, corporate, and bank sectors over the course of 2003, as corporate and household sectors continued to build up liquidity, and rising asset values strengthened net worth. Nevertheless, rising interest rates may increase the debt service burden, particularly in a number of European countries where debt levels of the corporate sector remain high. Directors noted that the fall in long-term yields had increased refinancing activity in the U.S. mortgage market, reopening the possibility of hedging activity that might amplify yield movements. They welcomed, in this context, proposals to strengthen the regulation of the U.S. mortgage agencies and address the implicit government guarantee.

The relatively benign overall conditions in mature and emerging markets, Directors stressed, provided an advantageous window of opportunity to focus policy attention on several key structural reforms to underpin financial stability over the longer run. In mature markets, scandals in the mutual funds industry and some companies, such as Parmalat, again underscored the need to build on efforts to improve corporate governance and strengthen market foundations. In particular, Directors called for steps to strengthen scrutiny by investors and regulators of firms with complex ownership and capital structures, as well as to enhance public oversight of auditing practices. Priorities on emerging market countries' agenda should include further reductions in the level and vulnerability of public debt, development of local capital markets, and continued strong efforts to improve the climate for foreign direct investment, which had remained at disappointingly low levels in spite of the general rebound in capital flows.

Risk Transfer and the Insurance Industry

The Board discussed a range of regulatory and disclosure issues raised by the transfer of risk from banking to non-banking institutions in mature markets, including the hedge fund industry, where, despite closer counterparty and investor monitoring, there appears to be a need for broader and more systematic transparency of exposures and prac-

tices. Directors noted that future staff work would focus on the hedge fund and pension fund industries.

Directors observed that the reallocation of credit risk to the insurance sector, together with improvements in risk management in the sector, appeared to have contributed to enhanced overall financial stability. Moreover, by allocating a greater share of their portfolio to credit instruments, many life insurers had availed themselves of a more predictable return. While the investment in credit instruments by insurers deserves to be supported, Directors stressed that this would need to go hand in hand with continued efforts to improve risk management and regulatory oversight of the sector. Recommended improvements include wider implementation of risk-based capital standards by regulators; enhancement of supervisory resources in many mature market jurisdictions; increased information sharing among supervisors; and strengthened disclosure requirements. Directors welcomed the current debate on international accounting standards for insurers and looked forward to the development of converging standards that provide an accurate reflection of insurance companies' financial positions. Directors noted that disclosure should be comprehensive and include information on sensitivities and risks. While rating agencies play a helpful role in disseminating information on risks, Directors cautioned that they should not be a substitute for appropriate supervision.

Institutional Investors in Emerging Markets

As to the institutional investor base for claims on emerging markets, Directors saw the development of a stable investor base as a key element in reducing the volatility of capital flows to emerging markets. While ongoing changes have been contributing to a welcome broadening and diversification of the investor base, the decline in dedicated—relative to crossover—investors may also have increased the volatility of capital flows. Another source of potential volatility arises from the impact that even small changes in the portfolio positions of institutional investors can have on emerging markets, given the large size of the assets under the management of these investors. Directors agreed that the factors influencing the changing nature of the investor base as well as their policy implications—including for debt-management policies and practices in emerging markets—would require continued careful analysis. They emphasized the importance of adequate transparency and disclosure regarding both government policies and corporate developments, with investor relations programs being a particularly useful instrument. In addition, Directors noted that the development of an efficient market infrastructure in emerging economies would be helpful in attracting institutional investors from both mature and domestic markets.

Directors also commented on the supervisory and regulatory implications of the expanding portfolios of nonbank institutional investors in emerging markets, in particular the rapid growth of pension funds. In view of the growing imbalance between the assets under the management of these funds and the available securities, close coordination would be required between changes in the regulatory framework, the development of local capital markets, and the gradual easing of limits on foreign investment by pension funds to increase their opportunities for portfolio diversification. Directors viewed the development of local securities markets as key to ensuring proper risk management by the insurance industry. In view of the rapid growth and increasing sophistication of the activities of local institutional investors involved in both local and international markets, Directors observed that it would also be important to persevere with strong efforts to enhance the risk-management skills of both investors and regulators.

Regional Surveillance

Euro Area Policies

In September 2003, the Executive Board discussed euro area policies and the trade policies of the European Union (EU).

Euro area authorities faced many policy challenges, Directors noted. In particular, economic growth had come to a virtual standstill since the last quarter of 2002, with net exports and investment declining, and unemployment on the rise. Moreover, challenges loomed, with the aging of the population and slowing of labor force growth becoming an increasing drag on potential output growth, fiscal sustainability, and old-age income security. EU enlargement, while of benefit to all concerned, would also be a source of new challenges. Directors advised that meeting these challenges successfully would require a sustained shift toward more forward-looking national policies and the vigorous implementation of structural reforms. While adversity had begun to induce such forward-looking policies, notably on the structural side, the Board noted that it was essential that these potentially promising steps be sustained once difficulties recede.

Directors considered that the weakness of area-wide activity reflected a number of shocks as well as structural rigidities and policy lapses. The shocks included the bursting equity bubble, low business and consumer confidence, reduced external demand, the correction of the euro to longer-run equilibrium levels, and geopolitical uncertainties. Rigidities in labor markets and lesser reliance on market-based financing had, in some measure, contained the effects of the shocks, but they had also slowed both the post-bubble and intra-area adjustments. As a result, the area-wide stagnation

was expected to be overcome only gradually, with growth remaining subpar well into 2004. Board members were encouraged, however, by improvements in survey and confidence indicators, which signaled a gradual pickup in growth during the second half of 2003. They saw the risks to the outlook as having become more balanced.

Despite the possible implications of the recent appreciation of the euro for the area's short-term prospects, Directors viewed the appreciation as beneficial on balance, noting that it had helped curb inflation and that the competitiveness of the euro area was back to its long-term average. Most Directors agreed that the euro area had borne a disproportionately large share of the burden of adjustment to a weaker dollar and called for a more equitable global distribution of any further adjustment burden to reduce imbalances in the global economy and to achieve balanced growth in the major currency areas.

Monetary policy had done well and had established its credibility. It has been in line with inflation and output developments, and the monetary framework has been appropriately modified based on the experience of the past five years. In particular, the European Central Bank's (ECB's) clarification of its inflation objective as being "below but close to 2 percent" substantially reduced the scope for misinterpretation and provided a clear anchor for longer-run inflationary expectations. Most Directors noted that aiming for such inflation outcomes over the medium term provided scope for inflation differentials across member countries and a buffer against shocks that could lead to area-wide deflation. Directors also welcomed the clarification of the relative roles of long-term monetary analysis and short-term economic analysis in the ECB's anti-inflation strategy.

Directors agreed that the ECB needed to guard against downside risks to inflation, noting that inflation pressures had subsided. While the downside risks had become somewhat more balanced with the pullback in the euro, the cumulative effects of weak activity, a continued softening of labor markets, and the significant past appreciation of the euro should combine to push headline inflation well below 2 percent by late 2004. Directors saw the costs of undershooting the inflation objective as greater than those of overshooting it. Low inflation would not help balance sheet adjustments and would provide less room for, and, hence, increase the costs of, relative price adjustments across the area. This, Directors observed, together with the risk of euro appreciation, strengthened the case for monetary policy to maintain an accommodative bent in order to support confidence until a self-sustaining upturn in domestic demand is in place.

There is a need for forward-looking fiscal policies to improve the quality and ensure the long-term sustainability of public finances in light of potential fiscal pressures

Japan



The IMF's FY2004 policy dialogue with the Japanese authorities focused on initiatives that could stimulate high and sustained medium-term growth. In recent Article IV consultations, the Fund emphasized the need to revitalize the corporate and financial sectors, tackle deflation, put the fiscal balance on a sustainable medium-term footing, and undertake regulatory reforms to facilitate the reallocation of resources.

The authorities shared the Fund's view and have taken steps to address these issues. They have fashioned a framework for corporate restructuring, strengthened bank supervision and regulation, taken monetary policy steps to counter deflation, reduced and allocated public works spending more efficiently, and started to deregulate important sectors.

In addition, Japan participated in the Financial Sector Assessment Program. The authorities will continue to address issues identified by the assessment, which stressed the need for the government to pursue further banking reforms and to reduce its involvement in Japan's banking sector over the medium term.

Japan-IMF activities in FY2004

August 2003	Completion of Article IV consultation by the Fund's Executive Board
September 2003	Publication of Financial System Stability Assessment and supplementary information
February 2004	Visit of Managing Director Horst Köhler

created by population aging. In this regard, the Board noted that fiscal developments have not been positive, particularly in the three largest economies, where most policies have had a short-term focus, and fiscal excesses during the boom years contributed to difficulties in observing the nominal deficit ceiling. Directors agreed that these developments underlined the need for a fiscal framework in the European Economic and Monetary Union (EMU). Directors felt that, from a longer-term standpoint, the basic parameters of the EU Treaty and Stability and Growth Pact (SGP) were broadly appropriate. Noting the focus on breaches of the 3 percent deficit limit, Directors stressed that past lapses in fiscal discipline, and not the fiscal framework itself, had been responsible for the limited amount of fiscal leeway in the three largest euro area economies. The aging of the population requires that most euro-area countries move at least toward underlying balance over the medium term. If they did so, there would be room for the automatic stabilizers to work, and the 3 percent limit would not be binding aside from exceptional circumstances, which the pact allows for.

There was a potential conflict between the short-term need for fiscal stimulus to boost economic growth and the need for fiscal consolidation to restore the credibility of the SGP and to achieve fiscal sustainability. However, Directors believed that more forward-looking fiscal policies could provide a bridge to long-term sustainability while permitting greater short-run flexibility. The SGP should indeed focus on growth as well as stability, but that growth means first and foremost structural reforms rather than short-term demand management. Within such a framework, most Directors acknowledged that there was scope to trade short-run fiscal consolidation for credible multiyear commitments to growth- and consolidation-oriented structural reforms, notably by cutting spending and increasing incentives rather than raising taxes. Although it was recognized that this entails credibility risks for the SGP insofar as it implies further breaches of the 3 percent deficit limit, the standard remains that countries with weak underlying positions should take discretionary fiscal policy actions to achieve underlying high-quality fiscal adjustments of 0.5 percent of GDP a year. Many Directors agreed, however, that, where underpinned by meaningful gains on the long-run structural and macroeconomic fronts, delays that meet the standard on a cumulative basis—that is, 1.5 percent of GDP—during 2004–06 would also strike an appropriate balance between long- and short-run goals. A number of Directors, though, cautioned against departures from commitments to achieve a steady underlying fiscal adjustment of 0.5 percent of GDP a year.

Board members called for more sustained and vigorous implementation of structural reforms. They noted that, while the area's low underlying growth rate reflects, in large part, slow population growth, there was considerable scope

for raising rates of utilization of labor resources and for increasing technological progress and innovation. Long lags in effecting increases in labor force participation rates require early concerted actions to slow—if not reverse—the aging-induced fall-off in potential per capita growth and deterioration in public finances. In this context, Directors emphasized the importance of labor market and pension reform. The loss of the exchange rate as an adjustment mechanism within the monetary union, particularly in the context of limited labor mobility, makes greater flexibility in goods and labor markets imperative.

The promising reform steps recently taken in some countries was welcomed by Directors, but they emphasized that much more is needed to achieve the goals set out in the Lisbon agenda agreed by the European Council in 2000. Directors were particularly encouraged by progress in creating a single market for financial services. Moreover, the reform process in the larger countries, particularly with respect to labor markets and social security systems, had been revived. In some cases, progress surpassed earlier expectations. There was also a growing recognition of the largely unexploited synergies to be reaped between structural reforms, improved economic performance, and fiscal sustainability. These synergies hold the promise of improving medium-term growth prospects and restoring the credibility of the SGP. However, Directors noted that the agenda of needed reforms was long and varied across countries, while resistance to reform remains strong and is likely to strengthen as the economic situation improves. It is essential that the new reform momentum not become simply a response to economic adversity but that it be sustained for many years to come. Directors, therefore, welcomed the steps taken by the Commission and endorsed by ECOFIN to toughen surveillance by making the Broad Economic Policy Guidelines both more targeted and more forward-looking.

Directors endorsed the recent decision to reform the Common Agricultural Policy, noting that the agreed “decoupling” of agricultural supports from production would lessen downward pressures on world prices. Many Directors noted that greater commitment to opening EU markets will be crucial to achieving the objectives of the Doha Round of multilateral trade negotiations and that creating a multilateral trade environment supportive of economic development and poverty reduction would require more concessions by the EU and other advanced economies to developing countries.

Adopting the Euro in Central Europe

In February 2004, Executive Directors discussed the challenges facing the five former transition countries of Central Europe (CECs)—the Czech Republic, Hungary, Poland, the Slovak Republic, and Slovenia—as they moved toward the

adoption of the euro along with the Baltic states, Cyprus, and Malta.

The discussion focused on how best to address two fundamental questions: when to adopt the euro, and how to prepare for it. Directors noted that, while all countries acceding to the European Union faced challenges, the macroeconomic issues surrounding euro adoption would be especially complex for the CECs, which maintained flexible exchange rate arrangements. They observed that addressing these issues would require careful case-by-case assessment, and the path and pace of euro adoption would differ according to individual country circumstances.

Euro adoption is likely to bestow substantial benefits on the CECs over the long term, Directors noted, provided strong supporting policies are in place. These benefits would stem from the elimination of exchange rate risk, lower transaction costs, enhanced policy discipline, lower real interest rates, and greater transparency of prices. Although difficult to quantify, the benefits would be manifested primarily through increased trade and investment and more rapid productivity and income growth. Directors stressed that, to realize these gains, the countries would need to secure sound macroeconomic and structural conditions and continue to foster private sector development. In particular, goods and factor markets should be flexible, and public finances should be put on a sustainable track with minimal rigidities from nondiscretionary spending. Directors noted that the CECs’ policy strategies were already on a promising path toward fulfilling these conditions in many important areas.

Adopting the euro would also entail costs stemming from the loss of the monetary policy instrument, Directors observed, given the role that monetary policy can play in offsetting asymmetric demand shocks and providing an instrument for containing demand pressures. While further convergence of business cycles would help to minimize the risk of asymmetric shocks, countries would be well advised to build up sufficient policy flexibility to deal with any remaining shocks prior to adopting the euro. Joining the euro area would effectively eliminate the high degree of exchange-rate-induced volatility to which CECs are exposed.

The path to euro adoption involves participation in the Exchange Rate Mechanism (ERM2) and meeting the Maastricht criteria. The Board’s discussion confirmed that decisions on the timing of these steps would need to be made on a case-by-case basis, taking into full account the policy issues involved. Three considerations appear to be of primary importance to ensure that the euro candidates will be well prepared for successful participation in the EMU.

- Prior to adopting the euro, the harmonization of economic conditions—particularly the correlation of

business cycles and trade links—should be strong. While business cycles can be expected to become even more synchronized once countries adopt the euro, a sufficient degree of cyclical convergence, prior to euro adoption, would help improve prospects for a successful experience in the euro area.

- Adjustment mechanisms—wage and price flexibility and the capacity to run countercyclical fiscal policy—would need to be in place to ensure that asymmetric shocks can be effectively absorbed in the absence of monetary policy.
- Euro candidates must achieve an adequate degree of nominal convergence. Directors indicated that the issue of how best to assess the appropriate standards for nominal convergence deserved further reflection. Several Directors saw the proposal to use the ECB's inflation objective as the basis for defining "best performing in terms of price stability" when setting the Maastricht inflation ceiling as judicious. This approach would ensure that appropriate consideration is given to the conditions prevailing in the candidate countries. However, others cautioned against interpretations of the Maastricht Treaty criteria that could raise issues of unequal treatment of new and current members.

Meeting these conditions will require further strong efforts, but Directors noted that, in many respects, in particular progress with trade integration, the CECs were already at least as well positioned as some of the current EMU members were at the same stage of the accession process.

The discussion highlighted several sources of vulnerability that would need to be carefully managed. Directors noted that the CECs would continue to attract capital inflows that could be volatile by virtue of their size and susceptibility to speculation about the timing and conditions of euro adoption. They also noted that the prospect of rapid credit growth starting from the present low rates of bank intermediation entailed possible risks of overheating and asset price bubbles. Sound and consistent macroeconomic policies and strong and effective bank supervision would be key to minimizing these vulnerabilities and positioning the CECs for a successful experience in ERM2 and the early years in the euro area, Directors cautioned. While it was acknowledged that temporary restrictions on capital inflows could, in some limited circumstances, play a complementary role, it was also considered that this option would go against the objective of greater integration.

Directors agreed that further progress toward fiscal consolidation would likely be the greatest challenge facing the CECs in preparing for euro adoption. They noted that fiscal consolidation would require both the articulation of credible plans for medium-term fiscal adjustment based on a strong consensus and the demonstration of sustained

progress in meeting adjustment goals. It was also suggested that the CECs should stand ready to accelerate the pace of fiscal consolidation in the event of a boom in bank credit. While they acknowledged the challenge of reaching this objective in practice, Directors saw considerable merit in a medium-term strategy that would bring structural fiscal deficits well below the Maastricht deficit criterion of 3 percent of GDP by the time of euro adoption, with a view to allowing the full operation of the automatic stabilizers in the event of adverse cyclical conditions. Lower deficit levels would also help the CECs achieve public debt ratios that are sufficiently prudent given the volatility of fiscal revenues and the extent of expenditure rigidities. At the same time, the need to maintain public investment at levels that support further real convergence underscores the importance of high-quality fiscal adjustments focused on restraining the least productive expenditures, in particular social transfers and subsidies.

The discussion raised several important aspects of ERM2 in the run-up to euro adoption. Decisions about the central parity at which the CECs would enter the mechanism will require difficult and delicate judgments about where the parity should be set given the uncertainties as to the equilibrium exchange rate. In any event, participating members would have to agree on the parity and conversion rates.

Participation in ERM2 would also require well-planned policy strategies on the part of the CECs. There was support for the view that countries should apply to enter ERM2 only after they have made substantial progress toward achieving low inflation, correcting fiscal imbalances, and implementing structural reforms. This would allow the stay in ERM2 to be limited to the minimum two-year period. However, there was also support for the view that ERM2 would provide participating countries with a useful and flexible framework for testing policy consistency and the appropriateness of the central parity, and for helping them direct economic policies toward sustainable convergence and reduced exchange rate variations. In this view, there are good arguments against any bias toward shortening the length of stay in ERM2, which may need to vary across countries. At the same time, the discussion highlighted that the conversion to the euro should not be unduly delayed for countries entering ERM2 with sound fundamentals and policies consistent with full participation in the euro area, given the potential risks of speculative pressures related to a prolonged stay in ERM2 and the obligation set out in the Maastricht Treaty to move toward euro adoption once all criteria are fully met.

Directors pointed to the importance of a clearly defined monetary policy framework during ERM2. With the support of sound underlying policies, the aim should be to put in place a framework that enhances the stabilizing effects of an

appropriately set central parity, strengthens the likelihood of achieving the criteria for exchange rate stability and inflation, and offers protection against speculative pressures. Directors discussed a variety of possible frameworks but cautioned that no single monetary regime met the requirements of all countries. They accordingly stressed the constructive role the IMF staff and regional institutions could play in encouraging national authorities in candidate countries to make choices on their monetary policy frameworks with a full appreciation of the trade-offs and risks involved. Directors also stressed the need for chosen frameworks to provide markets with a clear indication of how monetary policy would respond to various types of potential shocks.

Lastly, the Board underscored that, given the considerable policy challenges ahead, each country will need to place a high priority on building broad-based support for its euro adoption strategy. Maintaining clear and timely communication with the markets, and between the CECs and the European Commission and the ECB, will help in this task. This will also involve minimizing any uncertainties about the criteria to be used in assessing compliance with the requirements for euro adoption while preserving the room for using judgment when making the final assessment of compliance with the Maastricht criteria.

Central African Economic and Monetary Community

In November 2003, Directors discussed developments and regional policy issues 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.

Macroeconomic developments in the CAEMC region were generally satisfactory in 2002, with growth remaining buoyant, inflation moderate, and the level of official reserves rising. However, the region remained excessively dependent on the oil sector, and human development indicators had improved only marginally despite the region's endowment of natural resources. More broadly, Directors considered that greater convergence in members' fiscal, monetary, and trade policies would help CAEMC realize the full potential of regional economic integration.

Against that background, Directors regretted the slow progress in macroeconomic convergence and urged greater political commitment to, and strengthening of, the surveillance process. They welcomed the introduction of improved convergence criteria and suggested further strengthening the peer review process. Given the volatility of oil revenues, they encouraged the CAEMC authorities to modify the basic fiscal balance criterion by using a fiscal rule and to introduce greater transparency in the management of oil resources in line with international best practices. Directors

welcomed the plans for making the administration of national stabilization funds and "Funds for Future Generations" more flexible and suggested that consideration be given to improved ways of investing these resources with the Bank of Central African States (BEAC).

As for monetary policy, Directors considered the BEAC's stance in 2002 to have been generally prudent, and the 2003 monetary program was broadly consistent with the regional inflation objective. However, Directors noted that more progress was needed in removing the long-standing structural weaknesses that hinder the effective conduct of monetary policy in the region. Directors urged the CAEMC authorities not to delay further the replacement of the BEAC financing of budget deficits by the issuance of treasury bills. In that context, they encouraged the BEAC to consider issuing its own negotiable certificates of deposit to enhance its liquidity-management capacity until government treasury bills become more generally available. Directors also considered that country-specific reserve requirements might create distortions across the region's financial markets, which could impair the competitiveness of financial service providers in some member countries, and called for their realignment. Board members also called for additional measures, such as freeing up interest rates, improving the payments system, and simplifying the procedures used for open market operations, to enhance the functioning of the interbank market.

Continued efforts were needed to strengthen the banking system, which remained fragile despite the restructuring of distressed banks, and Directors emphasized the role of the Banking Commission of Central Africa (COBAC) in ensuring banks' compliance with prudential norms. They recommended that COBAC be made the sole authority for issuing and withdrawing bank licenses, and that the common bank licensing rules be revised to further facilitate opening of bank branches across the region. Directors welcomed COBAC's plans for progressive tightening of the capital adequacy ratio, but highlighted the need to match capital requirements to the high operational risks inherent in CAEMC economies because of their undiversified economic structure.

Directors encouraged the CAEMC authorities to press ahead with other financial sector reforms, including early and effective implementation of new regulations for the microfinance sector. They welcomed the adoption of anti-money-laundering regulations, but noted that additional steps were needed to make them fully operational. In light of the modest size of the private sector in CAEMC countries, Directors expressed a preference for merging the nascent regional stock exchange in Libreville with the existing one in Douala. There is merit in adopting a prudent approach in the operations of the recently reorganized

Mozambique



Mozambique completed four IMF-supported programs during 1987–2003. These programs helped the country make significant structural reforms—moving from a centrally planned economy to a market-based one—achieve macroeconomic stability, and substantially reduce its debt burden. GDP growth averaged nearly 7 percent a year during this period. The country built up its foreign exchange reserves, and the net present value of Mozambique’s public external debt fell from over 500 percent of exports at the end of 1998 to less than 100 percent at the end of 2003. The proportion of the population living below the poverty line has declined by about 15 percentage points since 1997, when it was 70 percent.

The government’s program for calendar year 2004 calls for broadening and sustaining growth by maintaining prudent macroeconomic management and addressing an important agenda of unfinished reforms to accelerate private sector development.

The Fund provides significant levels of technical assistance in the financial and fiscal sectors in close cooperation with development partners, which also contribute financial support. This assistance has enabled Mozambique to make great strides in strengthening public finances, including customs and tax administration.

Mozambique-IMF activities in FY2004

June 2003	Completion of the fifth review of Mozambique’s performance under the country’s PRGF-supported program
July 2003	Visit of Managing Director Horst Köhler, who also attended the second African Union Heads of State meeting in Maputo
November 2003	Mozambique began participating in the Fund’s General Data Dissemination System; publication of Financial System Stability Assessment by the IMF and the World Bank
December 2003	Completion of Article IV consultation and ex post assessment of Mozambique’s performance under Fund-supported programs by the Fund’s Executive Board

regional development bank (BDEAC) so as to confine its lending operations to refinancing activities in accordance with sound financial criteria, relying on its own funds and long-term resources borrowed on the regional market.

Directors regretted that member countries still do not consistently apply the provisions of the common external tariff (CET), and they saw expediting trade integration among CAEMC nations as urgent. Remaining nontariff barriers need to be eliminated; customs codes, valuations, and exemptions need to be harmonized; and the CET needs to be overhauled, including by reducing the top tariff rate of 30 percent. Directors encouraged the authorities to pursue tax harmonization in other fiscal areas as well and to strengthen the collection of the regional tax on imports to ensure financing of the regional institutions and regional integration funds.

Some of the competitiveness gains resulting from the 1994 devaluation of the CFA franc had been eroded, Directors observed. To maintain the region’s external competitiveness and its share in export markets, they underscored the need to pursue policies aimed at broadening the productive base and diversifying the economies, including by accelerating structural reforms, strengthening basic infrastructure, and adopting common sectoral policies.

Directors urged the authorities to improve the quality, harmonization, and distribution of CAEMC’s economic data, notably in the areas of price indices, the real sector, and public finance. In light of the high incidence of poverty in the region, the collection of social sector statistics to track progress with poverty reduction and human development indicators was especially important. Directors supported elevating the regional discussions on economic developments and policies to the level of formal regional surveillance of CAEMC-wide issues in the context of Article IV consultations with member countries.

Structural Reforms and Growth

A common theme in many of the Executive Board’s discussions during the financial year was the need in many countries for more vigorous efforts at structural reform, especially to enhance economic growth. The theme arose in a variety of contexts: not only in surveillance discussions at the country, regional, and global levels, but also in discussions of policy programs supported by IMF financing.

Many economic problems are due to shortcomings in the working of markets, rather than to resource shortages or an excess or deficiency of overall demand. There is broad consensus that where there are such problems, structural reforms—policy measures that change the institutional and regulatory frameworks governing market behavior—can

lead to greater efficiency in the allocation and use of resources and to stronger incentives for innovation, and thus not only to higher productivity and per capita incomes but also to faster long-run growth. Structural reforms can also boost growth in the short run by increasing returns to investment and by providing scope for macroeconomic policies to allow the economy to run at higher levels of capacity utilization without inflationary pressures. Unfortunately, however, many structural reforms impose costs on a few individuals or social groups in the short run, and those who perceive themselves as potential losers often successfully oppose reforms.

For the April 2004 *World Economic Outlook*, an IMF staff team researched structural reforms in industrial countries to distill lessons from the experience of the past three decades, particularly on the obstacles to reform and what can be done to overcome them. The analysis suggested that several considerations could make a difference in the success of reforms:

1. A recovery from an economic downturn is a good time to start reforms. Difficult economic conditions often make the need for reform more obvious, thereby weakening traditionally strong interest groups.
2. There are advantages to starting with reforms that bring quick, clear benefits. Trade and financial market reforms, for example, produce benefits in the short run. If these are successful, they not only have a demonstration effect but may also increase competitive pressures, making further reform easier.
3. Strong fiscal positions enable countries to provide compensation to those hit hardest by reforms, suggesting that countries should seek to improve their fiscal positions to gain the flexibility to support reforms in this way.
4. Outside support for reforms can be helpful. Signing an international agreement or joining an international club can provide external discipline that will force the pace of reforms. For example, membership in the World Trade Organization provides support for trade liberalization. Membership in the IMF is another example.

Through the Fund's surveillance, financial assistance, and technical assistance, the Executive Board continued in the latest financial year to press for structural reforms in

many countries and highlighted the success of past reforms.

In its surveillance of policies in the industrial countries—in its discussions of the *World Economic Outlook* and the relevant country surveillance cases—the Board observed that growth-enhancing structural reforms were particularly important for both the euro area and Japan, which have suffered sluggish growth in recent years because they lacked the scope to ease macroeconomic policies, given the already low level of interest rates as well as actual and projected fiscal imbalances. Structural reforms in the euro area and Japan were thus seen as an important component of the policies needed to rebalance global growth and narrow payments imbalances. The Board also emphasized the importance of labor market reforms in many European countries to tackling problems of chronic unemployment.

For many emerging market countries, the Board emphasized the importance of fiscal and financial sector reforms to make growth more robust. The three Baltic countries—Estonia, Latvia, and Lithuania—are examples of successful reformers in which the Fund was able to play a crucial role in guiding the authorities in making difficult choices. These three countries have recorded growth rates of 6 to 9 percent annually, with low inflation, over the past few years despite a difficult global environment—a remarkable recovery from the recession triggered by Russia's financial crisis of 1998. The recovery was due, in large part, both to sound macroeconomic policies and to the implementation of often painful structural reforms in anticipation of European Union accession in May 2004.

For many low-income countries, the Board stressed, in particular, the need for reforms that would improve governance and other features of the investment climate, because of the importance for growth and poverty reduction of attracting private investment—including from abroad—and fostering domestic saving.

Specific reform agendas in the financial sector, trade and tax systems, and product and labor markets were discussed in many Article IV country consultations and in multilateral and regional surveillance activities. Instances of how various countries have benefited from structural policy assistance as well as from macroeconomic advice provided by the Fund appear throughout this report.



Strengthening the International Financial System

The growing integration of the world economy in recent decades has brought substantial benefits to the IMF's member countries. But this economic interdependence has also created new challenges, as demonstrated by the financial crises of the 1980s and 1990s. The IMF has responded to these challenges, in part, by strengthening its framework for, and enhancing the content of, surveillance—its foremost means of helping countries avert crises. Surveillance allows the Fund, working with its member countries, to identify economic and financial policy strengths and weaknesses and vulnerabilities that could lead to crises and to formulate policy actions that can safeguard stability. And, given the potential for national crises to spill over to other countries in today's global economy, surveillance is a means for the Fund to fulfill its mandate of promoting international economic and financial stability.

During FY2004, the Fund sharpened its focus on global imbalances, vulnerabilities, and structural rigidities that impede economic growth and undermine the resilience of the world economy as well as on tools such as debt sustainability assessments and analysis of balance sheet fragilities. It also continued to strengthen financial sector surveillance through such mechanisms as the Financial Sector Assessment Program (FSAP), financial soundness indicators (FSIs), and assessments of Offshore Financial Centers (OFCs) and Anti-Money-Laundering and Combating the Financing of Terrorism (AML/CFT) regimes. Further enhancements to its surveillance framework, including a number that draw on recommendations of the Independent Evaluation Office (see Section 3), are in train. The Fund is also enhancing the modalities of its relationships with member countries to maximize the impact of surveillance. The Board will further consider these and

other issues in the context of the next Biennial Surveillance Review, scheduled for mid-2004.

Given the importance of timely, accurate, and comprehensive data for effective surveillance, during the financial year the IMF's Executive Board conducted reviews of the quality and timeliness of the data members provide to the Fund. In line with the Fund's evolving surveillance needs, the Board expanded the categories of data that members are required to provide and took steps to strengthen the legal framework for data provision.

Despite the best efforts of national authorities and the international community to prevent them, crises are likely to continue to occur, however, and the IMF will continue to play a key role in their resolution. During the financial year, the Board further discussed mechanisms that could facilitate the rapid and orderly resolution of crises. Such mechanisms include Collective Action Clauses (CACs), aggregation provisions, and a voluntary code of conduct.

Enhancing the Framework and Content of Surveillance

In a Board discussion in August 2003, Directors reviewed the challenges faced by the IMF in its surveillance work, assessed the initiatives the Fund had set in motion to address them, and had a preliminary exchange of views on avenues for strengthening those initiatives preparatory to the 2004 Biennial Surveillance Review.

Periodic reassessments of economic conditions and policies were necessary in all members, Directors stressed, noting that, for members with IMF-supported programs, it was essential to step back from the program framework at regular intervals to recon-

sider the economic strategy underlying the program. For other members—particularly countries whose policies have a systemic or regional impact or those experiencing a buildup of vulnerabilities, facing significant changes in domestic or external conditions, or showing a chronic inability to realize their growth potential—it was important to augment regular surveillance activities periodically with reflection on the broad thrust of the Fund’s analysis and policy recommendations. Emphasizing that the Fund should take full advantage of its knowledge of experiences in a broad range of countries, Directors called for more cross-country analyses.

Although periodic Article IV country consultations were the cornerstone of Fund surveillance, Directors underscored that effective surveillance required mechanisms operating with greater frequency. They also emphasized the need for country authorities to reassess the adequacy of their policy frameworks in the face of changing conditions and, in the case of countries with IMF arrangements, to engage in discussions of broad issues relevant for Fund surveillance that went beyond the specific details of program review.

Against these broad considerations, Directors generally thought that the current framework of surveillance, if consistently implemented and enhanced by recent initiatives, had the capacity to deliver fresh assessments of economic conditions and policies on a regular basis in each member country. They noted that several measures had been taken to promote reassessments of members’ economic strategies during Article IV consultations:

- New tools had been introduced to ensure that actual and incipient financial and balance sheet fragilities receive adequate attention. These tools include the strengthened framework for debt sustainability assessments; the FSAP and associated Financial System Stability Assessments (FSSAs); and Reports on the Observance of Standards and Codes (ROSCs), which assess the extent to which countries observe certain internationally recognized standards and codes.
- The IMF’s internal review process had been modified to enhance independent reviews of the strategy recommended by the relevant area department. Modifications included early consultations between area and functional departments, more systematic incorporation of lessons

from cross-country experiences, and greater focus on strategic issues.

- Steps had been taken to clarify the substantive content of Article IV country consultations in a program context. Rules guiding the timing of Article IV consultations were modified to allow them to take place when a reassessment of economic strategy was most useful. A few area departments had experimented with alternative models for the conduct of Article IV consultations in program countries. Based on early feedback, Directors encouraged area departments to pursue these experiments but stressed the need for flexibility, to reflect differences in members’ circumstances and in departments’ resource constraints.

Directors observed that several high-frequency multilateral surveillance procedures—for example, the World Economic and Market Developments sessions, which focus on developments in the Fund’s largest members and emerging markets; informal meetings on country matters; and ad hoc informal Board sessions on individual countries—could be integrated with Article IV country consultations. Directors also pointed to the periodic vulnerability assessment exercise introduced in May 2001, which provides a platform for independent assessments of key risks in individual countries.

Directors considered candor and transparency to be essential dimensions of surveillance and took note of efforts to improve information provided to the Executive Board and to encourage members to consent to publication of staff reports. There was also a need for staff to improve communication with national authorities and to better engage civil society in each country.

The IMF faced a difficult task implementing the surveillance framework systematically across the membership, not least because of the framework’s substantial evolution in recent years. Directors considered that challenges were concentrated in the following areas: data availability, realism of baseline scenarios, analysis of alternate scenarios, integration of bilateral and multilateral surveillance, attention to systemic or regional spillovers from domestic policies, early integration of vulnerability assessments, impact of developments in international capital markets, the evaluation of cushions against shocks, follow-through on recommendations of FSAP exercises and ROSCs, and use of outside expertise.

Pakistan



In 2001, Pakistan embarked on a three-year adjustment program supported by an arrangement under the IMF's Poverty Reduction and Growth Facility (PRGF). The arrangement expires in December 2004.

During FY2004, the Fund's Executive Board completed its fifth, sixth, and seventh reviews of Pakistan's performance under the PRGF-supported program. The Fund also sent a mission to Pakistan to provide technical assistance in public-expenditure management.

Pakistan has come a long way in a short time. Its public debt burden has been reduced considerably, and the country has become much less vulnerable to external shocks. Growth has picked up significantly in the past few years and is expected to exceed 6 percent in 2004. The recovery was spurred by the authorities' determined implementation of sound financial policies and structural reforms. In the macroeconomic area, the crucial elements have been the sizable fiscal adjustment and a monetary policy geared toward achieving and maintaining low inflation. Meanwhile, some improvement has been made in establishing a more favorable business environment to foster private sector development, including reforms of taxes and tariffs, bank supervision, and major public enterprises.

Despite this progress, a large part of Pakistan's population still lives below or close to the poverty line. Pakistan's full Poverty Reduction Strategy Paper (PRSP), finalized in December 2003, calls for a special effort to ensure that the benefits of economic growth are shared by all by emphasizing greater social inclusion, increasing the poor's access to physical and financial resources, and setting up safety nets designed to protect the poorest and most vulnerable.

Pakistan-IMF activities in FY2004

June 2003	Completion of the fifth review of Pakistan's PRGF arrangement
October 2003	Completion of the sixth and seventh reviews of Pakistan's PRGF arrangement
November 2003	Pakistan began participating in the IMF's General Data Dissemination System
December 2003	Publication of Pakistan's finalized PRSP; publication of ROSC data module assessment of Pakistan's macroeconomic data sets
March 2004	PRSP endorsed by the Fund's Executive Board

Maintaining a reasonable degree of stability of the surveillance framework would help the IMF tackle these implementation challenges and contribute to strengthening Fund surveillance. At the same time, Directors stressed that the framework of surveillance must continue to evolve to reflect lessons from experience and changes in the global environment and felt that there was scope for further steps to strengthen the surveillance framework.

Board members supported a proposal to reassess surveillance in low-income countries in light of the frameworks provided by the Poverty Reduction Strategy Papers (PRSPs) and arrangements under the Poverty Reduction and Growth Facility (PRGF) (see Section 4). Generally, they saw merit in reevaluating how IMF surveillance could best contribute to the development of conditions propitious to sustained high growth in these countries.

Strengthening Analytical Tools

The IMF is improving its analytical tools for the early identification of vulnerabilities, including in the financial sector, sharpening its focus on balance sheet weaknesses in the context of large and volatile international capital flows, and looking at accounting issues related to public investment.

Debt Sustainability Assessments

In June 2002, as part of the Fund's efforts at crisis prevention and resolution, the Executive Board endorsed a new framework for assessing the sustainability of countries' public and external debt. Such assessments underpin the Fund's policy advice in both program and surveillance contexts. The new framework was intended to bring a greater degree of consistency and discipline to sustainability analyses, including by laying bare the basis on which projections are made and subjecting projections systematically to sensitivity tests. At the time of that Board discussion, it was understood that the approach represented work in progress.

In July 2003, Directors reviewed the application of the framework and considered possible methodological refinements.

They noted that realistic and credible assessments of debt sustainability were a necessary basis for effective IMF surveillance and informed decisions on the use of Fund resources. Debt sustainability depends on a confluence of factors, including macroeconomic developments, political and social constraints on adjustment, and the availability and cost of private and official financing. Debt dynamics should therefore be viewed against a variety of indicators—including the level, structure, and characteristics of the debt; the plausibil-

ity of whether the primary surplus required to stabilize the debt dynamics can be infinitely sustained; and the possible rollover risk arising from financing needs. Directors also highlighted the importance of a good understanding of market views and sound debt-management strategies.

During the past year, debt sustainability assessments based on the standard framework were progressively introduced and became routine in connection with requests for use of Fund resources under the General Resources Account and Article IV consultations with countries with significant market access. Directors agreed that sustainability assessments had, on the whole, contributed to more realistic projections of debt dynamics.

While welcoming the promising start of the debt sustainability framework, Directors agreed that there was scope for improvement. In particular, debt sustainability assessments were still insufficiently integrated with the rest of the staff's analysis and its policy discussions with country authorities, and experience thus far pointed to an overly optimistic bias in baseline projections.

Against this backdrop, Directors welcomed modifications and enhancements intended to facilitate interpretation of the debt sustainability analysis and its integration into staff reports. In particular, they supported the use of alternative, country-specific scenarios—including a scenario based on no policy changes—highlighting the main vulnerabilities in the baseline projections against which corrective measures might be contemplated.

Although contingent liabilities, in particular those associated with the potential costs of financial sector restructuring, were often a source of increases in public indebtedness, Directors recognized the inherent difficulties of quantifying such liabilities. They emphasized the need for a flexible, case-by-case approach and encouraged country authorities to provide relevant information to help refine estimates of contingent liabilities in the context of FSAP missions and Article IV consultations.

Agreeing that debt sustainability assessments should become an integral part of the analyses underlying staff reports, Directors noted that further improvements might be needed. They underscored the importance of continued efforts to ensure technical understanding of the framework by markets and country authorities and of engaging the latter fully in discussing debt sustainability assessments.

(For the Board's discussion of debt sustainability in low-income countries, see Section 4.)

Balance Sheet Approach

The financial crises of the mid- to late 1990s pointed to the need to complement more systematically the Fund's

traditional flow-based analysis with an examination of countries' stock variables as shown on their balance sheets (see Box 2.1). Balance sheet mismatches—of currencies, maturities, and capital stock—can help gauge a country's exposure to interest rate, exchange rate, and rollover risk. The Fund is using the balance sheet approach to examine how the structure of public debt, and balance sheet mismatches more generally, can contribute to financial crises, and how these factors should affect judgments of reserve adequacy.

During the financial year, the Fund worked on improving its analysis of the balance sheets of both the public and the private sectors. The balance sheet approach is already used in the advanced countries by the authorities (for example, the Bank of England's Financial Stability Review), who discuss the risks identified with the Fund during Article IV consultations. The Fund applied the approach during Article IV consultations with Thailand (2002) and Peru (2004) and has begun similar work with other members. Corporate sector balance sheets in several emerging market economies have been analyzed in some detail, and a chapter in the April 2004 *World Economic Outlook* evaluated the risks posed by credit booms.

The role of the balance sheet approach was considered by the Executive Board at informal seminars in July 2003 and March 2004. While Directors felt that the balance sheet approach provided a useful analytical framework for the study of vulnerabilities, its data requirements and resource costs are high. Most viewed it as complementary

Box 2.1 What Is the Balance Sheet Approach?

Traditionally, analysts seeking to assess the financial health of a country looked mainly at the *flow variables*, such as annual GDP, the external current account balance, and fiscal balances. After the capital account crises of the 1990s, observers realized that signs of impending trouble might have been spotted had they looked more closely at countries' balance sheets and, specifically, paid more attention to mismatches between the stock of a country's assets and the stock of its liabilities—that is, *stock imbalances*. For example, did short-term foreign-currency-denominated debt exceed foreign currency reserves?

The balance sheet approach to crisis prevention and resolution begins with a look at a country's consolidated external balance sheet—the external debts that the country's government, banks, firms, and households have relative to their external assets (notably, liquid external reserves). Close attention is also paid to the balance sheets of individual sectors, because mismatches at the sectoral level might not show up on the consolidated sheet. These sectoral balance sheets are often linked, so that if one sector has trouble servicing its debt, a second sector's assets will deteriorate and it may, in turn, have difficulty repaying its creditors.

to traditional flow-based analysis. Directors generally supported integrating the balance sheet approach into Fund operations in a phased, cautious manner, but not making full-fledged balance sheet analysis a standard requirement for surveillance. Thus, for the time being, given data and resource constraints, the Fund's work on balance sheet analysis will be focused on emerging market countries based on a risk-oriented approach.

Public Investment and Fiscal Policy

The Fund has continued to seek ways not only to help members reduce vulnerabilities but also, within the framework of its mandate, to help them promote growth. These two strands of work are closely related, not only because vulnerabilities threaten instability that would jeopardize growth but also because a failure to grow may jeopardize external and public debt sustainability.

In an informal seminar in April 2004, Directors discussed fiscal policy and accounting issues related to public investment, with a view to finding ways to protect infrastructure investment when fiscal adjustment is required. They emphasized the importance of ensuring that borrowing is consistent with macroeconomic stability and debt sustainability, and the need for a rigorous cost-benefit analysis of projects. At the same time, they stressed that infrastructure investment should be accommodated to the extent possible within these constraints. The primary focus of analysis should remain the overall fiscal balance and gross public debt, but appropriate attention should be paid to current and cyclically adjusted balances. In addition, the operations of commercially run public enterprises should be excluded from fiscal indicators and targets. Preliminary criteria put forward by the staff for identifying such public enterprises were broadly endorsed and will be studied further.

Public-private partnerships (PPPs) were viewed as having the potential to attract private capital to infrastructure investment and to secure efficiency gains in asset building and service provision. At the same time, their appropriate role must be carefully assessed, and their fiscal risks transparently reflected in the government's accounts.

The Fund is reviewing the accounting framework for public investment and has proposed approaches that safeguard infrastructure financing, allow commercially run public enterprises to be excluded from fiscal indicators and targets, and clarify the accounting treatment of public-private partnerships. Pilot case studies have commenced (including in Brazil, Chile, Colombia, and Peru) to refine these approaches. The Fund's Executive Board is expected to discuss the results of the pilots early next year.

Systemic Issues

The Fund continues to search for ways to make its work more incisive in its traditional core areas. In November 2003, the Executive Board held a discussion on *exchange rate arrangements*, suggesting that the "bipolar" view of exchange rates—according to which rates should be either firmly fixed or freely floating—needed to be nuanced in recognition of the fact that the benefits of exchange rate flexibility increase with economic and institutional development. Directors emphasized that macroeconomic and structural policies should be consistent with the chosen exchange rate regime.

In March 2004, the Board considered the implications for surveillance of the Independent Evaluation Office's report on *fiscal adjustment* in Fund-supported programs. The action plan discussed by the Board seeks to ensure that, in countries where structural and institutional fiscal reform is a priority, this area receives appropriate attention in surveillance.

The IMF, together with the World Bank, is also helping to support further *international cooperation on trade*, including through stepped-up surveillance of trade policies, especially in countries whose trade policies are of fundamental importance for the world trading system, with a focus on increasing market access. (See Sections 3 and 4 for more developments related to trade.)

Financial Sector Stability

In recognition of the key role played by the financial sector in the generation and transmission of vulnerabilities, financial sector surveillance has been strengthened further. It is now a core area of Article IV country consultations. The Fund is also refining tools such as the Financial Sector Assessment Program and financial soundness indicators. Recognizing the risks that offshore financial centers could pose to the international financial system and the importance of strong anti-money-laundering and combating the financing of terrorism regimes, in FY2004 the Board endorsed assessments of OFCs and AML/CFT regimes as core areas of Fund work.

Financial Sector Assessment Program

The FSAP, undertaken in collaboration with the World Bank, remains the primary vehicle for identifying vulnerabilities in financial sector supervision and oversight at the country level and the development of programs to strengthen the financial sector. FSAP teams (IMF and Bank staff and experts from central banks, national super-

visory agencies, and international standard-setting bodies) conduct comprehensive checkups of financial systems—the whole range of financial institutions; financial markets; payment systems; and regulatory, supervisory, and legal frameworks. The teams use a variety of tools (including stress tests and FSIs) to review financial sectors, evaluate how risks are managed, weigh possible technical assistance needs, and help countries prioritize policy responses.

In addition to providing important input for surveillance purposes, the FSAP is a vehicle for institution building in the financial sector. The Fund is working with the World Bank to deepen the coverage of development issues in FSAP exercises and has stepped up its research and policy advice in such areas as the development of securities and derivatives markets. Work is also being done to strengthen the links between the FSAP and other Fund and World Bank financial sector activities, especially follow-up technical assistance. The new Basel capital agreement, Basel II, will be a focus of both FSAP assessments and technical assistance.

Roughly half of the Fund's members have had an FSAP. Therefore, consistent with the recommendations of the March 2003 Board review, and to release resources for FSAP follow-ups and updates, the number of FSAP exercises has been reduced by about one-fourth to 18 a year and their scope streamlined, with more selective preparation of Reports on the Observance of Standards and Codes.

The Independent Evaluation Office will carry out an evaluation of the FSAP and the associated Financial System Stability Assessments in FY2005.

Financial Soundness Indicators

Efforts to strengthen the analytical underpinnings of financial system stability assessments are supported by the Fund's ongoing work to develop FSIs. FSIs are used to assess the soundness of financial institutions and identify vulnerabilities in the corporate and household sectors that may pose risks to the stability of the financial system. (See Table 2.1.)

In June 2003, the Executive Board endorsed further work to encourage the compilation and dissemination of FSIs and

Table 2.1 Financial Soundness Indicators: Core and Encouraged Sets

	Core Set
Deposit-taking institutions	
Capital adequacy	Ratio of regulatory capital to risk-weighted assets Ratio of regulatory Tier I capital to risk-weighted assets Ratio of nonperforming loans net of provisions to capital
Asset quality	Nonperforming loans as share of total gross loans Sectoral distribution of loans
Earnings and profitability	Return on assets Return on equity Ratio of interest margin to gross income Ratio of noninterest expenses to gross income
Liquidity	Liquid assets as share of total assets (liquid asset ratio) Ratio of liquid assets to short-term liabilities
Sensitivity to market risk	Ratio of net open position in foreign exchange to capital
	Encouraged Set
Deposit-taking institutions	Ratio of capital to assets Geographical distribution of loans Ratio of gross asset position in financial derivatives to capital Ratio of gross liability position in financial derivatives to capital Trading income as share of total income Personnel expenses as share of noninterest expenses Spread between reference lending and deposit rates Spread between highest and lowest interbank rate Ratio of customer deposits to total (non-interbank) loans Foreign-currency-denominated loans as share of total loans Foreign-currency-denominated liabilities as share of total liabilities Ratio of net open position in equities to capital Ratio of large exposures to capital
Market liquidity	Average bid-ask spread in the securities market ¹ Average daily turnover ratio in the securities market ¹
Nonbank financial institutions	Assets as share of total financial system assets Ratio of assets to GDP
Corporate sector	Ratio of total debt to equity Return on equity Ratio of earnings to interest and principal expenses Ratio of corporate net foreign exchange exposure to equity Number of applications for protection from creditors
Households	Ratio of household debt to GDP Ratio of household debt service and principal payments to income
Real estate markets	Real estate prices Residential real estate loans as share of total loans Commercial real estate loans as share of total loans

¹Or in other markets that are most relevant to bank liquidity, such as foreign exchange markets.

to develop their role in financial stability analysis. Directors considered FSIs to be a key tool that enhances the overall effectiveness of Fund surveillance, increases the transparency and stability of the international financial system, and strengthens market discipline. They commended the results achieved in three areas since the Board endorsed a “core” and “encouraged” set of FSIs in June 2001: a draft *Compilation Guide* on FSIs has been completed; substantial progress has been made in enhancing the role of FSIs in macroprudential analysis; and the use of FSIs in Fund surveillance has been further developed.

Directors noted that FSIs differed from country to country because of differences in accounting and bank supervision

rules and varying levels of financial sector development but felt that convergence toward internationally accepted accounting standards should result in greater data comparability.

The use of both FSIs and stress testing in macroprudential surveillance was encouraged by Directors. They noted that stress tests could be particularly valuable in assessing market risk but cautioned that they should complement, not substitute for, FSIs.

As for the staff's proposed Framework for Financial Stability Analysis, Directors considered it a useful tool for integrating macroprudential surveillance, analysis of macrofinancial linkages, and surveillance of macroeconomic conditions. They observed that macrofinancial linkages might vary across countries and endorsed further analysis to clarify these linkages, including the role of financial market functioning and cross-border linkages, and to identify the data needed to assess them.

While recognizing resource constraints, Directors encouraged countries to compile at least a core set of FSIs on a continuing basis. They endorsed proposals for assessing countries' capacity to compile FSIs and helping them develop this capacity. They generally endorsed the preparation of a guidance note on financial sector monitoring, including the use of FSIs, and the continued development of an operational database on FSIs.

Directors endorsed the proposal that, to support country compilation efforts, the Fund should conduct, with the assistance of other international agencies, a coordinated compilation exercise for supervisors and statisticians after finalization of the *Guide* in the second half of 2004. About 60 countries will participate.

Progress on the FSI work program will be reviewed in about two years.

Offshore Financial Center Assessments

In November 2003, the Board reviewed the OFC assessment program. They commended the significant progress made by the program, which was initiated in 2000. Since that time, of 44 jurisdictions contacted by the Fund, 41 have undergone initial assessments. The assessments will be updated in four to five years' time, with interim risk-focused assessments triggered by specific concerns carried out as needed.

Directors welcomed the improvements made to the supervisory and regulatory systems of a number of OFCs as a result of the program but noted that supervision and regulation of the nonbanking sector, in particular, needed to be strengthened in many.

The Board emphasized that the IMF's role should continue to be guided by the Fund's mandate and expertise in this area, and that the program should, in the future, be based on four broad elements:

- regular monitoring of OFCs' activities and compliance with supervisory standards;
- improved transparency of OFC supervisory systems and activities;
- technical assistance in collaboration with bilateral and multilateral donors; and
- collaboration with standard-setters and onshore and offshore supervisors to strengthen standards and exchanges of information.

Directors stressed that participation in OFC assessments and monitoring should continue to be voluntary.

Ongoing monitoring of OFC activities would help ensure that well-managed jurisdictions maintained good supervisory practices and that other jurisdictions were making progress in the development of supervisory systems. Directors encouraged all jurisdictions to consent to publication of their reports, noting that this was in their interest since failure to do so would send an adverse signal to the market. They underlined that all OFCs should meet minimum international financial regulatory standards but stressed that the Fund should not set financial supervisory standards. Directors recognized that information-sharing arrangements play a key role in effective cross-border supervision, and, in this context, they indicated that the Fund should help strengthen information-sharing mechanisms through increased collaboration with standard-setters and supervisors.

Directors agreed that the staff should continue to provide periodic updates on the OFC program and that the Board should conduct its next review of the OFC program in two to three years.

Anti-Money-Laundering and Combating the Financing of Terrorism

In its March 2004 review of the 12-month pilot program of AML/CFT assessments jointly undertaken by the Fund and the World Bank (see Box 2.2), the Board endorsed the 40 + 8 Recommendations of the Financial Action Task Force (FATF) as the new, expanded standard for AML/CFT assessments. The Board decided to expand the Fund's AML/CFT assessment and technical assistance work to cover the full scope of the expanded recommendations.

Directors welcomed the participation of the FATF and FATF-style regional bodies in the pilot program, underlined the importance of coordinating the work of the Fund and

the Bank with that of the FATF and FATF-style bodies to avoid duplication, and were encouraged by the assessment reports received. Directors looked forward to receiving (1) a full review of the assessments and their consistency with the principles of the ROSCs, as well as the effectiveness of coordination efforts, in about 18 months' time and (2) a comprehensive review of the overall effectiveness of the Fund/Bank program in about 3 years' time.

The pilot had achieved its initial goals, Directors noted. It had led to a considerable deepening of international attention to AML/CFT issues and to the provision of substantial technical assistance in this area. They were encouraged that most jurisdictions responded positively to the assessments. Directors commended the generally high level of compliance with the FATF recommendations in higher- and middle-income countries, while noting that many lower-income countries faced a challenge in implementing the FATF standard owing, in part, to resource constraints. While observing that there were more general weaknesses regarding compliance with the 8 Special Recommendations on Terrorist Financing established in 2001 than with the original 40 FATF Recommendations, Directors welcomed the heightened awareness among jurisdictions of the need

for strong legislative and institutional frameworks in this area and emphasized that a key element of raising global compliance with the FATF standard is the delivery of technical assistance. In particular, they welcomed the significant and increased assistance by the Fund in the areas of legislative drafting, support for supervisory bodies, establishment of financial intelligence units, and training.

In view of the success of the pilot program and the importance of AML/CFT work, Directors agreed that it should be a regular part of the Fund's work and that AML/CFT assessments, whether prepared by the Fund or the Bank or the FATF and FATF-style bodies, should continue to be included in all FSAP and OFC assessments. Directors agreed on the importance of continuing collaboration with the FATF. The FATF and FATF-style regional bodies combined are expected to conduct assessments of 15 to 20 countries a year.

In considering the options for advancing the Fund's work on AML/CFT, the majority of Directors agreed to support the Fund's becoming fully accountable, together with the World Bank, for carrying out AML/CFT assessments and providing technical assistance, including in the sectors previously covered by the independent AML/CFT experts.

Box 2.2 The Pilot AML/CFT Assessments Program

During the 12 months that ended in October 2003, the Fund and the World Bank, in collaboration with the Financial Action Task Force (FATF) and FATF-style regional bodies, undertook a pilot program of AML/CFT assessments of 41 jurisdictions. The assessments all employed a common methodology based on the FATF's original 40 Recommendations, plus 8 Special Recommendations on Terrorist Financing (40 + 8). The Fund conducted 20 of the assessments, the World Bank conducted 6, and 7 were conducted jointly by the Fund and the World Bank. The FATF and the FATF-style regional bodies conducted the remaining 8. Reports on the Observance of Standards and Codes (ROSCs) have been or will be completed for all of the pilot assessments and, with the consent of national authorities, are being posted on the IMF website.

To help countries address weaknesses in their AML/CFT regimes, the delivery of technical assistance by the Fund and other donors has been greatly increased. During the past two years, there have been 85 country-specific technical assistance projects benefiting 63 countries, and 32 regional projects reaching more than 130 countries.

In response to the assessments, a Fund and Bank priority has been to provide assistance in legislative drafting, supporting financial intelligence units, and training financial sector supervisors. Most progress is being made in developing up-to-date legal and institutional frameworks. The staffing and training of supervisory and law enforcement agencies is a longer-term process, requiring additional resources in the countries concerned. Since the Fund is only one of many technical assistance providers, close collaboration with other donors will continue to be a hallmark of IMF involvement in AML/CFT assistance.

Data Provision to the IMF and the Public

Financial year 2004 saw a continuation of the steady progress made in both data provision to, and data dissemination by, the IMF.

The framework for data provision to the Fund for surveillance purposes is based on the Articles of Agreement (particularly, Article VIII, Section 5) and relevant decisions of the Executive Board, and relies on a cooperative approach. The current framework, established in 1995, has three main components: (1) a common set of data that all members provide to the Fund and complementary data, as needed, that vary according to members' individual circumstances; (2) the Fund's assessment of the adequacy of the data provided and, where relevant, of the impact of any data deficiencies and how they can be addressed; and (3) a graduated approach to address the rare cases of members' reluctance to provide the data necessary for surveillance. (See Box 2.3.)

In three discussions during the year, the Board reviewed and refined these related issues: the voluntary Data Standards Initiatives, the legal framework for data provision, and the current data provision framework.

Data Standards Initiatives

In July 2003, the Executive Board concluded its fifth review of the Fund's Data Standards Initiatives (see Box 2.4).

Box 2.3 Revisions to the IMF's Data Provision Framework

Under Article VIII, Section 5, of the Fund's Articles of Agreement, IMF members have an obligation to provide certain information to the Fund. In 1995, it was agreed that members should be encouraged to provide to the Fund, on a voluntary basis and in the context of surveillance, information referred to as the "core statistical indicators" in addition to the information required under Article VIII, Section 5. In January 2004, the Board decided, first, to expand the categories of data members would be obliged to provide to the Fund under Article VIII, Section 5, and, second, to set out a procedural framework for enforcing this obligation. The expanded list of data members will be obliged to provide to the Fund effective end-January 2005 corresponds to the so-called core statistical indicators. In March 2004, the Board renamed these the "common indicators required for surveillance," which, pursuant to the decision of January 2004, will have to be provided to the Fund on an obligatory basis.

Directors discussed developments of the Special Data Dissemination Standard (SDDS) and the General Data Dissemination System (GDDS), proposals for updating the SDDS and the GDDS to maintain their relevance and reflect evolving international best practice, plans for follow-up on the data modules of the ROSCs, refinements to the Data Quality Assessment Framework (DQAF), and the integration of the Data Standards Initiatives within the Data Quality Program.

Directors expressed their strong satisfaction with the significant contribution that the Data Standards Initiatives had made toward strengthening the compilation, dissemination, quality, and transparency of data in member countries, and saw continued progress in these areas as a key pillar of surveillance and crisis prevention. (For example, all subscribers to the SDDS now meet the requirements for the template on international reserves and foreign currency liquidity as well as for the international investment position, with many subscribers exceeding the dissemination requirements for the last.) They highlighted the important role that the Fund has come to play as a data standard-setting body and in providing technical assistance on data issues. Directors supported the overall strategy for promoting data transparency by increasing members' participation in the Data Standards Initiatives, keeping up with international best practices. They called for a continuation of the consultative process with members and other institutions and underscored the importance of the voluntary nature of the Data Standards Initiatives.

Underscoring the role of the GDDS as a catalyst in the mobilization and coordination of technical assistance by the Fund, the World Bank, and other donors, Directors welcomed the support provided by some bilateral donors for technical assistance activities and encouraged others to

follow suit. Given the expanding number of GDDS participants and the continued interest of nonparticipating countries in joining, Directors stressed the importance of making the most effective use of available resources.

Directors underscored that the data module of the ROSCs played a key role in contributing to data transparency and facilitating the identification of priority areas for statistical improvements. Directors supported the proposed strategy to balance the preparation of "new" ROSCs with follow-up ROSCs, including for those countries whose reports were undertaken before the incorporation of the Data Quality Assessment Framework. The possibility of self-assessments by countries that have the capacity to carry them out was also highlighted.

Directors agreed that the next review of the Fund's Data Standards Initiatives should take place in the second half of 2005.

Legal Framework for Data Provision

The IMF relies primarily on voluntary cooperation to obtain from member countries the information needed to carry out its responsibilities, including surveillance and the provision of financing to member countries. On the whole, this cooperative approach has served the institution and its members well. In recent years, however, several instances of reporting problems—including delayed reporting, failure to report certain information, and reporting of inaccurate information—have motivated efforts to improve the legal framework of the provision of data by members. In June and December 2003, the Executive Board discussed strengthening the legal framework for the provision of information to the Fund. The conclusions of this discussion were incorporated in the decision that the Board approved on January 30, 2004.

The decision is intended to strengthen the effectiveness of Article VIII, Section 5, of the IMF's Articles of Agreement, a central pillar of this legal framework, which requires member countries to report certain information to the Fund to the extent that they have the capacity to do so. Remedies and sanctions are available to the Fund to address the relatively rare cases involving reporting problems that are not amenable to cooperative approaches.

The Board decision augments the categories of data that members are required to provide, in line with the Fund's evolving surveillance needs, and establishes a new framework of procedures and remedial actions to address a failure to provide data or the provision of inaccurate data. The decision also limits the circumstances in which Article VIII, Section 5, may be applied in the context of the use of Fund resources in the General Resources Account, to avoid possi-

ble nuisance cases whose pursuit would not be in the interest of the Fund.

Data Provision for Surveillance Purposes

In March 2004, the Executive Board held its sixth review since 1995 of data provision to the Fund for surveillance purposes. Data needs vary according to members' circumstances, and the Fund's data requirements have evolved over time in line with developments in the coverage of surveillance and other Fund activities. This is reflected in the Executive Board's review in FY2004 of the legal framework for the provision of information to the Fund, which, as explained above, expanded the categories of information that members will be required to report to the IMF under Article VIII, Section 5 (the "common indicators required for surveillance").

In taking stock of developments in the coverage and frequency of data provision by members, Directors were encouraged that a rising share of members were providing data deemed adequate for Fund surveillance and that most

members—including virtually all countries with market access—provided them on a timely basis. At the same time, Directors recognized that in nearly one-third of the Fund's membership—mostly countries with small populations or low per capita incomes—severe data deficiencies continued to hamper policy analysis and Fund surveillance. Directors acknowledged that, in many cases, time, national effort, and international support would be needed to overcome long-standing statistical capacity constraints.

Other key points from the March 2004 review:

- Directors agreed that the current framework for data provision to the Fund should be essentially preserved but called for strengthened implementation, stressing that Article IV reports should identify data shortcomings and their policy implications and recommend remedial actions if data are inadequate for effective surveillance.
- Directors supported addressing data quality issues in staff reports based on available ROSCs.
- New initiatives to strengthen surveillance call for new data requirements. Directors focused on the data

Box 2.4 Data Standards Initiatives and ROSCs

The Fund's Data Standards Initiatives aim to enhance the public availability of reliable, timely, and comprehensive statistics, thereby contributing to the pursuit of sound macro-economic policies and to the improved functioning of financial markets.

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 practice with respect to the integrity, access by the public, and quality of the data. SDDS subscribers provide information about their data dissemination practices for posting on the Dissemination Standards Bulletin Board (DSBB) at <http://dsbb.imf.org>. Subscribers are also required to maintain an Internet website that contains the actual data. It is referred to as a national summary data page and is electronically linked to the DSBB. SDDS subscribers began disseminating prescribed data on external debt in September 2003. As of April 30, 2004, there were 57 subscribers to the SDDS.

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 comprehensive approach. Voluntary participation allows countries to set their own pace but provides a detailed framework that promotes the use of internationally accepted methodological principles, the adoption of rigorous compilation practices, and ways in which the professionalism of national statistical agencies can be enhanced. The 70 IMF members participating in the GDDS at end-April 2004 provide metadata describing their data compilation and dissemination practices as well as detailed plans for improvement for posting on the DSBB.

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 the Bank. The reports—about 70 percent of which have subsequently been published—examine three broad areas: (1) transparent government operations and policymaking (data dissemination, fiscal transparency, monetary and financial policy transparency); (2) financial

sector standards (banking supervision, payment systems, securities regulation, insurance supervision, and AML/CFT); and (3) market integrity standards for the corporate sector (corporate governance, accounting, auditing, insolvency, and creditor rights).

Participation in the standards and codes initiative continues to grow. As of end-April 2004, 524 ROSC modules had been completed for 106 economies, or 57 percent of the Fund's membership, and most systemically important countries have volunteered for assessments. Participation rates continue to vary substantially across regions. Based on completed ROSC modules, they range from 28 percent of members in developing Asia to 88 percent in central and eastern Europe.

Data Quality Assessment Framework (DQAF). The DQAF is an assessment methodology that was integrated into the structure of the data module of the ROSCs following the fourth review of the Data Standards Initiatives in 2001. The DQAF's broader application in providing guidance for improving data quality has been integrated into the Data Quality Program as well as more prominently into Article IV consultations.

implications of the work the Fund is doing in four areas: the balance sheet approach, the framework for debt sustainability assessments, liquidity management, and financial soundness indicators. Most Directors agreed that a priority in the period ahead is to improve the availability of data needed to conduct balance sheet analysis, emphasizing the importance of breakdowns of assets and liabilities that would make it possible to gauge currency and maturity mismatches in sectoral balance sheets and the need to address weaknesses in public debt data. In this context, the Board considered a pragmatic action plan to deal with the implications for resources.

- The significantly increased dissemination of macroeconomic data by the Fund has been a vital part of efforts in recent years to strengthen the international financial architecture. To minimize the risk of misperceptions about the accuracy and reliability of Fund data that may arise from the publication of different data series for a given variable, Directors endorsed efforts to strengthen metadata and explain data differences; work to promote common sourcing and better sharing of data across the Fund; and inclusion of a general disclaimer on published staff reports.

Directors agreed that the next review of data provision to the Fund should be conducted in about two years' time.

Crisis Resolution

Crisis prevention efforts notwithstanding, debt-servicing difficulties, which may develop into financial crises, will still be experienced by some countries, and during FY2004 the IMF continued to work toward improving crisis resolution mechanisms. Guided by the September 2003 Communiqué of the International Monetary and Financial Committee (IMFC), the Fund's efforts on crisis resolution focused on promoting the inclusion of collective action clauses (CACs) in international sovereign bonds to be issued in jurisdictions where CACs were not yet the market standard, contributing to initiatives aimed at formulating a voluntary code of conduct for sovereign debtors and their creditors, and considering issues that are of general relevance to the orderly resolution of financial crises.

Collective Action Clauses

The IMF has taken an active role in promoting the inclusion of such clauses in international sovereign bond issues in all markets, through increased dialogue with sovereign issuers (including in the context of Article IV discussions) and private market participants. In part because of these efforts, financial year 2004 saw a clear shift toward the use of CACs in international sovereign bonds issued under New York

law, where, until recently, these clauses had not been the market standard. There is no evidence that issue prices included a premium for CACs. Among the key developments during FY2004 were the following:

- Sovereign bonds containing CACs accounted for more than 70 percent of the total volume of sovereign bonds issued during the second half of 2003 and early 2004.
- An increasing number of emerging market countries (18 as of end-April 2004—Belize, Brazil, Chile, Colombia, Costa Rica, Guatemala, Indonesia, Israel, Korea, Mexico, Panama, Peru, the Philippines, Poland, South Africa, Turkey, Uruguay, and Venezuela) have included CACs in their international sovereign bonds issued under New York law.
- In 2003, Turkey and Peru were the first non-investment-grade countries to include CACs in bonds governed by New York law. The CACs included a voting threshold of 75 percent of outstanding principal for majority restructuring clauses. This represented a change in market practice, since previous non-investment-grade issuers had included higher voting thresholds. Moreover, Brazil announced in April 2004 that it would reduce the voting threshold for majority restructuring provisions to 75 percent in future sovereign issues.
- Eight industrial countries included CACs in their sovereign bonds issued in foreign jurisdictions. However, with the exception of Italy, all issued their bonds under English law, in which the inclusion of CACs has long been market practice.

Notwithstanding this rapid progress, a large share (58 percent) of the outstanding stock of emerging market sovereign bonds do not contain CACs.

Related Issues

Aggregation Provisions

The IMF is also continuing to explore the potential contribution that aggregation can make to the resolution of collective action problems and difficulties associated with creditor coordination. The benefits and risks of aggregation clauses were discussed at a Board seminar in October 2003. Despite some progress in the inclusion of aggregation clauses in sovereign bonds, it was considered premature for the Fund to endorse a particular set of provisions. The Fund will continue to monitor the use and evolution of aggregation provisions.

Code of Conduct

In its Communiqués of September 2003 and April 2004, the IMFC looked forward to efforts to develop a voluntary code

Peru



of conduct—which would outline standards of behavior and responsibilities for debtors and their private creditors—and encouraged the Fund to contribute to work in this area. A code could, in principle, facilitate dialogue between creditors and debtors, promote corrective policy action to reduce the frequency and severity of crises, and improve the prospects for an orderly and expeditious resolution of crises.

Progress in this area has been limited, but work continues in both the official and the private sectors. The G-20 has held several high-level meetings on this issue with representatives of the private sector, indicating that proposals for introducing a voluntary code are a key element of its work on crisis resolution.¹ A technical working group including Brazil, Korea, and Mexico has been established to work further with private sector representatives to prepare a draft code for broader consideration. At the same time, the Institute of International Finance (IIF) is continuing its efforts to develop a code based on key principles predicated on enhanced debtor-creditor cooperation.

IMF surveillance already supports many of the elements that would likely be part of a code, such as investor relations programs, CACs, and adherence to standards and codes. Beyond these elements, the Fund's involvement in assessing progress in creditor-debtor dialogue and negotiations will continue to be guided by the Fund's lending into arrears policy and the Board's recent review of the application of the good faith criterion to reach a collaborative agreement. The content and application of that policy may, however, need to be revisited when greater clarity emerges concerning the precise content of the code.

Sovereign Debt Litigation by Private Creditors

In April 2004, the Board held a seminar on developments in sovereign debt litigation and the implications of such litigation for countries' efforts to reach agreement with their creditors in sovereign debt restructuring and debt relief processes. There has been a significant increase in litigation against sovereign debtors over the past several years. The Fund will continue to closely monitor developments in this important area.

The Evian Approach

In an effort to contribute to the orderly resolution of financial crises, the Paris Club agreed in October 2003 on a new, flexible approach for addressing debt sustainability

¹The G-20 was set up in 1999 on the recommendation of the G-7 finance ministers. It is an informal forum that seeks to promote dialogue between industrial and emerging market countries on key issues related to the international financial system.

In a difficult external environment and despite an unsettled domestic political situation, Peru stayed the course in FY2004, pursuing the sound macroeconomic policies adopted under its two-year Stand-By Arrangement, which expired in February 2004. Its economic performance under its program has been strong. In 2003, it registered solid GDP growth of 4 percent and low inflation of 2.5 percent and reduced its fiscal deficit to 1.7 percent of GDP. Developments in early 2004 indicate that it is well on the way to achieving its medium-term goal of limiting the deficit to 1 percent or less of GDP. The government has been able to secure the passage of key laws to establish a sound legal framework for fiscal decentralization, and the authorities are working with the IMF, the World Bank, and the Inter-American Development Bank on further measures to ensure that decentralization supports medium-term fiscal consolidation.

During FY2004, IMF staff provided the Peruvian authorities with an ex post assessment of long-term engagement highlighting the importance of structural reform in the fiscal area and reduction of the public debt. The Fund also sent a mission to Peru to provide technical assistance in tax policy. In April 2004, IMF staff completed a Report on the Observance of Standards and Codes (ROSC) with suggestions on steps the Peruvian authorities could take to improve fiscal transparency, including clarifying functions within the public sector; establishing a stable and unified legal framework for the budget process, treasury operations, and debt management; and making explicit the spending responsibilities, revenue sources, and borrowing limits of subnational governments.

Peru-IMF activities in FY2004

October 2003	Publication of ROSC data module and detailed assessment using the Data Quality Assessment Framework
February 2004	Completion by the Fund's Executive Board of Article IV consultation and fourth (last) review of Stand-By Arrangement
April 2004	Publication of ROSC fiscal transparency module

concerns in non-HIPC countries. The so-called Evian approach focuses on enabling the Paris Club to (1) take explicit account of debt sustainability considerations; (2) adapt its response to the financial situation of the debtor countries; and (3) make a contribution to current efforts to make the resolution of crises more orderly, timely, and predictable. The Fund's debt sustainability analysis framework would be the principal instrument through which the Paris Club would form initial judgments about a country's debt sustainability prospects. For countries facing a liquidity problem but considered to have sustainable debt, the Paris Club would continue to provide flow relief based on exist-

ing terms and tailored to the debtors' needs. Countries with serious debt problems could be provided, on a case-by-case basis, with a comprehensive debt treatment, including flow rescheduling, stock reprofiling, or stock-of-debt reduction, with a view to restoring debt sustainability.

In line with a case-by-case approach, the Paris Club could deliver debt treatment in a number of different ways. In some cases, a debt treatment could be delivered in several phases to maintain a strong link with the debtor country's track record under its Fund-supported programs. To date, experience with the Evian approach has been limited.

Improving IMF Lending Policies and Practices



Providing financial support under adequate safeguards to member countries with balance of payments difficulties is one of the IMF's main responsibilities. In a time of increasing and volatile capital flows, the Fund continues to seek better ways of bolstering members' efforts to adjust to adverse circumstances, restore a viable balance of payments, implement reforms, and strengthen growth.

Financing Facilities and Policies

The IMF has a number of "facilities," or loan programs, through which it provides assistance to its member countries to help them deal with different kinds of balance of payments problems. (See Table 3.1.) Following major changes to its lending policies in recent years, the Fund has kept these facilities under review to ensure that they remain responsive to the changing global environment and the evolving needs of members, including those related to their growing financial interdependence.

The great majority of members that draw on Fund financing use either Stand-By or Extended Arrangements within the normal access limits or the Poverty Reduction and Growth Facility (PRGF). But the Fund also has other means through which it seeks to provide more focused support for members in particular circumstances, and the Board reviewed three of these in FY2004: the Contingent Credit Lines (CCL), aimed at crisis prevention; the provisions for access in excess of the normal limits; and the Compensatory Financing Facility (CFF), intended to provide financing for certain types of temporary current account shocks.

Review of Contingent Credit Lines and Possible Alternatives

The Fund has been working to develop or revamp instruments through which it can provide members pursuing strong policies with a precautionary line of defense against adverse capital market developments. This was the objective of the CCL, which the Fund introduced in April 1999 as part of its response to financial market crises in Asia and elsewhere in 1997–98, to provide a precautionary line of defense for members with "first-class" policies that might nevertheless be vulnerable to contagion. The facility was intended to provide assurances of substantial financial support to members that met the demanding eligibility criteria in the face of financial market pressures resulting from factors outside the members' control and to reinforce incentives for implementing sound policies.

In 2000, several changes were made to the terms of the CCL to make the facility more attractive. Nevertheless, the CCL remained unused, and, in March 2003, the Executive Board began a review of the facility. While there continued to be general support for the objectives of the CCL, there was no broad consensus that redesigning the CCL would enhance the facility's attractiveness. The Executive Board agreed that the staff would explore the possibility of strengthening surveillance and improving existing Fund lending instruments to make them more effective in crisis prevention and to strengthen the Fund's capacity to respond quickly to the needs of members with strong policies.

In June 2003, the Executive Board discussed a staff paper that proposed enhancements to an existing instrument—precautionary arrangements—to help in crisis prevention and achieve some of the objectives of the CCL. Precautionary arrangements are

Table 3.1 IMF Financial Facilities

Credit Facility	Purpose	Conditions	Phasing and Monitoring ¹	Access Limits ¹
Credit tranches and Extended Fund Facility⁴				
Stand-By Arrangements (1952)	Medium-term assistance for countries with balance of payments difficulties of a short-term character	Adopt policies that provide confidence that the member's balance of payments difficulties will be resolved	Quarterly purchases (disbursements) contingent on observance of performance criteria and other conditions within a reasonable period	Annual: 100% of quota; cumulative: 300% of quota
Extended Fund Facility (1974) (Extended Arrangements)	Longer-term assistance to support members' structural reforms to address balance of payments difficulties of a long-term character	Adopt 3-year program, with structural agenda, with annual detailed statement of policies for the next 12 months	Quarterly or semiannual purchases (disbursements) contingent on observance of performance criteria and other conditions	Annual: 100% of quota; cumulative: 300% of quota
Special facilities				
Supplemental Reserve Facility (1997)	Short-term assistance for balance of payments difficulties related to crises of market confidence	Available only in context of Stand-By or Extended Arrangements with associated program and with strengthened policies to address loss of market confidence	Facility available for one year; frontloaded access with two or more purchases (disbursements)	No access limits; access under the facility only when access under associated regular arrangement would otherwise exceed either annual or cumulative limit
Compensatory Financing Facility (1988)	Medium-term assistance for temporary export shortfalls or cereal import excesses	Available only when the shortfall/excess is largely beyond the control of the authorities and a member has an arrangement with upper credit tranche conditionality, or when a member's balance of payments position excluding the shortfall/excess is satisfactory	Stand-alone disbursements or, if there is an arrangement, disbursements are in two phases	45% of quota each for export and cereal components. Combined limit of 55% of quota for both components
Emergency assistance	Quick, medium-term assistance for balance of payments difficulties related to		None, although post-conflict assistance can be segmented into two or more purchases	Generally limited to 25% of quota, although larger amounts can be made available in exceptional cases
(1) Natural disasters (1962)	(1) Natural disasters	(1) Reasonable efforts to overcome balance of payments difficulties		
(2) Post-conflict (1995)	(2) The aftermath of civil unrest, political turmoil, or international armed conflict	(2) Focus on institutional and administrative capacity building to pave the way for an upper credit tranche arrangement or PRGF		
Facility for low-income members				
Poverty Reduction and Growth Facility (1999)	Longer-term assistance for deep-seated balance of payments difficulties of structural nature; aim is sustained poverty-reducing growth	Adopt 3-year PRGF program. PRGF-supported programs are based on a Poverty Reduction Strategy Paper (PRSP) prepared by the country in a participatory process and integrating macroeconomic, structural, and poverty reduction policies	Semiannual (or occasionally quarterly) disbursements contingent on observance of performance criteria and reviews	140% of quota; 185% of quota in exceptional circumstances

¹The resources used in the IMF's lending come mainly from the capital subscribed by member countries; each country is assigned a *quota* that represents its financial commitment. A member provides a portion of its quota in foreign currencies acceptable to the IMF—or in SDRs—and the remainder in its own currency. An IMF loan is disbursed or drawn by the borrower *purchasing* foreign currency assets from the IMF with its own currency. The loan is considered repaid when the borrower *repurchases* its currency from the IMF with foreign currency. See Box 7.1 on the IMF's Financing Mechanism.

²The *basic rate of charge* on funds disbursed from the General Resources Account (GRA) is set as a proportion of the weekly interest rate on SDRs and is applied to the daily balance of all outstanding GRA drawings during each IMF financial quarter. In addition to the basic

rate plus surcharge, an up-front commitment fee (25 basis points on committed amounts up to 100% of quota, 10 basis points thereafter) is charged on the amount that may be drawn during each (annual) period under a Stand-By or Extended Arrangement. The fee is, however, refinanced on a proportionate basis as subsequent drawings are made under the arrangement. A one-time service charge of 0.5 percent is levied on each drawing of IMF resources in the GRA, other than reserve tranche drawings, at the time of the transaction.

³For purchases made after November 28, 2000, members are expected to make repurchases (repayments) in accordance with the schedule of expectations; the IMF may, upon request by a member, amend the schedule of repurchase expectations if the Executive Board agrees that the member's external position has not improved sufficiently for repurchases to be made.

Charges ²	Repurchase (Repayment) Terms ³		Installments
	Obligation Schedule (Years)	Expectation Schedule (Years)	
Basic rate plus surcharge (100 basis points on amounts above 200% of quota; 200 basis points on amounts of 300%) ⁵	3¼-5	2¼-4	Quarterly
Basic rate plus surcharge (100 basis points on amounts above 200% of quota; 200 basis points on amounts above 300%) ⁵	4½-10	4½-7	Semiannual
Basic rate plus surcharge (300 basis points, rising by 50 basis points a year after first disbursement and every 6 months thereafter to a maximum of 500 basis points)	2½-3	2-2½	Semiannual
Basic rate	3¼-5	2¼-4	Quarterly
Basic rate	3¼-5	Not applicable	Quarterly
0.5%	5½-10	Not applicable	Semiannual

⁴The term *credit tranches* refers to the size of purchases (disbursements) in terms of proportions of the member's quota in the IMF; for example, disbursements up to 25 percent of a member's quota are disbursements under the *first* credit tranche and require members to demonstrate reasonable efforts to overcome their balance of payments problems. Requests for disbursements above 25 percent are called *upper* credit tranche drawings; they are made in installments as the borrower meets certain established performance targets. Such disbursements are normally associated with a Stand-By or Extended Arrangement. Access to IMF resources outside of an arrangement is rare and expected to remain so.

⁵Surcharge introduced in November 2000.

Stand-By Arrangements in which a country indicates its intention not to draw upon the Fund's resources unless its economic circumstances deteriorate. Precautionary arrangements are common—56 were approved between 1987 and April 2003—and experience with them has generally been positive. They are typically used when balance of payments pressures are likely to arise in the current account, although they have been used on occasion to help prevent capital account crises. The staff proposed several modifications designed to enhance the suitability of precautionary arrangements to crisis prevention. While there was interest in the proposed modifications, there was not sufficient Board support for them during the June discussion. In particular, Directors differed on a proposal to make more explicit the policy for using high, possibly exceptional, access levels in precautionary settings.

In concluding the review of the CCL on November 26, 2003, the Board discussed a staff paper that outlined the issues examined to date in the review of the facility and proposed several options for responding to its approaching sunset date (November 30). Most Directors again broadly supported the CCL's objectives but noted that, despite the modification of the facility in 2000, the CCL had remained unused.

Many Directors considered that the sunset clause should be extended for a short period: they felt that the CCL should not be allowed to lapse before the design of the facility was improved or alternative means were found to achieve its objectives. They were concerned that allowing the CCL to expire on the sunset date would leave a gap in the Fund's toolkit for crisis prevention, given remaining imperfections in the functioning of international capital markets, and might be misinterpreted as a weakening of the credibility of the Fund's commitment to help countries with good policies become more resilient to crises. But a number of other Directors saw little prospect of the CCL being used if extended and favored its expiration. Overall support among Directors to extend the facility fell well short of the 85 percent of votes necessary and the CCL therefore expired on November 30, 2003.

The discussion by Directors highlighted a number of considerations that mitigated concerns about the scheduled expiration of the CCL.

- First, as the IMF's record of helping members facing capital account crises shows, the Fund stands ready to move quickly and flexibly to approve the use of Fund resources and to adjust the level and phasing of access to a member's need when conditions so require and permit.
- Second, the IMF's strengthened surveillance, support for greater transparency, and technical assistance operations are promoting sound policies and helping to prevent crises more generally.

- Third, recent innovations in the financial architecture, improvements in market differentiation across different borrowers, and stronger policy efforts by many emerging market countries seem to have lessened the threat of contagion that the CCL facility was intended to avert.

Looking forward, most Directors expressed interest in precautionary arrangements as a potential instrument in crisis prevention. The staff will further explore the scope for adapting precautionary arrangements, paying special attention to a number of concerns that have been raised in this connection—including the potential impact of high-access precautionary arrangements on debtor and creditor behavior and on IMF liquidity, the appropriate circumstances for use of such arrangements, and ways of measuring potential balance of payments need.

Directors also considered the option of establishing an Enhanced Monitoring Policy that would provide a framework for close monitoring without performance criteria and with a limited financial backstop. Directors generally felt that such a policy would not be effective in meeting the objectives of the CCL and—given its similarity to precautionary arrangements—would not be a useful addition to the Fund’s toolkit. A number of Directors, nevertheless, considered that an Enhanced Monitoring Policy might provide a useful signaling device for low-income member countries making the transition to a pure surveillance relationship. They encouraged the staff to explore this idea further.

Exceptional Access Policy Review

In April 2004, the Executive Board met to review experience with the Fund’s policy framework relating to its provision of financing in amounts that exceed the Fund’s normal limits, which is called “exceptional access.” (See the discussion of financial risk management and the concentration of IMF lending in Section 7.) The framework for exceptional access in capital account crises was put in place in September 2002 and clarified in February 2003, and informed the Board’s decisions to provide exceptional access for Argentina and Brazil.

The framework set out four criteria for determining the circumstances in which exceptional access in capital account crises could be considered:

- The member is experiencing exceptional balance of payments pressures on the capital account resulting in a need for Fund financing that cannot be met within the normal limits.
- A rigorous and systematic analysis indicates that there is a high probability that the debt will remain sustainable.
- The member has good prospects of regaining access to private markets within the time Fund resources would be outstanding.

- 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.

The framework also set out procedures to ensure involvement of the Executive Board before the formal Board discussion and increased information requirements. It lengthened the maturity of Supplemental Reserve Facility (SRF) repurchase expectations by one year and repurchase obligations by six months, and strengthened the presumption that exceptional access during capital account crises would be provided under the SRF.

At their one-year review of the framework in April 2004, Directors noted that it had helped improve the clarity and predictability of the Fund’s response to capital account crises for both members and markets. They underlined that the strengthened decision-making procedures agreed to in February 2003 should continue to apply to all requests for exceptional access. Most Directors felt that the four substantive criteria for exceptional access remained appropriate and, given the limited experience with the framework, considered that it was still premature to change the exceptional access criteria. Stressing that the number of cases of exceptional access should be limited to safeguard Fund resources, these Directors were in favor of maintaining the requirement that every request for exceptional access be justified in terms of the four substantive criteria.

However, Directors noted that the exceptional access criteria were designed for members facing capital account crises and acknowledged that, in rare circumstances, a need for exceptional access could arise in situations other than a capital account crisis and that, in those cases, a member could not be expected to meet all four criteria. Directors noted that the Fund has the flexibility to grant access under the exceptional-circumstances clause.

Most Directors opposed a staff proposal to establish four principles to guide exceptional access in the case of a member that has a pre-existing high exposure to the Fund and that does not face a capital account crisis. They felt that the proposal could be seen as a weakening of the policy on exceptional access that could lead to an inappropriate increase in the number of exceptional access cases, with risks to the Fund’s financial position. A number of other Directors, however, thought that the criteria in place had not provided sufficient guidance in recent requests for exceptional access and were unlikely to do so for future requests. Most Directors expressed preliminary views on the merits of exceptional access in the context of a precautionary arrangement, and many of them were willing to consider the possibility of exceptional access in precautionary arrangements. A number of other Directors, however, did not support use of the concept of “potential

need” for exceptional access. They expressed concerns about the provision of Fund financing as “insurance” against potential problems, as this could create problems of moral hazard, diminish the role of conditionality, and lead markets to expect the augmentation of exceptional access.

Most Directors noted the importance of incentives for members to repay the Fund as their balance of payments improves and reiterated the strong presumption that exceptional access should be provided in the form of SRF resources. But many Directors noted that the maximum maturity of the SRF obligations may sometimes be too short relative to the duration of the balance of payments need. Directors agreed to continue their discussion of the applicability of the SRF to precautionary settings in July 2004. The Board will review issues related to charges and maturity of the SRF and other facilities at a date to be determined.

In connection with exit strategies, and based on experience in earlier cases where the IMF was repaid, Directors observed that a member’s capacity to make repurchases and reduce its large Fund exposure would depend on improvements to both the current account and the capital account of the balance of payments. Directors recognized that some of the features of countries that have been granted exceptional access, particularly high debt levels, will require the relevant members to sustain large primary fiscal surpluses into the medium term. Given that the balance of payments difficulties of the beneficiaries of exceptional access appear to be of a medium-term nature, Directors could not rule out the possibility of continued Fund financing for some of these countries.

Directors agreed that the strengthened decision-making procedures for exceptional access cases—with early Board involvement and the provision of additional information and documentation—have worked well.

Directors agreed to include future reviews of the exceptional access policy with general reviews of access to Fund resources; the next such review is scheduled to take place by the end of 2004.

Compensatory Financing Facility Review

The Board reviewed the CFF in March 2004. This facility was established in 1988. It supersedes a similar facility established in 1963 to help member countries cope with temporary shortfalls in export earnings and temporary excesses in cereal import costs that are largely attributable to circumstances beyond the member’s control. It has been modified several times. In 2000, the Board simplified the structure of the facility and decided that CFF financing could be used if at the time of the request the member’s

Brazil



Brazil’s economic and financial situation improved significantly in FY2004. Under Brazil’s IMF-supported program, the country’s new government pursued policies that were both prudent and courageous, combining fiscal and monetary discipline with initiatives to relieve poverty.

To allay concerns over debt sustainability, the government increased the primary surplus target from 3¼ percent of GDP to 4¼ percent of GDP, while the central bank undertook a proactive interest rate policy to guide inflation back to the target under the program. Moreover, the government has adopted key structural measures—including pension and tax reforms and the adoption of a new bankruptcy law—that should pave the way to equitable and sustainable economic growth. The resulting increase in economic policy credibility, together with supportive international capital flows to emerging markets, contributed to record high equity prices and a substantial narrowing of sovereign bond spreads. When international financial markets became more volatile in the spring of 2004, the government’s efforts to reduce vulnerabilities paid off. Higher international reserves, improvement in the structure of domestic public debt, and a swing to current account surpluses have helped limit the impact on Brazil.

Brazil-IMF activities in FY2004

May 2003	Visit of First Deputy Managing Director Anne Krueger
June 2003	Completion of third review of Brazil’s performance under Stand-By Arrangement
September 2003	Completion of fourth review of Brazil’s performance under Stand-By Arrangement
November 2003	Visit of First Deputy Managing Director Anne Krueger
December 2003	Completion of fifth review of Brazil’s performance under Stand-By Arrangement. IMF approval of 15-month extension of the arrangement, coupled with an increase in access of SDR 4.5 billion. Brazilian authorities have been treating the arrangement as precautionary
February 2004	Visit of Managing Director Horst Köhler
March 2004	Completion of sixth review of Brazil’s performance under Stand-By Arrangement

balance of payments position is satisfactory apart from the effects of the exports shortfall and that it should be in parallel with a Fund-supported adjustment program when preexisting balance of payments weaknesses have to be addressed. The CFF has not been used since these modifications were introduced. At the March review, the Board considered the reasons for this and discussed the role of the CFF in the Fund's array of lending facilities.

Directors reflected on whether the CFF was not being used because there was less need for the facility, particularly in light of the availability of other financing options, or whether the changes made to the CFF in 2000 had reduced demand for it. Directors considered the premises on which the usefulness of the CFF rests: (1) temporary shocks are common, and the appropriate response to such shocks consists of up-front financing rather than adjustment; (2) members have little or no access to alternative sources of financing to cushion a temporary balance of payments shock; and (3) other Fund facilities are not suitable for dealing with CFF-type shocks.

Many Board members agreed that it is hard to distinguish in advance between the temporary and persistent components of balance of payments shocks, especially those caused by commodity price shocks. Directors also pointed to evidence of the significant downward trend and increased volatility of commodity prices over time, as well as the persistence of negative commodity price shocks. In their view, these factors indicate that up-front compensatory financing entails the risk that needed adjustment could be postponed.

Given that private capital flows have increased substantially since the inception of the CFF, most Directors felt that the usefulness of the facility in coping with shocks had diminished for middle-income countries. Members with access to private capital markets can be expected to retain such access in the face of temporary shocks as long as their balance of payments position remains strong. Directors acknowledged that low-income members enjoy access to capital market financing to a much smaller degree and that official financing is often not large enough or flexible enough to deal with temporary shocks. But they noted that the CFF is typically not an attractive option for low-income members in the face of such shocks, mainly because of its nonconcessional nature.

Exploring the usefulness of other Fund facilities in dealing with the types of shocks that would be covered by the CFF, here, too, Directors noted a fundamental asymmetry between middle- and low-income members. Many Directors considered that Stand-By or Extended Arrangements could provide sufficient resources to middle-income countries in a timely fashion, and these arrangements are suffi-

ciently flexible to incorporate appropriately tailored conditionality. But Stand-By or Extended Arrangements are often ill suited, owing to their nonconcessional nature, to low-income members without an active PRGF arrangement, and the CFF suffered from the same shortcoming. For low-income countries, Directors considered the possibility of subsidizing the rate of charge for Stand-By or CFF resources, but viewed such an option as a suboptimal way to allocate scarce concessional resources. Many Directors believed that a short-term "window" under the PRGF Trust Fund would be a better way to help PRGF-eligible countries that did not have an active PRGF arrangement deal with temporary shocks. For countries with an active PRGF arrangement, Directors generally supported the use of augmented access to PRGF resources to accommodate temporary shocks. Overall, Directors were in favor of developing the PRGF instrument, as is currently being considered in the context of the discussions on the role of the IMF in low-income countries, so that it could play the role of the CFF in low-income countries.

With regard to the possibility of other changes to the CFF, a number of Directors argued in favor of broadening the coverage of the facility's import element by including other basic food items beyond cereals. Many, however, acknowledged that data shortages would limit the usefulness of such an option. Many Directors considered that the strengthened requirements introduced at the time of the previous review of the facility were consistent with the Fund's mandate to support orderly balance of payments adjustment with appropriate safeguards to Fund resources and should be retained.

Many Directors argued that, on balance, there is a strong case for eliminating the CFF, to further streamline the structure of the Fund's facilities. Other sources of Fund and non-Fund financing were adequate to help middle-income members cope with temporary balance of payments shocks, while the envisaged new financing instruments would be more useful than the CFF to low-income members. Most of these Directors, however, were willing to retain the CFF in its current form until the next review, both to give the facility extra time to prove its usefulness and in recognition of the time it would take to develop and gauge the usefulness of the new financing instruments being considered for low-income countries. They suggested that the CFF should be eliminated if there was no clear demand for it by the time of the next review. Many other Directors were of the view that the CFF provided a useful element in the mix of financing options available to the membership, and most of these Directors supported keeping the CFF as it is, while others considered that demand for the facility could pick up with appropriate modifications. Directors agreed to review the CFF again in three years.

Box 3.1 Trade Integration Mechanism

In April 2004, the Executive Board established the Trade Integration Mechanism (TIM). The TIM is designed to mitigate concerns in some developing countries that their balance of payments position could suffer temporarily as multilateral liberalization changes their competitive position in world markets. Chief among these concerns is that, in the context of a Doha Round agreement, broad-based tariff liberalization might erode the value of developing countries' preferential access to important export markets or that a reduction of agricultural subsidies might result in higher prices and thus higher import costs for food-importing developing countries. Another concern is that the expiration of the World Trade Organization's (WTO) Agreement on Textiles and Clothing (ATC) in January 2005 will hurt some developing countries as quota constraints on competitors are eliminated.

While the phasing out of the ATC and Doha Round-related concerns provided the impetus for the new mechanism, its application will not be limited to shocks stemming from trade liberalization under the aegis of the WTO. More generally, countries may request support from the Fund under the TIM if they expect a net balance of payments shortfall as a consequence of measures implemented by other countries opening their markets in a nondis-

crimatory manner. Balance of payments difficulties stemming from a country's liberalization of its own trade regime will continue to be addressed through other Fund facilities.

The TIM details that the Fund

- stands ready to discuss with countries facing such balance of payments shortfalls new arrangements within its existing lending facilities;
- will take into account the expected impact on the members' balance of payments in determining the size of access under both new and existing arrangements (the "baseline feature"); and
- is prepared to augment arrangements under simplified procedures if the actual balance of payments effect turns out to be larger than expected (the "deviation feature").

Potential Impact

Estimates of the impact of the trade policy changes suggest that balance of payments shortfalls are likely to be small and generally offset by the positive effects of a more liberal global trade system. Assuming a fairly ambitious Doha Round liberalization scenario, model simulations suggest that a 40 percent reduction in average preference margins

(through the reduction in most-favored-nation tariff rates) could result in about two dozen countries experiencing a fall in their average export prices of more than 2 percent. A slightly smaller group of countries might be vulnerable to a food import price shock. It is difficult to predict the impact on individual countries from the imminent expiration of the ATC, but if the elimination of 15 percent of bilateral quotas in 2002 is any guide (the ATC's Phase III liberalization), a significant shift in the allocation of worldwide production of garments will take place starting later this year.

TIM's Architecture

The TIM is not a new lending facility but, rather, a measure making Fund resources more predictably available to qualifying member countries under existing Fund facilities—that is, assistance will not be available on a stand-alone basis but only in connection with a regular Fund arrangement. A similar approach underlay the Fund's 1980s policy to increase the predictability of financing for debt and debt-service-reduction operations in the context of Fund support of the Brady Plan. Arrangements that incorporate a TIM are subject to the same general access limits as other arrangements.

Support for Trade-Related Balance of Payments Adjustments

In April 2004, the Executive Board met to discuss IMF support for trade-related balance of payments adjustments. Directors welcomed the opportunity to discuss ways in which the Fund could give its member countries additional confidence to pursue ambitious trade liberalization under the Doha Round of trade negotiations. They reiterated that a successful conclusion of the Doha Round would bring significant benefits to the world economy. Any transition to a more liberal trade environment, however, also involves economic adjustments, which may create added policy challenges for several developing countries. Directors underscored the important role that the Fund is already playing—in accordance with its mandate—in advocating the benefits of open trade in the context of its surveillance across the membership and promoting trade-related reforms through the provision of technical assistance and program support (see Section 4). They stressed the importance of continued efforts to communicate clearly the Fund's role in supporting trade liberalization.

While some Directors felt that the Fund's readiness to make its existing instruments available for supporting trade liberalization should give sufficient confidence to members, most Directors saw considerable merit in a more tailored approach to addressing the balance of payments impact of trade adjustment resulting from the Doha Round. Directors, accordingly, supported the establishment of a Trade Integration Mechanism (TIM) (see Box 3.1) within the Fund's existing lending facilities to clarify the Fund's readiness to help its members mitigate short-term balance of payments pressures stemming from trade liberalization.

The Board highlighted the importance of close cooperation with the World Bank, in particular in view of the lending initiatives that the Bank is developing to facilitate members' adjustment to trade reforms and help them strengthen their institutions and infrastructure for trade. If a member requests support from the Fund and the Bank concurrently under these new policies, the staffs will be expected to coordinate closely—in line with the established framework for Fund/Bank collaboration—to avoid duplication of work and ensure that their policy advice is tailored to effectively

Tanzania



Tanzania has made considerable progress in macroeconomic and structural adjustment since the mid-1990s under IMF-supported programs. It registered an average annual growth rate of 5 percent in 1996–2002—roughly double the rate of the previous five years—and reduced inflation from an average of over 30 percent a year during the previous two decades to about 5 percent from 1999 onward.

Tanzania is using the revenues freed up from debt relief granted in 2001 (about \$2 billion over time in net-present-value terms) under the HIPC Initiative to increase spending on education, health care, and agriculture and to keep its debt levels sustainable.

The country's latest program, which is supported by the Poverty Reduction and Growth Facility (PRGF), aims at stabilizing inflation at about 4 percent and achieving real GDP growth averaging over 6 percent a year during 2003–06. Tanzania will underpin growth through improvements in the business climate—in particular, reforms of the financial sector based, in part, on recommendations that grew out of a Financial Sector Assessment Program (FSAP) exercise completed in July 2003. In addition, Tanzania intends to undertake a range of reforms to encourage agricultural production, notably changes to crop boards and local government taxation. To help maintain macroeconomic stability and avoid undue dependency on aid, the Tanzanian authorities plan to enhance revenue performance through improvements in tax administration and changes in tax policy aimed at broadening the tax base and closing loopholes.

During FY2004, the Fund provided Tanzania with technical assistance in tax and customs administration, as well as in the rationalization of tax incentives in the East African Community.

Tanzania-IMF activities in FY2004

July 2003	Completion of sixth (last) review under PRGF arrangement; approval of new PRGF arrangement
August 2003	Publication of joint IMF-World Bank Financial System Stability Assessment (FSSA)
September 2003	Publication of joint IMF-World Bank assessment of PRSP progress report
February 2004	Completion of first review of performance under new PRGF arrangement; visit by IMF Deputy Managing Director Agustín Carstens
March 2004	Publication of Report on the Observance of Standards and Codes (data module and detailed assessments)

addressing the member's needs. The importance of avoiding cross-conditionality was highlighted in this context. Directors also called for close coordination with the World Trade Organization (WTO) and donors in the trade-related assistance area, as well as for continued technical assistance by the Fund to help members address the loss of tariff revenue resulting from trade reforms.

Directors stressed that the TIM is designed as a temporary policy to address concerns associated with the current round of multilateral trade negotiations. They therefore expected that a decision would be taken as to the duration of the TIM when it is reviewed in three years.

Program Design and Conditionality

Well-thought-out programs are critical not only for lasting prosperity in borrowing countries but also for the IMF, which needs to be assured of timely repayment so that it can assist other members as need arises. Program design and the conditions attached to the Fund's loans therefore remain subject to continual review.

Lessons from the Crisis in Argentina

In November 2003, the Executive Board discussed the lessons from the severe financial crisis experienced by Argentina in 2001–02. During that crisis, output, which had begun to contract in the second half of 1998, fell by about 20 percent in the three years ending December 2002; inflation reignited; the government defaulted on its debt; the banking system became largely paralyzed; and the Argentine peso, which was then pegged at par to the U.S. dollar, reached lows of Arg\$3.90 a U.S. dollar (in mid-2002). The economy began to recover in 2003, but the road back to sustained growth and stability remains long.

The severity of the crisis—and the fact that it occurred in a country that had been widely hailed as a model performer until a few years earlier and that had been engaged in a nearly uninterrupted program relationship with the IMF since the early 1990s—made Argentina's case a particularly important one to examine for lessons for other countries and for the Fund. The Executive Board reviewed a staff paper that examined the origins of the Argentine crisis and its evolution up until early 2002, with a view to drawing out such lessons. This report was to be complemented by an evaluation by the IMF's Independent Evaluation Office in July 2004 (see below).

The Board noted that Argentina's crisis reflected the interaction of several sources of vulnerability that were already present during the boom years of the 1990s: the public debt dynamics, the constraints on monetary policy imposed by

the currency board, and a variety of structural and institutional factors. These vulnerabilities were not adequately taken into account in the design of Fund-supported programs during the 1990s; in particular, the fiscal policies pursued were, in hindsight, unsustainable, reflecting in part overoptimistic medium-term growth projections. The crisis also underscores the importance of ensuring that a country's exchange rate regime is supported by fully consistent macroeconomic and structural policies and that there be broad domestic ownership for these policies. Directors also noted that Argentina's experience highlights the need for strong and candid surveillance in countries with Fund-supported programs.

IEO Reports and Discussions

The Executive Board established the Independent Evaluation Office (IEO) in July 2001 to conduct objective and independent evaluations of issues relevant to the mandate of the IMF. The IEO serves as a means to enhance the learning culture within the IMF, strengthen the Fund's external credibility, promote greater understanding of the IMF's work throughout the membership, and provide independent feedback to the Executive Board in its institutional governance and oversight responsibilities. Independent of IMF management and staff, the IEO works at arm's length from the Executive Board. The IEO's activities complement the IMF's review and evaluation of its work. The IEO's website (www.imf.org/ieo) gives detailed information on its terms of reference, work to date, status of ongoing projects, evaluation reports, and seminars and outreach activities. The website also provides opportunities for interested stakeholders (country authorities, academia, nongovernmental organizations, and other members of civil society) to interact with the IEO in defining its work program, determining the terms of reference of individual studies, and submitting substantive inputs to these studies.

The IEO's establishment has provided an additional dimension to the learning process in the IMF through regular independent assessments of the Fund's work. The IEO reports have, in some cases, raised new issues and, in others, added impetus to work already under way. Box 3.2 summarizes common themes in IEO evaluation reports to date.

The IEO's evaluations have had a distinct impact on the Fund's approach to issues, and IMF staff have undertaken extensive work to put into practice specific IEO recommendations endorsed by the Board.

- *Changes in procedures.* IEO recommendations have led in some cases to the establishment of new procedures, for example, for ex post assessments of IMF-supported programs, particularly in instances where the IEO has identified a need for a major redirection of the staff's efforts.

- *Incorporation of lessons into regular reviews.* For instance, the IEO's analysis of the need for better signaling arrangements provided a basis for the staff's work on ways of signaling assessments of members' policies, and some of the results of the IEO report on fiscal adjustment will figure prominently in a forthcoming conditionality review.
- *Dissemination of lessons to staff.* The incorporation of lessons learned into established work procedures is key to the successful implementation of recommendations. Some of the shortcomings identified by the IEO could be remedied by ensuring institution-wide application of what is already best practice within the IMF. Over time, a priority will be to enhance internal dissemination—through seminars, guidance notes to staff, website postings, and dialogue between area and review departments—to ensure that such practices are fully absorbed into the IMF's everyday operations.

In the fiscal year under review, the IEO completed work on two evaluation reports—the role of the IMF in the capital account crises of Brazil, Indonesia, and Korea; and fiscal adjustment in IMF-supported programs. It also issued its

Box 3.2 Common Themes in IEO Evaluations

The first three published IEO reports contain a number of common themes related to surveillance, program design and uncertainty, and conditionality and ownership.

Surveillance

- Greater candor is key to making surveillance more effective.
- Systematic stocktaking allows for greater learning from experience, especially in countries with IMF-supported programs.
- Surveillance can and should inform program design. Based on its surveillance activities, the Fund should provide the authorities with a frank assessment of critical weaknesses and encourage the authorities to develop a road map of reforms to address them.

Program design and uncertainty

- Risks should be explicitly taken into account in program design, and excessively optimistic assumptions avoided. Explicit contingency planning would help make programs more flexible. Greater transparency about the assumptions and rationale of program design would permit more rapid redesign in the event contingencies actually occur.

Conditionality and ownership

- Domestic political commitment to core policy adjustments is more important than specific conditions.
- The IMF should be willing to consider "second-best" adjustment programs that meet minimum criteria, but it should also be prepared to hold back financing when country ownership of programs is insufficient or programs do not meet minimum criteria.

first *Annual Report*, detailing the IEO's activities since its inception. (The IEO's first evaluation report, on the implications of the prolonged use of IMF resources, was discussed by the Executive Board in September 2002; see IMF *Annual Report 2003*, p. 60.)

In their discussion in July 2003, Executive Directors commented that the *evaluation report on the IMF's role in the capital account crises in Brazil (1998–99), Indonesia (1997–98), and Korea (1997–98)* and the lessons to be learned from these experiences were a useful complement to previous studies undertaken both within and outside the IMF. They broadly agreed with the report's conclusions.

However, Directors expressed several caveats regarding the findings and conclusions of the report. First, the report focused mainly on the IMF's involvement in the early stages of the crises, and the IEO's mandate not to interfere with ongoing IMF operations constrained the extent to which the report could examine later developments. Second, the IMF had already taken steps to address many of the concerns voiced by the IEO in areas such as transparency, conditionality, standards and codes, financial sector surveillance, vulnerability assessments, and Fund-Bank collaboration. Third, the report confirmed that every capital account crisis was unique. Thus, anticipating crises would always require difficult judgments in the context of great uncertainty, and distilling lessons from past crises was no guarantee of future success. Directors emphasized that there was no standard solution to capital account crises, that policy advice would need to take account of the causes and specific circumstances of each crisis, and that the capacity to prevent crises would depend to a large extent on the actions of member countries.

Directors noted that most of the IMF's efforts to anticipate or deal with the three crises were steps in the right direction. Nevertheless, they shared the report's view that the IMF had made some mistakes and that the crises highlighted the need for improvements in the IMF's policies and procedures.

In discussing the IEO *evaluation report on fiscal adjustment in IMF-supported programs* in August 2003, Executive Directors agreed that the report made a number of constructive recommendations whose implementation would enhance the IMF's advice and programs in the fiscal area. Most Directors were encouraged by the report's finding that some of the common criticisms of fiscal adjustment in IMF-supported programs—notably, that these programs adopted a “one-size-fits-all” approach, were inflexible, and caused a decline in social spending—were not supported by empirical evidence. Directors also noted that the report found significant weaknesses in the results of fiscal adjustment in programs and that fiscal targets were not met in a large number of cases. However, they cautioned against drawing

conclusions based on generalizations across a large number of countries and stressed that the appropriateness of the size, pace, and results of fiscal adjustment could be assessed only against the specific circumstances of each individual country.

Directors welcomed the report's conclusion that there was no evidence that IMF-supported programs were uniformly contractionary, but stated that a contractionary bias could exist in certain circumstances. Directors supported IEO's recommendation that program documentation should provide a more in-depth and coherent justification for the magnitude and pace of fiscal adjustment. They also noted the report's finding that IMF-supported programs were not associated with lower spending on public education and health care, but emphasized the need to shield the poor from economic downturns and called for the cost of social safety nets to be incorporated into IMF-supported programs.

In the coming financial year, the IEO will publish three new studies. The first will be an *evaluation of the role of the IMF in the PRSP approach and the PRGF initiatives*. (The World Bank's Operations Evaluation Department is preparing a parallel report on the Bank's experience with PRSPs.) Drawing on detailed case studies and broader cross-country analysis, the study will address a number of key questions: does the design of these initiatives ensure the achievement of their objectives? Is the IMF delivering the promises of the PRSP and PRGF approaches? And what improvements are needed in the design of these initiatives and their implementation by the IMF?

The second report will analyze the *role of the IMF in Argentina* from 1991 to early 2002. It will review the evolution of the IMF's advice and internal views on key areas of Argentina's economic policy, examine certain IMF decisions at critical junctures in its relationship with the country, and assess how reasonable the decisions were in light of information available at that time.

The third study will examine *IMF technical assistance during 2000–03*. It will focus on such themes as the effectiveness of internal IMF processes for identifying technical assistance priorities at the country level and for allocating resources accordingly; the effectiveness of technical assistance delivery and the dialogue with the authorities in ensuring success during implementation; and IMF monitoring of the impact of technical assistance.

Review of Bank-Fund Collaboration in Program Design and Conditionality

In March 2004, the IMF's Executive Board again reviewed collaboration between the World Bank and the IMF, this time on the basis of a joint report by the two institutions that presented the results of a survey of national authorities

and Bank and Fund staff. The Board concluded that the framework for collaboration between the Bank and the Fund, including in the area of program design and conditionality, is working well, although there is scope for improvement.

Directors reiterated that close collaboration between the Bank and the Fund is indispensable to ensuring that member countries receive support that is effective in promoting financial stability, sustainable growth, and poverty reduction. Bank-Fund collaboration is particularly important to ensure the effectiveness of the Fund's efforts in assisting low-income countries with the implementation of reform programs, based on strong country ownership, through the PRGF and the enhanced Heavily Indebted Poor Countries (HIPC) Initiative, and in helping low-income countries make progress toward the Millennium Development Goals.

Effective collaboration between the Bank and the Fund requires a clear demarcation of responsibilities based on the institutions' respective mandates and comparative advantages, Directors emphasized. They also stressed that the focus of conditionality should be on reforms that are critical to program success. Directors highlighted the importance of designating one of the two institutions as lead agency in particular policy areas, of systematic information sharing between the institutions, and of early interaction on program design and conditionality.

The survey found that the staffs of the two institutions typically share a common perspective regarding a country's critical areas for reform, and that the division of labor is now clearer than it has been in the past. Directors were also encouraged by the indications—in the survey responses of national authorities—that Bank-Fund collaboration is increasingly strengthening national ownership of programs, but stressed that continued progress in this area remains critical to the success of reform programs. Both institutions also appear to be showing increased sensitivity to social and political constraints, and close collaboration between the institutions is helping to reduce the time spent in program negotiations. At the same time, national authorities perceive a need for further progress in aligning program design and conditionality with a country's own reform priorities and implementation capacity.

While the survey results provide renewed support for the existing operational framework on collaboration, Directors stressed that there is no room for complacency. They noted that the survey results point to scope for further improvements in the implementation of the agreed division of labor, coordination in interaction with government author-

ities with a view to further promoting country ownership, and information sharing between the staffs of the two institutions.

Most Directors welcomed the decision by Bank and Fund managements to strengthen the role of the Joint Implementation Committee (JIC) to facilitate Bank-Fund cooperation at the senior staff level, complementing the broad-based mechanisms for institutional coordination that already exist. The role of this committee will be expanded to cover matters affecting both middle- and low-income countries. The Fund and the Bank will also explore ways to facilitate closer collaboration in analyzing thematic issues that feed into program design, such as public expenditure and fiscal management and coordination on poverty and social impact analysis (PSIA).

Board members underscored that the IMF should look to the Bank for assistance with the PSIA of reforms in Fund-supported programs, as this would be the best way of fully utilizing the relative strengths of each institution. At the same time, most Directors acknowledged that some in-house Fund capability in this area will be necessary, in particular, to facilitate the integration of PSIA's into PRGF-supported programs. Directors also suggested several other thematic areas in which more Bank-Fund collaboration could be useful and which will be carefully considered in the future.

The formal mechanisms for collaboration, embedded in the PRSP process (see Section 4), are playing an important role in strengthening Bank-Fund collaboration in the institutions' work on low-income countries, Directors observed. They recognized that formal arrangements are not always well suited to middle-income countries, given the diversity of these countries' circumstances and the differences in the degrees and timing of the engagement by each institution in them. But they reaffirmed that the principles for collaboration remain the same: a coherent program of support based on a country-owned strategy; early consultation on program conditionality and effective information sharing; and a clear division of responsibilities based on respective mandates.

Directors stressed that progress on Bank-Fund collaboration will remain a challenge, requiring steady implementation and sustained commitment, in particular by the country teams of each institution. They looked forward to keeping progress under review and agreed that, to allow for sufficient additional experience under the enhanced framework for collaboration, the next review should take place by 2007. In the meantime, Bank-Fund collaboration will be reviewed in the context of progress reports on thematic issues.



The Fight Against Poverty in Low-Income Countries

The IMF's goal in low-income countries is to help them achieve deep and lasting poverty reduction through policies that promote growth, generate employment, and target assistance to the poor. This aim is consistent with the IMF's mandate to "contribute . . . to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy."¹ The Fund pursues this goal in close collaboration with other development partners—particularly the World Bank. In doing so, the IMF focuses on its core areas of responsibility and expertise, namely, helping member countries achieve stable macroeconomic conditions by providing them with policy advice supported by financial and technical assistance.

In the late 1990s, the IMF and the World Bank launched two new major programs to help low-income countries: the Poverty Reduction Strategy Paper (PRSP) approach and the Heavily Indebted Poor Countries (HIPC) Initiative. Around the same time, the IMF established the Poverty Reduction and Growth Facility (PRGF) to make poverty reduction and growth more central to lending operations in its poorest member countries. These initiatives stress country ownership of programs, including through the broad participation of civil society. Subsequently, in 2002, the international community endorsed the "Monterrey Consensus" based on two pillars. First, low-income countries must be proactive in implementing sound policies, strengthening institutions, and improving governance. Second, the international community must provide strong support, in the form of greater trade opportunities and increased aid

flows, to those countries that carry out sound policies and reforms.

Recently, there have been encouraging signs that these strategies have begun to bear fruit. A review of the PRGF completed in 2002 confirmed that program design under the facility is becoming more pro-poor and pro-growth. In many low-income countries, growth of output and per capita incomes have increased markedly since the late 1990s. Indeed, Bangladesh, Benin, Cambodia, Mali, Mozambique, Tanzania, Uganda, and Vietnam have seen real growth averaging 5 percent or more a year for the past five years. Internal and external imbalances have been reduced, inflation has fallen to single digits—the lowest levels in two decades—and external reserves are at their highest levels since the 1980s. Moreover, improvements in macroeconomic performance have been especially marked in countries that have, or have had, Poverty Reduction and Growth Facility arrangements.

Nevertheless, while the progress in promoting good policies and the associated improvements in outcomes are heartening, they do not yet provide a sufficient basis for achieving the sustained high growth necessary for global achievement of the Millennium Development Goals (MDGs) by the deadline set out in the 2000 UN Millennium Declaration. Placed at the heart of the global agenda, the goals include combating poverty, hunger, disease, illiteracy, environmental degradation, and discrimination against women, and establishing a global partnership for development.

During FY2004, the IMF continued to work on these challenges by strengthening the PRSP approach, making available suitably tailored financial support, advancing HIPC debt relief, looking at ways countries can promote growth and support the efforts to achieve the MDGs without incurring unsustainable debt, and fostering an open trading system.

¹Article I, IMF Articles of Agreement.

PRSP Approach to Development Assistance

The IMF and the World Bank jointly developed the PRSP approach to help focus the attention and resources of both low-income countries and the international donor community on poverty reduction. Since its introduction in December 1999, the approach has been widely adopted in low-income countries and has been increasingly embraced by these countries' external development partners. In this context, alignment and harmonization of donor processes have been critical to sustaining the PRSP approach, designed to overcome long-standing problems of poor donor coordination and weak country ownership. Consequently, PRSPs are becoming effective instruments for countries to gain better control over external assistance.

Low-income countries prepare their Poverty Reduction Strategy Papers through a participatory process involving domestic stakeholders and external development partners. The strategies are endorsed by the Executive Boards of the IMF and the World Bank. Updated periodically (at least once every five years) and with annual progress reports, PRSPs describe countries' macroeconomic, structural, and social policies and programs over a three-year or longer horizon aimed at promoting broad-based growth and reducing poverty, as well as associated external financing needs and major sources of financing. Under the PRSP approach, countries may receive financing from the Poverty Reduction and Growth Facility loan program. PRSPs also provide the operational basis for debt relief under the enhanced Heavily Indebted Poor Countries Initiative.

Recognizing that preparation of a PRSP is a lengthy process, the World Bank and the IMF have agreed to provide concessional financial assistance on the basis of Interim PRSPs. An I-PRSP summarizes the current knowledge and analysis of a country's poverty situation, describes the existing poverty reduction strategy, and lays out the process for producing a fully developed PRSP in a participatory fashion.

During FY2004, the Executive Board approved 10 new PRGF arrangements (for Bangladesh, Burkina Faso, Burundi, Dominica, Ghana, Honduras, Kenya, Mauritania, Nepal, and Tanzania), with commitments totaling SDR 955 million (see Table 7.3). In addition, an augmentation of the existing arrangements for Madagascar was approved. Total

PRGF disbursements to these countries and other countries with existing arrangements amounted to SDR 865 million during FY2004. As of April 30, 2004, 36 member countries' reform programs were supported by PRGF arrangements, with commitments totaling SDR 4.4 billion.

In their latest annual review of the program, in September 2003, Executive Directors welcomed the continuing strong momentum of the approach. They noted evidence of progress across a wide range of fronts as the approach matured, and stated that the imperative was to address the emerging challenges in implementation, including the need for better prioritization of policies and objectives, improved donor alignment and harmonization, and strengthened public expenditure management and budgetary processes.

Directors underscored the importance of national ownership of poverty reduction strategies. They welcomed the increasing engagement of parliaments and noted that the PRSP process had survived transitions in national governments in several countries, while requiring adaptations to reflect the programs of the new administrations. Directors emphasized the need for greater cohesion between PRSPs and other planning documents and for better integration between teams responsible for PRSP preparation and other units of government.

The greater openness of policymaking processes, which the PRSP approach is facilitating, was welcomed by Directors. The private sector is increasingly active, and nongovernmental organizations have often carved out roles for themselves as suppliers of information and watchdogs in monitoring government efforts. Directors acknowledged that, at the same time, there remained some continuing criticisms from civil society organizations, in particular, that they were being asked to react rather than to contribute to program formulation, and that some critical policies underpinning the PRSP—such as the macroeconomic framework—were sometimes not sufficiently open to public debate.

Directors underscored that macroeconomic policies and projections provided the framework for any PRSP. Consistent with the preparation of the PRSP as a country-owned process, they emphasized that the government, and not the Fund, should lead the discussion of the macroeconomic framework in the public domain. It was, however, also

Democratic Republic of the Congo



The IMF has been providing policy advice to the Democratic Republic of the Congo (DRC) since early 2001—when the country was still torn by internal strife and armies from seven neighboring countries occupied about half its territory—first under a staff-monitored program and then under a program supported by the Poverty Reduction and Growth Facility (PRGF), which also provided financial assistance.

The two programs have contributed to a turnaround of the DRC's economy. Real GDP growth was positive in 2002 for the first time in 13 years, and it accelerated to 5.6 percent in 2003. The vicious circle of hyperinflation and currency depreciation has been broken. By implementing prudent fiscal and monetary policies, adopting a floating exchange rate regime, and undertaking bold structural reforms, the DRC has achieved macroeconomic stability. This turnaround has contributed to the peace process. Foreign troops have withdrawn from the country, which was reunified under the transitional government formed in June 2003.

In FY2004, the Fund continued to provide extensive technical assistance to the DRC in a number of areas. As part of this assistance, it posted resident experts to the ministry of finance and the ministry of the budget.

DRC-IMF activities in FY2004

June 2003	Submission to the Fund's Executive Board of the DRC's Preparation Status Report on the first year of implementation of the country's Interim Poverty Reduction Strategy Paper (prepared in 2002) and the preparation of the full PRSP
July 2003	The DRC became the 27th country to reach its decision point under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative, making it eligible for debt-service relief of \$6.3 billion, in net-present-value terms
March 2004	Completion of the third review of the DRC's program, supported by an arrangement under the PRGF

important for the Fund to continue its outreach efforts to civil society and donors. Directors called on governments to provide an explicit forum for macroeconomic dialogue in the context of the PRSP process in which Fund Resident Representatives could participate. Noting that the deepening and widening of skills is a prerequisite to strengthen any government's ownership of its macroeconomic framework, Directors emphasized that the Fund would need to continue to support countries' capacity-building efforts.

Board members considered it generally too early in the implementation of PRSPs to form judgments about whether the policies were delivering on their stated objectives. They welcomed the focus being placed in PRSPs on measures to foster private sector development. Noting the identification by a number of PRSPs of weak governance and corruption as significant constraints, they considered the implementation of measures to improve the investment climate as key to improving growth prospects. Directors noted that poverty-reducing spending has increased in the PRSP countries where data are available and were encouraged by the tentative signs of improved access of the poor to some basic services.

FY2004 saw a number of related measures to support the PRSP process:

- The Fund sought to coordinate PRGF arrangements with country budgets and PRSP cycles to ensure that macroeconomic policymaking moved in concert with national and donor decisions on poverty reduction initiatives.
- The Fund and the Bank collaborated more closely on country programs and conditionality (see Section 3). However, there is scope for improvement, and Fund staff will monitor performance closely and deal with issues of mutual concern through a reinvigorated Joint Implementation Committee.
- The Fund intensified its efforts to incorporate poverty and social impact analysis into the design of PRGF-supported programs. Plans called for a small group (four staff members) to be set up shortly within a division of the Fiscal Affairs Department.
- The IMF pressed for fuller inclusion of trade policy considerations in PRSPs, including through the Integrated Framework for Trade-Related Technical Assistance, a cooperative interagency effort supported by bilateral donors, as well as for regional conferences with development and trade officials.

The next Fund-Bank PRSP progress report, which will be completed before the 2004 Annual Meetings, will be informed by a forthcoming Independent Evaluation Office report on the PRSP approach and the PRGF. The report will propose ways to sharpen the focus of PRSPs so as to provide

a better link to the Millennium Development Goals and a better operational basis for policy choice and donor coordination.

Role of the IMF in the Medium Term

The Board met in August 2003 and again in March 2004 to consider various aspects of the role of the IMF in low-income countries.

The August discussion was broad. Directions considered that the Fund could best support poor members and contribute to the stepped-up international effort toward the achievement of the Millennium Development Goals by intensifying its policy advice, technical assistance, capacity building, and, when warranted, temporary financial assistance. They also reached the following conclusions:

- While Fund involvement in these countries will continue over the long term, greater selectivity about the circumstances in which it provides financial support may be required.
- The IMF's financial role is to focus on the provision of temporary assistance in support of macroeconomic reform efforts and the policy response necessary to help countries adjust to the effects of exogenous shocks.
- The IMF's instruments need to be strengthened further in three areas: (1) supporting post-conflict and other countries with severe institutional weaknesses in their efforts to get to a point where they can implement PRGF-supported programs; (2) assisting countries with more durable records of macroeconomic performance to move from a program-based to a surveillance-based relationship; and (3) providing policy advice and financial assistance to help member countries deal with exogenous shocks.

Directors also acknowledged the need to consider more carefully how the IMF's instruments might be better tailored to the diverse needs of its low-income country members.

In March 2004, the Board followed up by reviewing the instruments and financing for low-income countries. After affirming that the Fund had an important role in low-income member countries in terms of surveillance, policy advice, and technical assistance, Directors considered that the Fund would continue, where necessary, to support low-income countries financially, carefully calibrating its financing to the country's circumstances. Directors endorsed the following proposals:

- For members with continuing needs for IMF financing, to establish norms for access to PRGF resources for the third and subsequent arrangements under the facility,

and to strengthen Fund policy and guidelines for granting resources from both the PRGF and General Resources Account;

- For countries with a limited need for IMF financing, to establish a standard low-access level for PRGF arrangements;
- For countries that do not need IMF financing, to strengthen surveillance;
- For members with outstanding PRGF loans of 100 percent of quota or more, to cover under Post-Program Monitoring; and
- For countries emerging from conflicts, to modify the policy on emergency assistance to allow a longer time for transition to regular IMF lending through programs of longer duration and more tapered access.

Directors considered low-income countries to be particularly vulnerable to economic shocks outside their control—such as natural disasters and commodity price changes—that can harm growth, macroeconomic stability, debt sustainability, and antipoverty efforts. To help countries prepare for such events and provide financial support when appropriate, the Board endorsed the following proposals:

- To establish explicit principles for augmenting PRGF arrangements;
- To introduce a subsidy for emergency assistance for natural disasters; and
- To develop a vehicle that would provide lending on PRGF terms but with the program design features and duration of a Stand-By Arrangement. Such a vehicle could provide rapid and concessional assistance in response to shocks in circumstances where a comprehensive three-year PRGF arrangement might not be appropriate.

The Board also discussed the potential size of the financial resources required to support the Fund's continued involvement in low-income countries and of various options for financing (see Box 7.6).

HIPC Initiative

The HIPC Initiative was launched in 1996 by the IMF and World Bank with the aim of ensuring that no poor country would face a debt burden it could not manage. The Initiative entails coordinated action by the international financial community, including multilateral organizations and governments, to reduce to sustainable levels the external debt burdens of the most heavily indebted poor countries (see Box 4.1). Following a comprehensive review in September

1999, a number of enhancements were approved to provide faster, deeper, and broader debt relief and to strengthen the links between debt relief, poverty reduction, and social policies. Countries' continued efforts toward macroeconomic adjustment and structural and social policy reforms—including increased spending on social sector programs such as basic health care and education—are central to the enhanced HIPC Initiative.

The HIPC Initiative has freed up resources. Before the Initiative, eligible countries were, on average, spending slightly more on debt service than on health care and education combined. This is no longer the case in the 27 countries receiving HIPC relief. Under their recent IMF- and World Bank-supported programs, these countries have markedly increased their expenditures on health care, education, and other social services, and such spending is now almost four times the amount of debt-service payments, on average.

During FY2004, progress continued to be made in implementing the enhanced HIPC Initiative (Table 4.1) and reducing the debt burdens of poor countries:

- Five additional countries reached their *completion points* (Ethiopia, Guyana, Nicaragua, Niger, and Senegal) during FY2004, taking the total to 13.
- As of end-April 2004, about \$52 billion had been committed in *debt-service relief* to the 27 countries that

had reached their decision points. The debt stocks of these countries are projected to decline by about two-thirds as a result of debt relief under the HIPC Initiative.

- Of the 14 countries that have reached their *decision points but not their completion points*, the majority are on track with their macroeconomic programs and have made progress in the implementation of their full Poverty Reduction Strategy Papers. Several are expected to reach their completion points by the end of calendar year 2004.
- For the remaining 11 eligible HIPC countries (9 of which are in Africa), the *sunset clause* of the enhanced HIPC Initiative is due to take effect at end-2004. Many of these countries are affected by conflict and, in some instances, have substantial arrears outstanding to various creditors. A few of these countries are moving toward establishing a track record of macroeconomic performance. Burundi started a PRGF arrangement in January 2004, and discussions for establishing a track record toward a PRGF arrangement by putting in place staff-monitored programs are under way for Comoros and the Republic of Congo. The Executive Boards of the Fund and the World Bank will consider later in 2004 options for addressing the sunset clause of the enhanced HIPC Initiative.
- *Topping up* is provided under the Initiative to countries

that have experienced a fundamental change in their economic circumstances during the interim period because of developments beyond their control. By the end of FY2004, the Boards of the World Bank and the Fund had agreed to provide topping up to Burkina Faso, Niger, and Ethiopia.

- Three countries—Liberia, Somalia, and Sudan—have been in *protracted arrears* to the Fund, the World Bank, and other creditors for up to two decades. To date, no provision has been made for the HIPC grant resources that would be needed for these countries once they clear their arrears. Given the magnitude of their debt problems, achieving debt sustainability will require substantial additional resources from the international community. The mobilization of these resources could soon become urgent.

Box 4.1 How the HIPC Initiative Works

To qualify for HIPC assistance, a country must pursue strong economic policies supported by the IMF and the World Bank. There are two phases. In phase I, leading up to the decision point, it needs to establish a track record of good performance (normally, over a three-year period) and develop a Poverty Reduction Strategy Paper or an Interim-PRSP. Its efforts are complemented by concessional aid from all relevant donors and institutions and traditional debt relief from bilateral creditors, including the Paris Club.

In this phase, the country's external debt situation is analyzed in detail. If its external debt in net-present-value (NPV) terms, after the full use of traditional debt relief, is above 150 percent of exports (or, for small open economies, above 250 percent of government revenue), it qualifies for HIPC relief. At the *decision point*, the IMF and the World Bank formally decide on the country's eligibility, and the international community commits itself to reducing the country's debt to a sus-

tainable level. A country reaches its *completion point*—the second phase—once it has met the objectives set up at the decision point. It then receives the balance of the debt relief committed. This means all creditors are expected to reduce their claims on the country, measured in NPV terms, to the agreed sustainable level.

Once it qualifies for HIPC relief, the country must continue its good track record with the support of the international community, satisfactorily implementing key structural policy reforms, maintaining macroeconomic stability, and adopting and implementing a poverty reduction strategy. Paris Club bilateral creditors reschedule obligations coming due, with a 90 percent reduction in NPV terms, and other bilateral and commercial creditors are expected to do the same. The IMF and the World Bank and some other multilateral creditors may provide interim debt relief between the decision and completion points.

Table 4.1 Progress of Countries Under the HIPC Initiative, as of End-April 2004

Completion points reached (13)		Countries in the interim period (14)		Countries still to be considered (11)	
Benin	Mozambique	Cameroon	Honduras	Côte d'Ivoire	Myanmar
Bolivia	Nicaragua	Chad	Madagascar	Burundi	Somalia
Burkina Faso	Niger	Congo, Dem. Rep. of	Malawi	Central African Republic	Sudan
Ethiopia	Senegal	Gambia, The	Rwanda	Comoros	Togo
Guyana	Tanzania	Ghana	São Tomé and Príncipe	Congo, Rep. of	
Mali	Uganda	Guinea	Sierra Leone	Lao P.D.R.	
Mauritania		Guinea-Bissau	Zambia	Liberia	

Debt Sustainability for Low-Income Countries

Excessive debt in low-income countries poses serious problems. A debt overhang may undermine urgently needed progress on policy reforms and discourage private investment.

Donors and creditors can help low-income countries achieve debt sustainability, but the primary responsibility lies with the countries themselves. As they strive to reach the MDGs, low-income countries will need to preserve debt sustainability by limiting new borrowing to what they are able to repay and adopting better policies and institutions that help accelerate growth and gradually increase their resilience to exogenous shocks.

IMF staff, in collaboration with World Bank staff, have developed a debt sustainability framework for low-income countries. The aim of the proposed framework is to guide the borrowing decisions of these countries in a way that matches their need for funds with their current and prospective ability to service debt. At the same time, the framework provides guidance for the lending and grant-allocation decisions of official creditors and donors. Specifically, it combines (1) a template for analyzing the actual and projected debt-burden indicators in a baseline scenario and in the face of plausible shocks; and (2) indicative country-specific external debt-burden thresholds related to the quality of the country's policies and institutions.

Following the Executive Board's initial discussion of this framework in February 2004, staff members are undertaking further work on the framework, especially on the indicative thresholds and on the operational implications for the Fund and for other international financial institutions and donors. They will submit a report to the Board for consideration before the 2004 Annual Meetings. In the interim, the IMF is beginning to apply the debt-dynamics template in the Article IV context, in close consultation with World Bank staff. In many countries, debt-sustainability analysis is likely to show that additional borrowing, even on concessional terms, would be incompatible with debt sustainability, pointing to the need to ensure that an adequate share of donor support is provided in the form of grants.

Millennium Development Goals

The eight Millennium Development Goals seek, by 2015, to (1) halve extreme poverty and hunger relative to 1990, (2) achieve universal primary education, (3) promote gender equality, (4) reduce child mortality, (5) improve maternal health, (6) combat HIV/AIDS, malaria, and other diseases, (7) ensure environmental sustainability, and (8) establish a global partnership for development. The Fund has a key role in helping its member countries make progress toward achieving the MDGs through a variety of channels.

The Fund encourages low-income countries to use their Poverty Reduction Strategy Papers to set out realistic plans to achieve the MDGs by strengthening domestic policies and securing additional external financing. Since not all low-income countries have the absorptive capacity to use external assistance on a large scale, Fund staff regularly examine and discuss with country authorities the potential macroeconomic implications of fluctuations in aid flows and of a possible substantial increase in aid to finance the additional spending needed to achieve the MDGs. In this work, the Fund pays close attention to the implications of increasing aid flows for fiscal policy and debt sustainability.

Debt relief, especially through the enhanced HIPC Initiative, is essential to enable low-income countries to free up resources for the social and infrastructure spending that they will need to achieve the MDGs.

Sound domestic policies in low-income countries need to be matched by more support from the international community if the MDGs are to be met. More financial support is crucial and must be on the right terms if future debt distress is to be avoided. In addition, support includes strengthening international trade by improving market access for developing countries' exports and reducing trade-distorting subsidies in advanced economies (see below). Through its multilateral surveillance role, the Fund can act as an advocate for increased foreign aid and increased trade opportunities for low-income countries.

To enhance aid predictability and effectiveness, the Fund is working on donor harmonization and alignment with

Tajikistan



A key element of Tajikistan's Poverty Reduction Strategy Paper (PRSP), which was submitted to the IMF and the World Bank in 2002, was a commitment to undertake reforms that could accelerate growth. These reforms involve addressing constraints to growth in several sectors—namely, agriculture, banking, energy, and infrastructure—and increasing budget expenditures (as a share of GDP) on social services. For example, the Budget Law for 2004 increases spending in these areas by more than 1 percent of GDP. The authorities have finalized a comprehensive strategy for the education sector that includes reforming the curriculum and raising teacher salaries based on merit. And the authorities are reforming the gas (heating) sector in an effort to reduce the quasi-fiscal deficit. While this has meant increasing gas tariffs to cost-recovery levels, the government has sought to protect low-income households through a targeted compensation mechanism. As a result of these efforts and the country's advances under a program supported by the Fund's Poverty Reduction and Growth Facility (PRGF), in April 2004 the Tajik authorities were able to report progress in reducing poverty.

Tajikistan has also strengthened several institutions with ongoing Fund technical assistance in banking, debt management, and tax administration. Technical assistance in the banking sector has led to the restructuring of the central bank as part of an effort to improve the implementation of monetary policy. And, under the country's Fund-supported program, the authorities plan to strengthen the supervision of the banking sector and enhance the banking environment to improve the sector's intermediation function, especially for financing investment.

Tajikistan—IMF activities in FY2004

January 2004	Completion of second review of Tajikistan's performance under the country's PRGF-supported program
April 2004	Submission to Fund's Executive Board of Tajikistan's first Poverty Reduction Strategy Paper progress report; assessment of Tajikistan's statistical standards by Report on Observance of Standards and Codes (ROSC) mission

the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD) and the multilateral development banks. It is also helping donors and national authorities in the field develop more coordinated and streamlined frameworks for disbursing aid.

Joint efforts with the World Bank to strengthen the capacity of public expenditure management systems to track poverty-reducing public spending could contribute to such streamlining by simplifying reporting to donors.

The first *Global Monitoring Report*, prepared by the World Bank in 2004 with input from Fund staff, addresses policies and actions in developed and developing countries needed to achieve the MDGs and the related contribution of major agencies. The report makes clear that, although progress has been made, achievement of the development goals will require all parties to scale up their actions in line with the principles and partnership established at Monterrey.

The Fund staff is cooperating with the World Bank in the preparation of a report, "Mobilizing Financing for Development," scheduled to be completed by the time of the 2004 Annual Meetings. This report will consider proposals for international financing facilities and other modalities to increase current official development aid. (For an example of other joint efforts, see Box 4.2.)

Doha Round and Other Trade-Related Issues

A successful conclusion of the Doha Development Round of multilateral trade talks is essential for the world economy and will benefit all countries. As noted above, it will also contribute significantly to efforts by the international community to meet the Millennium Development Goals. Indeed, Directors have noted that the MDGs will be hard to achieve should the Doha Round fail.

During FY2004, the IMF continued to press for the successful conclusion of the Doha Development Round (began in 2001), and, together with the World Bank, urged participants from both developed and developing nations to make this a priority. In response to the setback in talks in Cancún, Mexico, in September 2003, the IMF Managing Director and the President of the World Bank sent a letter in November to heads of state and government, as well as trade and finance ministers, stressing the importance of pressing forward with the Doha Round. The letter emphasized the need for the meaningful liberalization of agricultural trade, for all countries to take on substantive obligations to liberalize trade, and for flexibility in areas that may result in heavy regulatory burdens on poor countries.

These messages were echoed in the April 2004 Communiqué of the International Monetary and Financial Committee (IMFC), which called for all countries to achieve early progress with the Doha Round by focusing their efforts on open markets and fair access and the reduction of trade-distorting subsidies, especially in agriculture. The IMFC members noted that a successful completion of the round is a shared responsibility, important for all countries, particularly developing countries.

The IMF itself has been doing its part to support an open international trading system. In April 2004, the Board approved a new financing policy, the Trade Integration Mechanism (TIM; see Section 3), aimed at mitigating concerns that countries might find it hard to cope with temporary balance of payments shortfalls resulting from the implementation of World Trade Organization agreements or nondiscriminatory trade liberalization by other countries. Under the new policy, the Fund has committed itself to providing access to its resources, within its existing facilities, to help countries meet balance of payments needs

resulting from specified trade measures taken by other countries and to augment such access if the effect is larger than anticipated.

Apart from the TIM, the Fund has helped to ensure member countries can take full advantage of the opportunities of multilateral trade liberalization by

- providing technical assistance in such areas as customs reform, tax and tariff reform, and data improvements;
- participating in the Integrated Framework for Trade-Related Technical Assistance to help incorporate trade reforms in national poverty reduction strategies;
- identifying potential risks and helping authorities to understand the benefits of international integration; and
- using its research capacity to assess the impact of trade reforms on member countries (for example, model simulations to measure the implications of reduced agricultural subsidies, preference erosion, and the phase-out of textile quotas).

Box 4.2 Second Regional Conference on Poverty Reduction Strategies

More than 150 government and civil society representatives, parliamentarians, and academics gathered at the second East Asia and Pacific Regional Conference in Phnom Penh on October 16–18 to share their experiences with designing and implementing poverty reduction strategies. Delegates also offered practical advice on broadening participation, decentralizing, “localizing” efforts to achieve Millennium Development Goals (MDGs), and addressing gender issues.

The conference—sponsored by the Asian Development Bank, the IMF, the United Nations Development Program, and the World Bank—focused on developments in Cambodia, Indonesia, Lao People’s Democratic Republic, Mongolia, Timor-Leste, and Vietnam.

Delegates emphasized the need to coordinate and integrate poverty reduction strategies with core national planning and budgeting to enable effective implementation as well as strengthen links between poverty reduction

strategies and the MDGs. They agreed that rural development, agricultural productivity, and trade opportunities played a critical role in efforts to boost growth and reduce poverty. On the theme of broadening participation, the delegates called for expanding the role of legislators, as representatives of the people, in the poverty reduction process.

A number of speakers at the conference recognized the challenges posed by decentralization. Dr. Bambang Bintoro struck a more optimistic, though still cautious, note when he said that the “big bang” approach to decentralization in Indonesia has led to “a new intergovernmental fiscal framework . . . a new accountability system at the local level, and it has promoted a vibrant civil society at the local level that can critically monitor local politics.”

The conference participants recognized the critical importance of the MDGs in providing benchmarks to measure progress in reducing poverty and promoting human development

and in mobilizing political commitment. Delegations from Cambodia and Vietnam described how their countries were “localizing the MDGs”—tailoring them to their specific circumstances. Mr. Nguyen Van Phuc of Vietnam indicated that his country had created different time frames for different goals. Vietnam had made substantial progress, for example, in boosting incomes, he said, but in other areas where more progress is needed, the country had added new goals, such as governance measurements.

As the conference drew to a close, participants pointed to the progress that had been made since the country teams met two years earlier at the first East Asia and Pacific Regional Conference in Hanoi when the countries were just embarking on their poverty reduction strategies. They also acknowledged that more needed to be done to coordinate and simplify external assistance and ease the reporting burden on limited local capacity.