The Medium-Term Strategy

CHAPTER • 2

In 2004, the year the IMF marked its 60th anniversary, its Managing Director, Rodrigo de Rato, initiated a broad strategic review of the organization's operations. A management-staff Committee on the Strategic Review, chaired by First Deputy Managing Director Anne Krueger, was set up, and discussions were held between staff, management, and the Executive Board, as well as with country authorities and outside observers. In September 2005, the Managing Director presented a report[1] outlining proposals for a Medium-Term Strategy (MTS) to the International Monetary and Financial Committee (IMFC), the primary advisory committee of the Fund's Board of Governors, after it had been broadly endorsed by the Executive Board. This report suggested that a central tenet of the Fund's work should be to help members meet the challenges of globalization. Using that framework, the report identified the Fund's key tasks as enhancing the effectiveness of surveillance, adapting to new challenges and needs in different member countries, helping member countries build institutions and capacity, addressing the issue of fair quotas and voice, and prioritizing and reorganizing work within a prudent medium-term budget. The IMFC welcomed and supported the broad priorities set forth in the report, and looked forward to specific proposals and timelines on the main tasks identified.

Six months later, after staff working groups had reviewed the IMF's policies and activities and made recommendations to management on possible improvements, the Managing Director presented his "Report on Implementing the Fund's Medium-Term Strategy"[2] to the Executive Board in early April 2006 (Box 2.1).

Implementing the Medium-Term Strategy: Executive Board Discussion

The Executive Board discussed the report on implementing the Medium-Term Strategy on April 3, 2006. It considered the issues that need to be addressed as the institution moves forward from conceptualizing the Medium-Term Strategy to implementing it.

Surveillance

Directors reiterated the importance of making Fund surveillance more effective, particularly by focusing both global and country surveillance on essential issues, sharpening the discussion of the context and of spillovers, remaining at the forefront of analysis, safeguarding the IMF's independence, and strengthening outreach. They agreed that the Fund remains the premier institution for global surveillance and that it should do more to leverage its universal membership and macroeconomic expertise to achieve progress on key multilateral issues.

Directors generally welcomed the further exploration of modalities for a new consultation procedure in a multilateral format that would allow the Fund to take up systemic issues collectively with key members as well as with regional entities.[3] A number of Directors underscored that the Board and the IMFC must be a key part of this process, as envisaged in the Managing Director's proposal, and that this approach must be transparent. Some Directors offered specific suggestions, as well as some qualifications. Directors also supported the intention to develop regional outreach—and, with a view to strengthening the multilateral perspectives of country surveillance—to develop new modalities for regional surveillance.

Broad support was also expressed for increased emphasis on the Fund's original objective of exchange rate surveillance, which remains to assess the consistency of exchange rate policies with national and international stability. Directors looked forward to a review of the 1977 Surveillance Decision. In this context, Directors generally welcomed management's intention to deepen the work of the Consultative Group on Exchange Rates, including by extending the scope of existing analyses of multilaterally consistent equilibrium rates to cover major emerging market currencies. Many Directors did not support publication of equilibrium exchange rates because of the market sensitivity of

[1]"The Managing Director's Report on the Fund's Medium-Term Strategy," *www.imf.org/external/np/omd/2005/eng/091505.pdf.*

[2]"The Managing Director's Report on Implementing the Fund's Medium-Term Strategy," *www.imf.org/external/np/pp/eng/2006/040506.pdf.*

[3]The first multilateral consultations, focused on the issue of global imbalances, were launched in June 2006. See *www.imf.org/external/np/sec/pr/2006/pr06118.htm*.

Box 2.1 Key elements of the IMF's Medium-Term Strategy

Surveillance. Increasing effectiveness by focusing on the essential, framing and discussing issues in a multilateral context, sharpening exchange rate analysis, and better integrating macroeconomic and financial market analysis. Also, safeguarding independence, staying at the forefront of analysis, and strengthening outreach efforts.

Emerging market economies. Centering work on financial and capital market issues, and ensuring appropriate financing instruments and terms.

Low-income countries. Supporting, in concert with others, the assessment and monitoring of aid flows in the context of the Millennium Development Goals (MDGs); assisting members in the development of medium-term debt strategies; refining the focus on macro-critical issues; reviewing modalities for Fund-Bank collaboration; and assessing possibilities for adapting facilities for post-conflict countries.

Fund governance. Reflecting important changes in the weight and role of members in the world economy in a fair distribution of quotas, adopting a transparent procedure for the selection of the Managing Director, and balancing Executive Board oversight with operational involvement at a detailed level.

Capacity building. Better aligning Fund capacity building with member needs and complementarities with other donors, and prioritizing work on the Financial Sector Assessment Program and on standards and codes.

Streamlining Fund operations. Eliminating extraneous documentation and increasing the efficiency of operations.

The Fund's medium-term budget. Embedding Medium-Term Strategy priorities in a sustainable medium-term real budget envelope and placing the Fund on a sound financial footing for the long term.

the information and the need to further refine analytical methods. There was a constructive exchange of views on whether exchange rate surveillance in the context of capital mobility should focus primarily on exchange rate policies, the exchange rate regime, or the exchange rate level. Directors underlined the importance of Article IV surveillance (see Chapter 3) in assessing the consistency of exchange rate policies, as well as of other macroeconomic policies, with international financial stability and sustainable growth. At the same time, some Directors raised concerns about undue focus on exchange rates at the expense of other policies and their spillovers. The Board will return to these issues when it reviews the 1977 Surveillance Decision.

Directors strongly endorsed strengthening the Fund's two flagship publications, the *World Economic Outlook* and the *Global Financial Stability Report*, and offered suggestions on steps to enhance their coverage and impact. They also welcomed proposals in the Managing Director's report to make surveillance more effective. This will require raising the standard of coverage of financial sector issues, clarifying and streamlining the focus of consultations through the development of multiyear surveillance agendas, underscoring the national context, and bringing to bear the multilateral perspective in consultations with individual countries. Directors noted the importance of avoiding a one-size-fits-all approach to financial sector surveillance, given countries' varying situations and levels of development. In addition, Directors supported simplifying bilateral consultation procedures for a selected number of countries every other year, but in a way that ensures that members are treated fairly and that the effectiveness of the Fund's advice on core surveillance issues is not reduced.

Directors underlined the importance of effective communication to the authorities and the broader public in explaining the policy recommendations developed in the Article IV process and in gaining wide support for them. In such outreach, the Fund will need to be mindful of its role as confidential advisor to members and to work closely with the concerned authorities and Executive Directors. It will also need to assess further the cost implications of outreach efforts.

Emerging market countries

Directors viewed the placement of financial and capital market issues at the center of the Fund's work in emerging market countries as a key element of the IMF's strategy. The new department created from the merger of the Monetary and Financial Systems Department and the International Capital Markets Department will play the key analytical and catalytic role in this process, and these efforts will be supported by prioritization of the Financial Sector Assessment Program and the Fund's work on standards and codes (see Chapter 4).

The role of the Fund in ensuring that adequate financing is available to emerging market countries covers a wide range of complex issues. The Board discussion of the report on the Medium-Term Strategy and the months of debate on the IMF's role that preceded the discussion provided Directors with a unique opportunity to clarify the framework for Fund financing for emerging market countries. The report's recommendations include revising the guidelines on exceptional access to Fund resources outside the context of a capital account crisis, establishing flexible modalities for the duration of large-scale financing, and relying on price-based incentives to encourage early repayment. A variety of views was expressed as to whether to modify the existing framework for exceptional access or to apply the existing framework rigorously to any new cases, with many Directors supporting a review of the guidelines.

Directors expressed broad support for further work on a new instrument for providing high-access contingent financing for countries that have strong macroeconomic policies, sustainable debt, and transparent reporting but still face balance sheet weaknesses and vulnerabilities, as proposed in the Managing Director's report. Taking into account Directors' comments during the discussion, the Fund will continue to explore the modalities of the role it could play in judiciously supporting regional and other arrangements for pooling reserves, including by signaling sound policies.

The discussion also covered the IMF's role in debt restructuring and lending into arrears in emerging market countries. Directors generally agreed that the orderly resolution of arrears should remain an important condition for Fund lending. They broadly endorsed the concept that financing in a debt restructuring case should be based on an agreed medium-term fiscal envelope and a macroeconomic framework on which the Fund expresses a clear view. In addition, they agreed that greater clarity is needed on how to define the good faith criterion in light of recent experience and in the absence of a structured debt restructuring framework of the kind that existed in the 1980s. Directors looked forward to the forthcoming staff paper reviewing all aspects of the Fund's approach to lending into arrears.

Low-income countries

In assessing the role of the IMF in low-income countries, Directors noted that two main considerations will play an important role, namely, the expected increase in aid flows, including debt relief; and the international community's responsibility for monitoring progress toward the Millennium Development Goals (MDGs)—a task in which the Fund will need to be judiciously involved within its areas of core competence.

Directors discussed how the Fund could best participate with others in assessing and monitoring aid flows in the context of the MDGs. They reviewed the principal recommendations in the Managing Director's report, which view Fund staff as making a contribution in its areas of competence by monitoring, advising, and reporting on the aggregate resource use of low-income countries, including their macroeconomic absorptive capacity. The Fund staff could perform this role effectively only by relying on other institutions—especially the multilateral development banks—with the necessary expertise in making assessments of the costs of meeting the development goals and helping to mobilize the necessary funding. On the basis of such partnerships with these institutions, the Fund could then in principle be well placed to advise donors on the circumstances in which there is scope for more aid to be absorbed or, conversely, in which aid flows could create the risk of macroeconomic instability.

Directors expressed a variety of views on such a role for the Fund on aid flows. Although there was broad agreement that the IMF should assess the macroeconomic impact of aid flows, many Directors expressed reservations about taking the Fund's role much beyond that—citing the limits of the IMF's mandate, the risk of mission creep, the resource-intensive nature of this kind of work, and the extremely limited scope for finding additional resources within the Fund's budget. It was agreed to reflect on these aspects of the discussion, exploring further the feasibility of mobilizing additional external funding for capacity building and for field-based collaboration with donors, and obtaining the necessary support from the multilateral development banks.

Directors also underscored the importance of ensuring that the beneficiaries of debt relief do not again accumulate excessive debt and called upon Fund staff to support these countries' efforts to develop a medium-term debt strategy, both in the context of IMF-supported programs and for nonprogram countries. In addition, stronger public expenditure management systems will be needed in many countries to ensure the effective use of resources released by debt relief. Directors agreed that, while the Fund may provide technical assistance in this area, it does not have expertise in sectoral allocation assessments, which remain the responsibility of the World Bank and other institutions.

They considered it critical for the effectiveness of the IMF's work in low-income countries that its policy advice, support for capacity building, and financial assistance be well focused on macro-critical issues, including institutions relevant to financial stability and economic growth. Given that economic development requires an interdisciplinary view and collective actions, clear understandings with other development partners will be crucial. Directors accordingly broadly welcomed the proposal for a country-specific division of labor between the Fund and the Bank. Following careful identification of the main growth-critical issues and the assistance required by the authorities in each low-income country, Fund and Bank staff, working with development partners and country authorities, would aim to agree on the areas in which they are prepared to take the lead, with Fund staff limiting their responsibility to those areas that fall within their macroeconomic and financial expertise. This will provide a valuable guidepost to the division of operational responsibilities between the two institutions at the country level. Some Directors considered that a clearer delineation should yield cost savings for the Fund.

Directors considered it timely to review the modalities for Fund-Bank collaboration set out in the 1989 Concordat and looked forward to the recommendations of the recently established External Review Committee on Bank-Fund Collaboration and to the work of the joint task force set up by the two managements (see Box 9.5).

Directors discussed the suggestion that, in some cases, such as post-conflict countries, the standard of upper credit tranche conditionality may be unreasonable. The staff will explore the possibilities for a facility with a more flexible standard and a larger capacity-building component, while bearing in mind the views of a number of Directors that the Fund's current toolkit might already offer possible ways to address these issues. Most Directors supported the proposal to eliminate Joint Staff Advisory Notes to allow better prioritization of staff resources.

Governance

Directors addressed the issues on IMF governance raised in the Managing Director's report. On quotas and voice, Directors agreed that the Fund's membership should aim for a significant step toward dealing with these issues by the September Annual Meetings in Singapore. A variety of views was expressed on the best way forward, with most Directors suggesting that a two-stage approach might offer the best hope. Most Directors also agreed that ad hoc quota increases for the members most underrepresented in terms of their weight in the world economy should be the centerpiece of the first stage. A broader consensus still needs to be reached, however, on how best to address other elements, including basic votes, the quota formula, and the size and composition of the Executive Board (see Chapter 9). Directors looked forward to the discussion of quotas and voice at the April 2006 meeting of the IMFC, which would provide the basis for making further progress with the aim of reaching the broadest possible consensus by the time of the Singapore meetings. Some Directors felt that such a consensus is more likely to be reached if there is a clear understanding on the elements to be included in each stage of the process. Some Directors were opposed to any ad hoc solutions in a two-stage process and preferred that the second stage be taken up immediately.

Directors acknowledged the importance of establishing an agreed transparent procedure for the selection of the Managing Director, and agreed to reflect further on the best way forward. Many Directors noted that this proposal should apply to all members of management. Directors also concurred that the Executive Board must ensure that its oversight is carried out in the most effective way possible and looked forward to returning to this issue.

Capacity building

Directors agreed that the IMF should continue to work to better align its efforts to build capacity with the evolving needs of members while addressing the constraints stemming from the growing pressures on the Fund's finances. They welcomed the report's suggestions designed to establish a coherent and integrated approach combining the objectives of member countries, the expertise of functional departments, and the perspectives of area departments. They also welcomed the proposed leading role of the area departments in producing technical assistance strategy notes that would identify capacity-building priorities for each member and form the basis for allocating the Fund's resources (see Chapter 7). Directors concurred that the key priorities would include the financial sector, public finances—with a focus on revenue administration and public expenditure management—and statistics. They called on staff to explore the scope for raising additional external financing, and the feasibility and usefulness of levying charges for technical assistance and training while subsidizing low-income countries. Directors also broadly endorsed the suggestions for prioritization of the Reports on the Observance of Standards and Codes (see Chapter 4).

Streamlining

Directors discussed the wide range of suggestions to streamline procedures and reduce the flow of paper, and generally favored moving forward to implement them, including longer intervals between policy reviews; greater flexibility in ex post assessments; more selective production of selected economic issues papers and statistical appendixes; greater reliance on lapse-of-time procedures for on-track program/post-program monitoring reviews; streamlined surveillance and program reviews; and reduced rigidities in misreporting procedures. Some Directors noted the importance of not undermining the effectiveness of ex post assessments and misreporting procedures. Staff will come back to the Board with proposed modalities requiring Board endorsement.

With regard to enhancing the effectiveness of Board discussions, some Directors pointed to the role of the Chair in facilitating full and interactive exchanges of views by Directors, and to the contribution that a more active and candid engagement by staff could make. Directors saw merit in reshaping the work program as a vehicle more directly linked to the implementation of the Medium-Term Strategy, with the Board maintaining a key role in shaping the priorities and contributing to the smooth implementation of the work program without undermining management oversight.

Medium-term budget

While Directors broadly supported the framework suggested in the Medium-Term Strategy, they emphasized that the final decisions on priorities and implementation would have to be taken in the context of the underlying budgetary envelope. In referring to the decline of Fund income, they stressed the need to address the resulting financing gap and urged decisive actions on both the income and the expenditure sides. On the income side, they emphasized the importance of finding solutions that will place the Fund on a sound financial footing over the long term, based on stable and predictable sources of income. Directors acknowledged the contribution that an external committee, headed by an eminent personality, could make to advance efforts of the Managing Director and the Board to come to a solution that can be sustained.[4] They noted that the Board would have a key role in forging a broad consensus in this complex area and that the priorities outlined could be accomplished in a moderately declining medium-term budgetary framework. In this context, and while welcoming the Fund's efforts to implement the proposed strategy in a budget-neutral manner, some Directors believed that a more ambitious stance might be required, especially given the uncertainty of the outcome of the income situation. Such efforts could include the need to revisit the strategic priorities and the implementation framework of the present medium-term proposals.

International Monetary and Financial Committee Meeting, April 22, 2006

At its April 2006 meeting, the IMFC welcomed the Managing Director's report on implementing the Medium-Term Strategy and called on management and the Executive Board to complete their considerations and move rapidly to implementation. The IMFC reiterated that the IMF's effectiveness and credibility as a cooperative institution must be safeguarded and its governance further enhanced, emphasizing the importance of fair voice and representation for all members. It underscored the role an ad hoc increase in quotas would play in improving the distribution of quotas to reflect important changes in the weight and role of countries in the world economy and called on the Managing Director to work with the IMFC and the Executive Board to come forward with concrete proposals for agreement at the September 2006 Annual Meetings in Singapore.

It also supported a review of the 1977 Surveillance Decision, with a view to making IMF surveillance more effective. In the context of the Managing Director's Medium-Term Strategy, the IMFC proposed a new focus on multilateral issues, especially the spillovers from one economy on others; a restatement of the commitments that member countries make to each other under Article IV; implementation of the new multilateral consultations procedure described above, involving the IMFC and the Executive Board; and an annual remit set by the IMFC for country and multilateral surveillance through which the Managing Director, the Executive Board, and the staff are accountable for the quality of surveillance.

The IMFC also welcomed the Fund's efforts to respond to the new challenges and needs of emerging market members. It supported further examination of the Managing Director's proposal on a possible new instrument to provide high-access contingent financing for countries that have strong macroeconomic policies, sustainable debt, and transparent reporting but remain vulnerable to shocks. It encouraged the Fund to explore the role it can play in supporting regional arrangements for pooling reserves and supported a review of the operational aspects of the IMF's policy on lending into arrears.

Stressing the critical role the IMF plays in low-income countries, including in helping to ensure that expected increases in aid flows and debt relief are absorbed effectively and in a manner consistent with macroeconomic stability, the IMFC called on the Fund to play its part within its areas of core competence in monitoring progress toward the MDGs. It supported efforts to clarify the division of responsibilities and accountabilities of the IMF and the World Bank and to improve their collaboration.

It also noted the recent decline in the Fund's lending, which requires actions on both income and expenditure, and called on the Managing Director to develop proposals for more predictable and stable sources of income.

The full text of the communiqué appears in Appendix IV of this *Report.*

[4]An external committee composed of eight eminent persons was established shortly after the end of the financial year. See Box 8.7 for a discussion of the Fund's medium-term income outlook and options.