CHAPTER 1

OVERVIEW: REFOCUSING THE IMF

OVERVIEW: REFOCUSING THE IMF

The global economy faced a number of challenges during FY2008. As problems in the U.S. subprime mortgage market spilled over into other credit markets, growth prospects slowed in a number of the advanced economies; at the same time, prices for food and oil surged, adding to inflationary pressures worldwide and creating severe hardships for many low-income countries.[1] The IMF's Executive Board—in accordance with the Fund's core mandate of safeguarding global macroeconomic and financial stability—responded to these developments immediately, strengthening the Fund's analysis of financial sector issues, recommending policies that could help member countries mitigate the impact of turmoil in financial markets on their economies, and offering policy advice to low-income countries on macroeconomic management in the face of rising costs for food and fuel as well as financial assistance to members in this group experiencing balance of payments problems triggered by the higher cost of imports.[2]

FY2008 was also a year of reform in the IMF, as the Executive Board moved ahead with measures that will enable the IMF to better meet the evolving needs of its member countries, keep pace with changes in the global economy and financial markets, and adjust to a reduced budgetary envelope.

1 Chapter 2 describes developments in the global economy and financial markets in FY2008.

2 As set out in its Articles of Agreement, the Fund is charged with, among other things, safeguarding the stability of the international monetary system and promoting sustainable economic growth. The Articles of Agreement can be found on the IMF's Web site, at www.imf.org/external/pubs/ft/aa/index.htm.

3 For an update on the progress made toward the Fund's key strategic objectives, see CD-Box 1.1 on the CD-ROM.

4 See "IMF Executive Board Adopts New Decision on Bilateral Surveillance Over Members' Policies," PIN 07/69, on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pn/2007/pn0769.htm.

5 See "The Recent Financial Turmoil—Initial Assessment, Policy Lessons, and Implications for Fund Surveillance," the paper discussed by the Board, which can be found on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/pp/eng/2008/040908.pdf.

The Board adopted a new, comprehensive framework for bilateral surveillance focused on identifying policies that could jeopardize macroeconomic and financial stability at both the national and the global levels.[3] In response to the turmoil in financial markets, it concentrated on analyzing the spillovers between individual economies and the global economy, and the linkages between financial markets and the real economy. It also took steps to improve the Fund's governance structure, agreeing on a significant package of quota and voice reforms designed to realign the quota shares of member countries with their relative weight in the global economy and to enhance the voice and participation of low-income countries in the Fund's decision making. Another landmark achievement of FY2008 was the Board's agreement on a new income and expenditure framework that will enable the Fund to put its finances in order.

These and other activities of the Board are described in greater detail in this chapter and the chapters that follow.

SURVEILLANCE

The IMF's surveillance activities are anchored in bilateral surveillance—the oversight of economic policies in member countries to ensure that members comply with their obligations under the Articles of Agreement and that their policies contribute to the stability of the international monetary and financial system. In early FY2008, after a year-long review of the 1977 Decision on Surveillance over Exchange Rate Policies, the Executive Board adopted a new framework for bilateral surveillance. The 2007 Decision on Bilateral Surveillance provides more complete guidance both to the Fund in the conduct of surveillance and to member countries in the conduct of exchange rate policies, but without creating new obligations for members. An important innovation is the 2007 Decision's introduction of the concept of external stability as an organizing principle of surveillance. As the 1977 Decision did, the 2007 Decision enjoins members to avoid exchange rate manipulation for specific purposes; it also recommends that members avoid exchange rate policies that result in external instability, regardless of their original purpose. It thus captures exchange rate policies that have proven over time to be a major source of instability. The Board viewed the adoption of the Decision as an important contribution to the Fund's efforts to discharge its surveillance responsibilities effectively and in an evenhanded manner.[4]

During FY2008, the Board devoted considerable attention to the turmoil in international financial markets, as reflected in its discussions of the *World Economic Outlook* (WEO) and the *Global Financial Stability Report* (GFSR), the IMF's primary vehicles for multilateral surveillance (see Chapter 3). The impact of the turmoil on global stability and growth was a central topic of the April 2008 WEO, while the April 2008 GFSR analyzed the impact on the international financial system and assessed the potential for spillovers, examining real and financial transmission channels and providing advice on short-term measures member countries could take to mitigate the impact of the turmoil on their economies.

Executive Directors also reviewed, in April 2008, the IMF staff's initial assessment of the events in financial markets, broadly supporting its preliminary findings and recommendations. The Board's discussion of the assessment covered risk-management practices related to structured finance products; the valuation of such products and the role and design of credit ratings for them, as well as accounting and disclosure practices; crisis and emergency liquidity management, including by central banks; and the regulation and prudential oversight of banks and other financial entities.[5] While recognizing that events were still evolving at the time of the discussion, Executive Directors underlined the importance for Fund surveillance of analyzing the causes of the turmoil and drawing lessons from

6 The Communiqué, PR 08/78, can be found in Appendix III on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/cm/2008/041208.htm.

it, and encouraged staff to continue to work closely with national authorities, international bodies, and market participants. In addition, a new methodology for distinguishing between vulnerabilities and crisis risk in emerging market economies was developed during the year, and the Spring 2008 Vulnerability Exercise focused on the impact of the financial market turmoil on these economies.

Given the increasingly important role played by sovereign wealth funds (SWFs) in the international monetary and financial system, the Executive Board, in its March 2008 discussion of such funds, considered that the IMF was well placed to facilitate and coordinate the development of voluntary principles and practices for SWFs, in collaboration with other organizations. The IMF is providing the secretariat for an international working group composed of representatives of 25 member countries that is tasked with developing a common set of voluntary principles for SWFs by the 2008 Annual Meetings of the IMF and the World Bank. This initiative was welcomed by the International Monetary and Financial Committee, the main advisory body of the IMF's Board of Governors, in its Communiqué of April 12, 2008.[6]

To further strengthen the framework within which the IMF conducts surveillance, the Executive Board began discussing the design of the Triennial Surveillance Review in April 2008. The Review is expected to include a Statement of Surveillance Priorities.

The Fund's surveillance activities during FY2008 are described in detail in Chapter 3.

PROGRAM SUPPORT AND CAPACITY BUILDING

The Executive Board continually reviews the IMF's financing facilities, capacity-building activities, and other programs and instruments through which the IMF provides assistance to member countries and adjusts them as the latter's needs change. The *emerging market economies'* demand for IMF lending has declined sharply over the past few years, as they reaped the benefits of their own improved policies, which have resulted in stronger economic fundamentals, and of benign market conditions. These economies, as a group, continued to grow strongly in FY2008, despite the slowdown in the advanced countries, and appeared resilient to the turmoil in financial markets, although in some cases balance of payments difficulties are emerging. However, vulnerabilities remain, particularly in emerging market countries heavily dependent on large capital inflows for financing current account deficits. Accordingly, in addition to standing ready to provide support via the Fund's existing lending instruments, the Board has placed increased emphasis on the analysis of financial sector risks and macrofinancial linkages, provision of advice and technical assistance in strengthening debt-management practices, and development of a liquidity or crisis prevention instrument—such as a rapid access line or a financial stability line—for countries integrating into global capital markets in the event they experience a sudden reversal of capital inflows.

The Executive Board is also taking steps to deepen the IMF's engagement with *low-income countries*, which is evolving as countries' economies grow and mature. There is growing emphasis on providing advice on policy responses to capital inflows, commodity price swings (including for food and oil), financial market development, and debt sustainability, among other things. One of the most serious challenges facing policymakers in low-income countries in FY2008 was the soaring cost of food and fuel imports, which threatened poverty reduction efforts and the low-income countries' ability to achieve the Millennium Development Goals (MDGs) by 2015. The IMF moved rapidly to help vulnerable members assess the implications of rising prices for their fiscal policy, balance of payments, and income, and convened a task force to coordinate the Fund's response to the crisis. At a briefing in April 2008, Executive Directors generally approved the task force's work program, supporting the provision of policy advice to low-income members adversely affected by higher food and fuel prices, as well as financial assistance, through both existing and new Poverty Reduction and Growth Facility (PRGF) arrangements and the Exogenous Shocks Facility (ESF), to countries suffering balance of payments problems. Executive Directors also encouraged Fund staff to cooperate with other international organizations working on measures to alleviate supply constraints.

As a participant in the UN High-Level Task Force on the Global Food Security Crisis, which was established in April 2008, the IMF is collaborating with a number of UN agencies and the World Bank in promoting a unified response to the global food price challenge, including by facilitating the creation of a prioritized plan of action and coordinating its implementation. In early FY2009, the Board approved financing through the PRGF for seven countries affected by the crisis, and considered revising the ESF to make it more easily accessible to countries facing food and fuel price increases.

Another measure to assist low-income countries in their efforts to reduce poverty and reach the MDGs was the Executive Board's approval in FY2008 of changes making the framework for the Heavily Indebted Poor Countries (HIPC) Initiative more flexible. To reduce delays in making debt relief available to HIPCs with protracted arrears, for example, the Board determined that performance under a Staff-Monitored Program meeting certain standards could count toward the track record of sound policies countries need to establish to reach the so-called decision point under the Initiative, when they receive commitments of debt relief from the international community (and may start receiving interim debt relief) pending further economic reforms. Liberia was the first country to benefit from the changes to the framework (see Box 4.1). The Board also considered a new framework for providing more effective capacity-building and financial assistance to so-called fragile states (states such as post-conflict countries, whose economic and social performance is impaired by weak governance, limited administrative capacity, social tensions, and a tendency to political instability), and called on management to prepare operational proposals that reflect the Board's views and the views of potential recipients and donors for discussion in FY2009.

The Executive Board is taking steps to make delivery of the Fund's *capacity-building assistance*—technical assistance (TA) and training—to member countries more efficient and cost-effective. It is emphasizing more rigorous prioritization and greater integration of TA and training with surveillance and lending, heightened collaboration with other donors, and increased external funding to leverage the IMF's own resources. It is also considering charging graduated fees according to recipient countries' per capita income. Many improvements in the Fund's capacity-building activities have already been implemented in the past few years, including relying more heavily on the regional technical assistance and training centers, having the Fund's area departments take the lead in setting TA strategies in coordination with country authorities, introducing quantitative performance indicators for TA, and mobilizing increased donor funding for training.

The IMF's role in, and support for, emerging market and developing countries is described in detail in Chapter 4.

GOVERNANCE, FINANCES, AND ORGANIZATION

Following two years of extensive discussions, the Board of Governors approved on April 28, 2008, an important package of reforms of the Fund's governance that will increase the voice and representation of emerging market and low-income countries.[7] The package, which delivered more than the Board of Governors committed to in its Resolution of September 18, 2006, sets out a quota formula that is simpler and more transparent than the five-formula system it replaces and calls for ad hoc quota increases for 54 members to realign their quota shares with their relative weights and roles in the global economy. The package also includes an amendment providing for a tripling of basic votes[8] to increase the voice of low-income countries (the first increase in basic votes since the Fund was established); creating a mechanism to ensure that the ratio of total basic votes to total voting power remains constant in the event of future quota increases; and authorizing a second Alternate Executive Director for Executive Directors elected by a large number of members, which in the current circumstances will benefit the two African chairs on the IMF's Executive Board. The Board of Governors' Resolution represents a major step forward in the modernization and restructuring of the Fund to better reflect the changing realities of the global economy. The proposed amendment on the increase in basic votes and the second Alternate Executive Director will enter into force once three-fifths of the Fund's members having 85 percent of the total voting power have accepted it. The ad hoc quota increases will become effective after the proposed amendment has entered into force and require each relevant member's consent to, and payment of, its quota increase.

The Board also reached agreement on a new income and expenditure framework that is expected to put the IMF's finances on a sounder footing. On the expenditure side, the Board identified approximately $100 million in savings to be achieved over the next three financial years through reductions in both staff

7 See "IMF Executive Board Recommends Reforms to Overhaul Quota and Voice," PR 08/64, on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pr/2008/pr0864.htm. The "Report of the Managing Director to the IMFC on Quota and Voice Reform in the IMF" can be found on the CD-ROM or on the IMF's Web site, at www.imf.org/external/pp/longres.aspx?id=4242.

8 As set out in the IMF's Articles of Agreement, each member was originally allotted 250 basic votes plus one vote per SDR 100,000 of its quota.

and nonstaff costs, and set out how a leaner, refocused institution will better serve its membership. On the income side, the Board of Governors approved on May 5, 2008, a proposed amendment to expand the investment authority of the Fund, which, to become effective, requires the acceptance of three-fifths of the Fund's members having 85 percent of the total voting power.[9] As part of the new income model, the Executive Board also supported a proposal to create an endowment funded with profits from the sale of a limited part of the Fund's gold. All Executive Directors have indicated either that they are ready to vote in favor of a decision to sell a limited portion of the Fund's gold, or that they will seek legislative approval to vote in favor of such a decision.[10] In parallel with the changes agreed in principle to the Fund's income and expenditure framework, the Board amended the terms of reference for its Budget Committee, to enable the Committee to consider the income and the expenditure sides of the budget together, in an integrated framework.

The IMF's communications strategy was also reviewed by the Executive Board in FY2008. The Board welcomed the efforts being made to better integrate the Fund's operations with its communications in building support for the Board's reform agenda. As part of this strategy, the Fund is increasingly shifting to Web-based and multimedia technologies and tailoring its outreach to key audiences of opinion leaders. It is also broadening its outreach by systematically producing key materials in languages other than English that are heavily used in the Fund's work, and refocusing its publishing program.

The IMF's institutional transparency continues to be high. In FY2008, the Fund published its third annual update on the implementation of its transparency policy, indicating that the overwhelming majority of country documents and policy papers are published, even though publication is voluntary.

The Board also continued to strengthen the Fund's risk-management framework during FY2008. It welcomed the Advisory Committee on Risk Management's update at an informal Board briefing in January with a call for greater prioritization in the risk-management framework and more consideration of risks stemming from misreporting by members. Also in January, in a briefing to the Board, the External Audit Committee indicated satisfaction with the Fund's internal and external audit processes and encouraged the Fund to take steps to make its financial statements clearer, implement a whistle-blower policy, and adopt a more formalized incident-reporting process.[11]

As part of its efforts to formalize the framework for IMF accountability, in FY2007, the Board called on Fund management to produce implementation plans for Board-endorsed recommendations in the Independent Evaluation Office's (IEO) assessments of Fund activities and, in FY2008, to issue periodic monitoring reports on the state of implementation. Three implementation plans have been produced so far; they cover the Board-endorsed recommendations in the IEO's evaluations of the IMF and aid in sub-Saharan Africa, the Fund's advice on exchange rate policies, and structural conditionality in Fund-supported programs. The first periodic monitoring report, which was issued in FY2008, covered recommendations from IEO evaluations that were discussed by the Board before the new formalized framework was put in place.

Turning its attention to sharpening the focus of its own work, in FY2008 the Board approved the recommendations of a working group of Executive Directors that was convened to examine the structure and mandate of Board committees and amended the terms of reference of a number of these committees accordingly. Notable among the changes approved was the broadening of the Budget Committee's mandate, as mentioned above, and the establishment of a Committee on Liaison with the World Bank and Other International Organizations, which is charged with keeping the Board informed of developments at other institutions whose work also involves promoting economic stability and growth.

More detail about the Fund's governance, finances, and organization can be found in Chapter 5.

9 See "IMF Board of Governors Approves Key Element of IMF's New Income Model," PR 08/101, on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pr/2008/pr08101.htm.

10 See "IMF Managing Director Strauss-Kahn Applauds Executive Board's Landmark Agreement on Fund's New Income and Expenditure Framework," PR 08/74, on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pr/2008/pr0874.htm. The "Report of the Managing Director to the IMFC on a New Income and Expenditure Framework for the IMF" can be found on the CD-ROM or on the IMF's Web site, at www.imf.org/external/pp/longres.aspx?id=4245.

11 In June 2008, the IMF launched an "integrity hotline," which will allow individuals inside and outside the Fund to raise concerns, on a confidential basis, about possible staff misconduct.