FOSTERING MACROECONOMIC AND FINANCIAL STABILITY AND GROWTH THROUGH SURVEILLANCE

Surveillance is at the core of the IMF's mandate. The IMF is responsible, under its Articles of Agreement, for overseeing the international monetary system to identify any vulnerabilities that could undermine its stability. It fulfills this responsibility in part by monitoring the macroeconomic policies of its 185 member countries and providing analysis and policy advice tailored to each member's specific circumstances (referred to as bilateral surveillance) and monitoring economic conditions and developments in international capital markets and assessing the global effects of major economic and financial developments, such as oil market conditions or external imbalances (multilateral surveillance). These activities are supplemented by the Fund's surveillance of regional institutions that conduct monetary and economic policy for groups of countries bound together in formal arrangements, such as currency unions (regional surveillance; see Box 3.1).

As financial markets experienced exceptional turbulence, growth slowed dramatically in some of the advanced economies, and world prices for food and oil soared during FY2008, the IMF's Executive Board intensified its efforts to further strengthen and modernize the Fund's surveillance activities.[15]

15 In June 2008, the G-8 called on the IMF to work with the International Energy Agency and appropriate national authorities in carrying out further analysis of the real and financial factors behind the surge in oil and commodity prices, the volatility of these prices, and the effect of rising prices on the global economy, and to report its findings at the October 2008 Annual Meetings of the IMF and the World Bank.

The Fund's 2007 Decision on Bilateral Surveillance Over Members' Policies includes a principle recommending that members avoid exchange rate policies that result in external instability, regardless of the particular purposes of the policies; implied in this principle is that countries have an overarching commitment to pursue policies consistent with external stability.

BOX 3.1

How the Fund conducts surveillance

Bilateral surveillance. When a country joins the IMF, it makes commitments under Article IV of the IMF's Articles of Agreement to pursue policies conducive to orderly economic growth and price stability and to avoid manipulating exchange rates for unfair competitive advantage. It also commits to providing the IMF with accurate and timely data about its economy. Article IV mandates that the IMF oversee members' compliance with these obligations, which it does through ongoing surveillance over members' economic policies. In addition to maintaining contact with the national authorities from its headquarters in Washington, D.C., the IMF sends staff teams to each member country once a year, in most cases. (Informal staff visits often take place between these formal visits, known as Article IV consultations.) During an Article IV consultation, the IMF team analyzes economic and financial data and discusses with government and central bank officials economic developments since the previous consultation, as well as the country's exchange rate, monetary, fiscal, and financial sector policies, and other policies with a direct impact on domestic and external stability. The team may also meet with legislators and nongovernmental parties, such as trade unions, academics, and financial market participants. It prepares a summary of its findings and policy advice, which it leaves with the national authorities, who have the option of publishing it. The team also submits a report to the Executive Board for review and discussion. The discussion formally concludes an Article IV consultation, and a summary of the Board's views is transmitted to the country's government. Through this kind of peer review, the global community provides policy advice to each of its members, and the lessons of international experience are brought to bear on national policies. If the member country agrees, the full Article IV consultation report and a Public Information Notice (PIN), which summarizes the Board discussion, are published on the IMF's Web site.

Through Article IV consultations, the IMF seeks to identify policy strengths and weaknesses, as well as potential vulnerabilities, and advises countries on appropriate corrective actions if needed. Supplementing the Board's systematic and regular reviews of individual member countries are frequent informal Board sessions. On a voluntary basis, countries may also choose to participate in the Financial Sector Assessment Program or to request Reports on the Observance of Standards and Codes in other areas. Results of these assessments are an important input into surveillance.

Multilateral surveillance. Given the linkages between national economies and financial systems and the international economy and financial markets, the Fund monitors world economic and financial market developments and prospects to help ensure that the international monetary and financial system is functioning smoothly and to identify vulnerabilities that could undermine its stability. Multilateral surveillance is carried out through the Board's reviews of the biannual WEO, which presents the staff's analysis of global economic prospects and the policies appropriate in different countries, and GFSR, which focuses on developments in, and risks confronting, the international financial markets. The Board also holds informal discussions of world economic and financial market developments, and IMF staff continuously monitor developments in mature and emerging financial markets as well as economic developments globally.

Regional surveillance. Bilateral and multilateral surveillance is supplemented by regional surveillance of formal arrangements such as currency unions, whose members have devolved responsibilities over monetary and exchange rate policies to regional institutions, as well as by the preparation of regional economic outlooks that bring together key cross-cutting insights relating to countries with regional ties.

In June 2007, the Board adopted a new, more comprehensive framework for bilateral surveillance, which replaced the framework that had been in place since 1977. In addition, the Board endorsed efforts aimed at achieving a better understanding of the linkages between national economies and the global economy and between financial markets and the real economy, which is essential to restoring confidence in, and stability to, global financial markets and to improving global economic prospects. New initiatives were launched, such as coordinating work on developing voluntary principles for sovereign wealth funds (see below).

The Board also sought to deepen the Fund's understanding of fiscal/financial linkages. It held a seminar in February 2008 to examine how fiscal policy can help countries realize the benefits of globalization and financial deepening (Box 3.2).[16]

BILATERAL SURVEILLANCE

In FY2008, the Executive Board completed 123 Article IV consultations (see CD-Table 3.1 on the CD-ROM). It also put more emphasis on strengthening the Fund's global perspective and better integrating the findings of the WEO and the GFSR, the Fund's main instruments for multilateral surveillance (see below), in bilateral surveillance, and improving the analysis of linkages between the real economy and the financial sector and spillovers between national economies and the international economy. For example, the April 2008 WEO outlined three lines of defense countries could adopt against the spreading effects of market turmoil—a combination of monetary policy easing, fiscal stimulus, and public funds, as appropriate, can play a complementary role by supporting demand and limiting the negative interaction between financial markets and the real economy—while the October 2007 WEO addressed appropriate policy responses to large capital inflows.[17] The regional dimension is also increasingly informing the Fund's bilateral policy discussions, and selected issues papers and staff reports are placing more emphasis on regional spillovers and cross-country experiences.

Exchange rate surveillance is one of the IMF's key responsibilities. Throughout its existence, the Fund has striven to strengthen its framework for assessing exchange rates, adapting it to underlying macroeconomic and financial developments in member countries. The Executive Board updated its surveillance framework, after a year-long review, on June 15, 2007.[18] The 2007 Decision on Bilateral Surveillance Over Members' Policies is much broader and more comprehensive than the 1977 Decision on Surveillance Over Exchange Rate Policies, which it replaces and which was adopted in the wake of the collapse of the Bretton Woods system.[19] By setting clear expectations, the new Decision should help improve the quality, evenhandedness, and effectiveness of IMF surveillance. It also brings greater clarity and specificity to the issues of which exchange rate policies countries should avoid and when these policies may be of concern to the international community. Some of the highlights of the new Decision are described in Box 3.3.

Key operational aspects in implementing the 2007 Decision are being clarified, including through an exchange of views among Executive Directors on the concepts and methodologies for assessing external stability, analyzing exchange rates and current account positions, and assessing exchange rate policies, and the Surveillance Guidance Note for staff is expected to be updated in FY2009. In an informal seminar at the end of FY2008, the Board began to review the system and methodology used to classify member countries' de facto exchange rate arrangements to clarify the definitions of the various categories and establish more operational and unambiguous criteria for their application. These discussions will inform this year's *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER), which has been published by the Fund since 1950. Prepared in consultation with member country authorities, but reflecting the staff's independent judgment, the AREAER provides a comprehensive description of the exchange rate arrangements, exchange restrictions, controls on capital flows, and other foreign exchange measures of all IMF members.[20]

Complementing the efforts of the Executive Board and the Fund's management and staff to take stock of the effectiveness of surveillance, the IMF's Independent Evaluation Office completed an evaluation in FY2007 of the IMF's exchange rate policy advice to member countries from 1995 to 2005. At the Board's discussion of the evaluation in May 2007, Executive Directors broadly endorsed the IEO's conclusion that the Fund should

16 See "IMF Executive Board Holds Seminar on Globalization, Financial Markets, and Fiscal Policy," PIN 08/28, on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pn/2008/pn0828.htm.

17 The WEO is available on the IMF's Web site, at www.imf.org/external/pubs/ft/weo/2007/02/index.htm. Although private capital inflows can result in long-term benefits if put to good use, they may pose significant risks to macroeconomic stability. The appropriate policy response to large capital inflows depends on country-specific circumstances and the nature of the inflows. The most robust lesson to emerge from a comprehensive cross-country analysis of policy responses over the past two decades is that keeping government spending on a steady path—rather than engaging in excessive spending during periods of heavy capital inflows—can help mitigate the adverse effects of large inflows.

18 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. The Decision can also be found on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pn/2007/pn0769.htm#decision.

19 Under the Bretton Woods system, which was established in 1944, central banks of countries other than the United States agreed to maintain fixed exchange rates between their currencies and the dollar, which was convertible into gold at the fixed price of $35 an ounce. The Bretton Woods system collapsed in 1971 when the United States ended the trading of gold at the fixed price.

20 Appendix II, "Financial Operations and Transactions," to this Report contains a brief summary of members' exchange rate regimes in Table II.9, "De Facto Classification of Exchange Rate Regimes and Monetary Policy Frameworks, End-April 2008." The Appendix can be found on the CD-ROM or on the IMF's Web site, at www.imf.org/external/pubs/ft/ar/2008/eng/index.htm.

BOX 3.2

Globalization, financial markets, and fiscal policies

In February 2008, the Executive Board discussed "Globalization, Financial Markets, and Fiscal Policy," a paper prepared by the Fiscal Affairs Department.[1] The seminar considered how fiscal policy can help countries realize the benefits of globalization and financial deepening.

The impact of globalization on public finances. Executive Directors noted that, despite the general trend toward lower tax rates—for corporate taxes—revenue has been strong until recently. While recognizing that tax competition could be healthy, they pointed out that sustained revenue buoyancy should not be taken for granted and that harmful tax competition could undermine members' revenue. On the expenditure side, globalization could create upward pressure because of demands for more social protection and more investment in human and physical capital. Executive Directors also called for more attention to financial sector contingent liabilities, noting that timely intervention strategies emphasizing preemptive restructuring of at-risk financial institutions could reduce the ultimate fiscal cost, but that such strategies should avoid creating expectations of government bailouts for financial institutions. On balance, the Board observed that, to the extent that globalization and financial deepening create fiscal pressures, a pre-positioning of fiscal policy is warranted. This would not necessarily mean a tighter fiscal policy, but fiscal policy should be flexible and able to respond to pressures by maintaining room for maneuver in revenue and expenditure policies.

Market access. Greater access to external market financing could either strengthen or loosen fiscal discipline. The effect of market discipline on fiscal policy can be enhanced by increased transparency and a credible political commitment to sound fiscal policies. Globalization and financial deepening could improve the ability of countries with sound policies to borrow abroad in domestic currency, and thus increase debt tolerance.

Fiscal policy with higher capital flows. Globalization and financial deepening have both altered the effectiveness of fiscal policy and led to increased capital flows. The stabilizing role of fiscal policy in response to capital inflows depends on country-specific circumstances. If large capital inflows create aggregate demand pressure, and the scope for using monetary policy is limited, fiscal tightening could be appropriate. In some cases, however, adjustment could occur mainly through the real exchange rate or through temporary capital controls, although in these cases fiscal policy can still be useful. A few Executive Directors, however, noted that fiscal policy may not be the best tool for dealing with significant shifts in capital flows, given the long lags in the implementation of fiscal measures.

Spillovers. Globalization magnifies fiscal policy spillovers. Some Executive Directors agreed that these strengthen the case for enhanced international policy cooperation in certain areas, although some other Executive Directors were reluctant to endorse a new mandate for Fund coordination efforts.

1 The paper is available on the IMF's Web site, at www.imf.org/external/np/pp/2007/eng/111607a.pdf.

The Surveillance Guidance Note (issued in May 2005) provides guidance to IMF staff on the conduct of bilateral surveillance, in light of its evolution over time and the conclusions of the 2004 Biennial Surveillance Review. The note covers both the content (in particular, the choice of issues to be addressed in an Article IV consultation and the quality of coverage of topics that have received particular attention in Board reviews of surveillance) and the modalities of surveillance. It also provides guidance on the treatment in Article IV consultations of matters related to Articles VIII and XIV that concern restrictions on payments and transfers for current international transactions and multiple currency practices. In addition, the note provides guidance on the treatment of other issues that are not legally part of surveillance under Article IV but, per guidance from the Executive Board, are to be raised in the context of Article IV consultations. Members have no obligation under Article IV surveillance to provide information or to pursue specific policies in these areas.

BOX 3.3

The 2007 Decision on Bilateral Surveillance Over Members' Policies

The new Decision expands on the 1977 Decision in a number of important ways, to clarify the framework of surveillance implied by the Articles of Agreement (and thus without creating new obligations for members):

- Introducing, as an organizing principle for bilateral surveillance, the concept of external stability, which encompasses both the current and the capital accounts of the balance of payments.
- Specifying the essential modalities of effective surveillance, including its collaborative nature, the importance of dialogue and persuasion, and the need for candor and evenhandedness, and emphasizing the importance of paying due regard to country circumstances and the need for a multilateral and medium-term perspective.
- Clarifying the concept of exchange rate manipulation to gain an unfair competitive advantage over other members, which is prohibited under Article IV of the Fund's Articles of Agreement, and relating such behavior to the concept of fundamental exchange rate misalignment.
- Providing more complete guidance to members for the conduct of their exchange rate policies so as to cover all such policies that may cause external instability, regardless of their particular purpose, as well as to the Fund in its conduct of surveillance.

The Executive Board endorsed the staff's definition of fundamental exchange rate misalignment but underscored the need for appropriate caution in applying it, stressing that it should be used with due acknowledgment of the considerable measurement uncertainties involved, and that estimates of misalignment require the exercise of careful judgment. In practice, an exchange rate would be judged to be fundamentally misaligned only if the misalignment were found to be significant, and the benefit of any reasonable doubt would be given to the authorities in establishing whether there is fundamental misalignment. The Board also noted that any judgment on misalignment should be applied in an evenhanded manner regardless of the nature of the exchange rate regime and the size of the economy, and a number of Executive Directors emphasized the potential market sensitivity of estimates of misalignment and the need for care in communicating them.

aim at enhancing the effectiveness of its analysis, advice, and dialogue with member countries, as well as address any perception of asymmetry in its exchange rate surveillance. Most Executive Directors concurred with the IEO's finding that the rules of the game for exchange rate surveillance remain unclear in some important areas. Over the review period, there had been problems in implementing various aspects of existing policy guidance, and most Executive Directors agreed that there remains scope for improvement in several areas, including the quality of analysis of exchange rate levels and incorporation of the analysis of policy spillovers into regional and bilateral surveillance. They also agreed with the IEO recommendation that Fund management should ensure that exchange rate work across the Fund is organized and managed effectively, in tandem with ongoing work to integrate financial sector issues into Fund surveillance, and they encouraged further strengthening of the existing coordinating mechanisms (including the Surveillance Committee and the Consultative Group on Exchange Rate Issues [CGER; see below]). Most Executive Directors emphasized that the Fund's management is responsible for providing the Executive Board with all the information that it needs to conduct surveillance and is accountable to the Executive Board for how it combines this duty with the need for the Fund to serve as a confidential advisor to members.

21 See "IMF Executive Board Discusses Implementation Plan Following IEO Evaluation of the IMF's Exchange Rate Policy Advice, 1999–2005," PIN 07/119, on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pn/2007/pn07119.htm.

22 In April 2008, the Fund published a paper describing these methodologies, *Exchange Rate Assessments: CGER Methodologies*, as Occasional Paper No. 261. See www.imf.org/external/pubs/cat/longres.cfm?sk=19582.0.

23 The full summings up of the Board's discussions of the October 2007 and April 2008 WEO can be found on the CD-ROM as well as in the reports themselves, which are available on the IMF's Web site. See www.imf.org/external/ns/cs.aspx?id=29 for links to different issues of the WEO as well as the WEO Updates.

Based on the IEO recommendations endorsed by the Board, staff and management prepared an implementation plan, which the Board discussed in September 2007 (see Chapter 5).[21] Executive Directors noted that the centerpiece of the implementation plan was, appropriately, the 2007 Decision on Bilateral Surveillance, and that strengthening work related to exchange rate issues would have to be carried out primarily in the context of Article IV consultations. Many Executive Directors agreed that strengthening the methodology and expanding the work of the CGER would provide important input to the Fund's exchange rate work, although a number cautioned that significant technical limitations would continue to exist in regard to estimating equilibrium exchange rates.

Since the mid-1990s the CGER has provided exchange rate assessments for a number of advanced economies from a multilateral perspective, with the aim of informing the country-specific analysis of the IMF's Article IV staff reports and fostering multilateral consistency. These assessments are additional tools at the disposal of the IMF staff country desks, which are responsible for formulating exchange rate assessments as part of the Fund's bilateral surveillance. The role of exchange rates in the external adjustment process is increasing as the world economy rapidly becomes more integrated. During the past 15 years, world trade and international financial integration have grown very rapidly, with the ratio of world trade to world GDP increasing by over 40 percent and the ratio of international financial cross-holdings to world GDP more than doubling. Emerging market countries have contributed significantly to these developments, as is evidenced by the increase in their share of world trade—from 27 percent in 1990 to 40 percent in 2006—as well as by their importance in international capital flows. Accordingly, the Fund has extended its CGER methodologies, which can help gauge the consistency of current account balances and real effective exchange rates with their underlying fundamentals, to cover about 20 emerging market countries.[22]

MULTILATERAL SURVEILLANCE

To assist and inform policymakers and the public, the Fund has introduced greater continuity in its multilateral surveillance work, for example, with formal quarterly updates of WEO forecasts and a quarterly financial stability note, to complement its two major vehicles for multilateral surveillance, the WEO and the GFSR, which are published twice a year. It has also deepened its analysis of macrofinancial linkages, exchange rates, and spillovers, especially from advanced economies and markets.

World Economic Outlook

In its September 2007 discussion of the WEO,[23] the Executive Board acknowledged that after strong economic growth in the first half of 2007, the global outlook had become exceptionally uncertain and underscored the importance of sound policies and continued vigilance. In its March 2008 discussion, the Executive Board agreed that global growth prospects for 2008 had deteriorated markedly since the January 2008 WEO Update. Executive Directors discussed global economic developments and prospects against the background of exceptional uncertainties about the likely duration and cost of the financial crisis that had spread far beyond the U.S. subprime mortgage market. Growth had slowed in the advanced economies in the face of tightening financial conditions but remained strong in the rapidly globalizing emerging economies. Executive Directors emphasized that the still-unfolding events in financial markets posed the greatest risk to the outlook. Many Executive Directors still saw a positive momentum driven by the potential strength of domestic demand in fast-growing emerging economies, while recognizing these economies' exposure to negative external risks through both trade and financial channels. Executive Directors also cautioned that risks related to inflationary pressures and the oil market had increased as commodity prices soared in the context of continued tight supply-demand conditions as well as of growing investor interest in commodities as an asset class and other financial factors. A number of Executive Directors also saw a continued risk of a disorderly unwinding of global imbalances despite the recent depreciation of the U.S. dollar against other flexible currencies and the narrowing of the U.S. current account deficit.

Against this backdrop, Executive Directors underscored that policymakers around the world faced a fast-moving set of challenges. The key priorities in the advanced economies were dealing effectively with the financial crisis and countering downside risks to growth while taking account of inflationary pressures and the need to preserve longer-term fiscal sustainability. The challenge for many emerging and developing economies was controlling inflationary pressures while ensuring


LEFT: Launch of April 2008 GFSR, Washington, D.C. RIGHT: Market in Port-au-Prince, Haiti.

that strong domestic demand did not lead to a buildup of vulnerabilities. A number of these economies were already facing a fallout from the slowdown in the advanced economies, and an intensified or prolonged global slowdown would require judicious responses from their policymakers. The Board considered that ensuring the consistency of policy approaches across countries in these difficult global conditions would be important.

More generally, Executive Directors welcomed the ongoing consultations among countries, especially by the monetary authorities of the advanced economies with each other and with international bodies such as the IMF and the Financial Stability Forum (FSF), in dealing with the present financial turmoil. Joint efforts could prove more effective than individual efforts in bolstering confidence and demand. Executive Directors agreed that the Fund was uniquely placed for adding a multilateral perspective to policy responses to the current crisis, providing a forum for discussion and exchanges of views, and promoting consistency of national policies and assessing their spillovers in an increasingly integrated global economy.

Global Financial Stability Report

At their March 2008 discussion of the GFSR,[24] Executive Directors noted that global financial stability had deteriorated markedly since their discussion of the October 2007 GFSR, which had also focused on financial market turbulence, as the deterioration in the U.S. subprime mortgage market had been followed by severe dislocations in broader credit and funding markets, posing risks to the macroeconomic outlook in the United States and globally. Policymakers' immediate priorities were to reduce uncertainty, mitigate risks to the global financial system, and restore confidence. The Board underscored that, in carrying forward the recommendations in the GFSR, directed at both the public and the private sectors, careful attention should be paid to sequencing and prioritization, to country circumstances, and to coordination among the relevant international and national agencies. It emphasized the role of the Fund in contributing to these efforts, working alongside national and international institutions and bodies.

Executive Directors generally supported the GFSR's finding that markets and investors, the official sector, and monetary authorities had collectively failed to appreciate the extent of leverage taken on by a wide range of financial institutions, and the associated risks of a disorderly unwinding. Private sector risk management and disclosure, and financial sector supervision and regulation all lagged behind rapid financial innovation and shifts in business models, and continuing uncertainty over the size and spread of losses had elevated systemic risks. Potential losses could be sizable, and financial institutions should move quickly to repair their balance sheets by raising equity and medium-term funding.

The resilience demonstrated by emerging markets and developing countries could yet be tested by rising costs, tighter external funding conditions, or a reversal of the recent commodity price boom. A protracted weakening of growth in the advanced economies or a broadening of the problems in financial markets could also have an adverse impact on emerging markets, depending on country circumstances, for example, by increasing the vulnerability to potential capital outflows of those emerging economies that are particularly dependent on advanced economies' direct investments.

24 The full summings up of the Board discussions of the October 2007 and April 2008 GFSR can be found on the CD-ROM as well as on the IMF's Web site. See www.imf.org/external/pubs/ft/GFSR/index.htm.

It was recognized that a sound understanding of the valuation and accounting of structured finance products was important for comprehending the depth and extent of present financial market instability. The Board noted that there were incentives to rely heavily on short-term wholesale funding to support these longer-term, illiquid structured products. It was also suggested that the rating agencies should review the quality of their methodologies. Executive Directors generally welcomed the prompt and innovative actions of central banks to inject liquidity into the banking system to keep interbank markets functioning smoothly and agreed that the financial turmoil has highlighted the need for central banks to consider more carefully their roles regarding financial stability and monetary policy implementation, noting that these roles were becoming more intertwined. While the authorities in individual countries are moving to stem the effects of disorderly financial market conditions, the Fund should, in coordination with other multilateral bodies such as the FSF as well as with national agencies, play a larger role in international forums to influence policy.

Multilateral consultation

In FY2007, the Fund launched a new vehicle—the multilateral consultation—for the purpose of fostering cooperation among appropriate groups of countries in addressing challenges to the global economy and individual members. The IMF's first multilateral consultation gave its five participants—China, the euro area, Japan, Saudi Arabia, and the United States—a forum for discussing global imbalances and how best to reduce them while sustaining robust global growth. In FY2008, the Board reviewed its experience, concluding that the multilateral consultation discussions have helped deepen agreement on a coherent medium-term approach that identified measures that should gradually reduce imbalances over time while supporting global growth, have been beneficial from a regional and international perspective, and have strong ownership. The participants' individual statements of policy intentions, while not as ambitious as the Fund advised in the context of Article IV consultations and the WEO, still constituted significant steps forward and, once implemented, should contribute substantially toward reducing imbalances over the medium term. Moreover, the publication of these policy intentions has provided a valuable road map for the future. Executive Directors recommended that the Fund continue to play an active role in monitoring progress, and this has been done in individual Article IV reports on the relevant members.

Executive Directors considered that the multilateral consultation approach is a useful instrument for enhancing and deepening Fund multilateral surveillance. They noted that the multilateral consultation had two unique aspects: voluntary participation of a limited number of participants that were possible major contributors to a solution to imbalances, and a framework wherein the voice of the entire international community could be heard through the Executive Board and through the International Monetary and Financial Committee (IMFC).[25] These features, together with uncertainty as to what future problems might need to be addressed, warrant retaining flexibility with respect to the operational modalities going forward.[26]

REGIONAL SURVEILLANCE AND OUTREACH

Since members of currency unions have devolved responsibilities over monetary and exchange rate policies—two central areas of Fund surveillance—to regional institutions, the IMF holds formal discussions with representatives of these institutions in addition to its Article IV consultations with the unions' individual members. During FY2008, the IMF's Executive Board discussed developments in the Central African Monetary and Economic Union (CEMAC), the Eastern Caribbean Currency Union (ECCU), and the euro area.[27]

Currency unions

CEMAC. Macroeconomic conditions in CEMAC were highly favorable at the time of the Board discussion, which took place in June 2007,[28] in large part because of sustained high oil prices. Nonetheless, in terms of growth, the region had fallen behind the rest of sub-Saharan Africa, there was little trade and financial integration, dependency on oil revenues had increased, and deep-seated structural impediments to economic diversification remained. These problems need to be addressed urgently if the region is to achieve the Millennium Development Goals (see Chapter 4). The Board thus welcomed the recent reform package adopted by the CEMAC Heads of State, which is intended to strengthen regional institutions and advance the integration process.

ECCU. In its February 2008 discussion, the Executive Board welcomed the ECCU's strong economic performance, characterized by robust growth and

25 The IMFC is an advisory body to the IMF's Board of Governors. It is composed of 24 Governors (or their alternates). See Box 5.3, "How the IMF Is Run," for more detail on the IMFC's composition and activities.

26 See "IMF Executive Board Discusses Multilateral Consultation on Global Imbalances," PIN 07/97, and "Staff Report on the Multilateral Consultation on Global Imbalances with China, the Euro Area, Japan, Saudi Arabia, and the United States," on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pn/2007/pn0797.htm and www.imf.org/external/np/pp/2007/eng/062907.pdf, respectively.

27 It discussed developments in the West African Economic and Monetary Union (WAEMU) early in FY2009.

28 See "IMF Executive Board Concludes 2007 Discussion on Common Policies of Member Countries with CEMAC," PIN 07/81, on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pn/2007/pn0781.htm. The members of CEMAC are Cameroon, the Central African Republic, Chad, the Republic of Congo, Equatorial Guinea, and Gabon.

29 The ECCU's members are Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. See "IMF Executive Board Concludes 2007 Discussion on Common Policies of Member Countries of the Eastern Caribbean Currency Union," PIN 08/12, on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pn/2008/pn0812.htm.

30 See "IMF Executive Board Discusses Euro Area Policies," PIN 07/89, on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pn/2007/pn0789.htm.

31 The REOs can be accessed at www.imf.org/external/pubs/ft/reo/reorepts.aspx. Materials related to the REOs published in FY2008 can also be found on the IMF's Web site.

generally low inflation. Observing that the region continues to face significant challenges nonetheless, it supported the focus on policies aimed at sustaining growth and building resilience by enhancing competitiveness and economic diversification. The Board also underscored the need to accelerate fiscal consolidation, avoid distortions in tax systems, and control spending. It commended the progress made in enhancing the regulatory framework for the banking system and the financial sector more broadly, and recommended continued efforts to strengthen the risk-based supervisory framework. Executive Directors supported the renewed momentum toward economic integration and noted that liberalizing capital and labor flows should play an important role in allowing the region to benefit more fully from globalization. Since data weaknesses remain a key constraint on effective policymaking and surveillance, Executive Directors encouraged the national and regional authorities to bolster statistical practices and data management.[29]

Euro area. In their discussion of euro area policies in July 2007,[30] Executive Directors welcomed the euro economy's move from recovery to upswing. They expected real GDP growth to remain above potential for the near term and employment gains to stay healthy thanks, in part, to reforms of labor markets and welfare systems. However, with rising resource utilization, inflationary pressures could be expected to build gradually and some further monetary policy tightening might be required. Executive Directors considered the external position of the euro area to be roughly in balance and the real effective exchange rate of the euro to be trading within range of the medium-term equilibrium. They welcomed the broad-based structural reforms under way and underscored that their continued implementation, in line with the authorities' commitments under the multilateral consultation (see above), would help strengthen prospects for an orderly resolution of global current account imbalances. Looking forward, population aging was likely to prompt a significant slowing of potential growth; thus, the fundamental challenge in the region is achieving a joint structural acceleration of productivity and labor force participation. Executive Directors emphasized the need for prompt implementation of the Markets in Financial Instruments Directive and welcomed steps to integrate national payments and securities clearing and settlement systems as well as ongoing work to facilitate cross-border bank mergers and acquisitions.

Other regional surveillance initiatives and outreach

The Fund has taken steps in the past few years to expand and strengthen its regional work. Some area departments have created units dedicated to regional issues as well as department-wide working groups on cross-cutting issues. For example, working groups in the African Department are studying such issues as the scaling up of aid, natural resource management, and the development of domestic debt markets; in the European Department, large cross-border capital flows, rapid credit growth, the implications of financial integration for growth and supervision, the use of EU funds by new member states, the competitiveness of the Mediterranean countries, and vulnerabilities in southeastern Europe; and in the Western Hemisphere Department, issues related to the financial sector, monetary and exchange rate policy, pensions, and oil and natural resources. The Fund's Regional Office for Asia and the Pacific, which is located in Tokyo, contributes to research and outreach on regional surveillance.

In addition, the IMF's five area departments now produce *Regional Economic Outlooks* (REOs) twice a year. Publication of the REOs is followed by extensive outreach events—such as seminars for government officials and academics, media briefings, and interviews of IMF officials—in several countries in each region. Press releases summarizing REO findings are posted on the IMF's Web site along with the full text of the REOs themselves, as well as transcripts and webcasts of press conferences held upon publication of the REOs.[31]

The IMF also organizes and participates in various regional forums. In June 2007, for example, the IMF participated in the Sixth Annual Regional Conference for Central America, which brought together ministers of finance, central bank governors, and financial sector superintendents from Central America, Panama, and the Dominican Republic to discuss two major regional projects—the consolidation of supervision of regional financial conglomerates and fiscal coordination, including the establishment of a customs union for Central America—as well as the development of equity and private debt markets and fiscal policies to support economic and social stability. In October 2007, IMF staff and the Honduran authorities held a regional workshop on medium-term expenditure frameworks. The workshop was attended by budget officials from Central America, the Dominican Republic, and Panama, and speakers from the IMF, the World Bank, the Inter-American Development Bank, Colombia, and Spain. In November 2007, the IMF's Western Hemisphere Department organized a conference on economic and financial linkages in the Western Hemisphere. A regional seminar on globalization and taxation, involving finance ministers and senior officials from 13 African countries, was held in February 2008 in Nigeria; a high-level seminar on African finance was held in Tunis in March 2008 (see Chapter 4). The IMF also participated in the April and September 2007 meetings of the Trade Policy Coordination Committee of the Central Asia Regional Economic Cooperation Program, held in Manila; the annual meeting of the finance ministers and central bank governors of the Gulf Cooperation Council, held in Jeddah in October 2007; and a conference on the role of the private sector in economic development and regional integration in the Maghreb, held in Tunis in November 2007.

In June 2007, the IMF held a policy seminar on financial integration in the Nordic-Baltic region, at which IMF staff and Executive Directors, the European Central Bank representative to the IMF, and academics discussed an IMF study of the arrangements for cross-border oversight and crisis management. The study highlights gaps that may have arisen as a result of growing financial integration in the region. Since financial integration is also increasing in Europe as a whole, and most countries in the Nordic-Baltic region are bound by the European regulatory framework, addressing these challenges may need to be considered in this broader European context.[32]

As part of its initiative to hold periodic seminars on economic developments and prospects in the Caribbean, the Board held its first such seminar in September 2007.[33] Executive Directors noted that the historically open nature of the Caribbean economies has served them well, enabling them to achieve relatively high per capita income levels. The macroeconomic performance of the region has been favorable in recent years, and its commitment to social development and equitable growth has contributed to notable progress in health care, education, and poverty eradication. Nonetheless, the region is vulnerable because of its limited economic diversification; persistent, large current account deficits; large public debt; and exposure to natural disasters—hurricanes, in particular. Executive Directors welcomed the initiative to establish the Caribbean Single Market and Economy, increased regional cooperation being key to enabling the Caribbean countries to make the most of globalization, and considered that closer integration of the Caribbean's still largely segmented financial markets could boost growth. They noted that the Caribbean countries' heavy reliance on tax incentives to attract investors was costly in terms of forgone revenues and recognized that the erosion of preferential access to European markets for bananas and sugar would entail significant losses for several countries in the region. Executive Directors also emphasized the importance of timely disbursement of aid and concessional assistance in support of countries' adjustment and restructuring efforts.


LEFT: Bananas are unloaded on the Caribbean island of St. Martin. RIGHT: Visitor to the European Central Bank, Frankfurt, Germany.

32 The study, "Financial Integration in the Nordic-Baltic Region: Challenges for Financial Policies," is available on the IMF's Web site, at www.imf.org/external/np/seminars/eng/2007/nordbal/pdf/0607.pdf.

33 See "IMF Executive Board Discusses Selected Regional Issues in the Caribbean," PIN 07/124, on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pn/2007/pn07124.htm.

FINANCIAL SECTOR SURVEILLANCE

The Fund has been strengthening its financial sector surveillance work at the bilateral, multilateral, and regional levels, on an ongoing basis, working on the development of analytical tools for assessing financial sector stability, both at the institutional level and system-wide, and quantitative analytical methodologies for identifying, measuring, and assessing the impact of financial sector credit and liquidity risks and improving stress testing. These tools have already been applied in the Fund's work, in particular in the context of financial sector assessment programs (FSAPs). Initiatives in FY2008 included analytical and policy-related work on the impact of the financial crisis that began in mid-2007 on economic activity; more emphasis on macrofinancial linkages in the conjunctural sections of the WEO; greater focus on financial sector analysis in Article IV consultations and continued emphasis on FSAPs; internal training on financial sector issues; data collection initiatives that focus on the position of financial institutions vis-à-vis other sectors and the associated risks; and analytical and empirical work on how financial and real sector reforms complement each other. Fund staff continued to collaborate with the FSF and its working groups, as well as to consult with the private sector, regulators and national authorities, standard setters, and other bodies.

Assessment of financial crisis and recommendations

In its October 2007 Communiqué, the IMFC asked the Fund to reflect on the underlying causes of, and policy lessons from, the turmoil that erupted in financial markets in August 2007. In response, five working groups in the IMF's Monetary and Capital Markets Department, in close cooperation with the relevant FSF working groups and other stakeholders, studied the structural causes of the ongoing crisis and drew up a set of recommendations of a medium-term nature. Their findings were discussed by the Board in April 2008 and are summarized in Box 3.4.[34] The shorter-term policy responses that may be required to help manage and mitigate the crisis are discussed in the April 2008 GFSR (see above).

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

Even though the turmoil in financial markets was still evolving at the close of FY2008, and consensus on the appropriate policy responses was still emerging, the Fund's surveillance has already responded. Recent developments suggest there is scope to sharpen surveillance and policy advice in the following areas:

- In its dialogue with supervisors and regulators, the Fund should seek to ensure that risk-management practices in financial institutions are adequate, especially with regard to complex structured finance products, and that stress testing by both private sector institutions and supervisors is robust.

- Many of these issues are also relevant to the Fund's dialogue with central banks. In countries where central banks do not have supervisory functions, it is particularly important to assess the degree of cooperation with banking supervisors and arrangements for coordinated action and early intervention in the event of financial sector stress.

- The Fund should pay special attention to the authorities' stress-testing and bank resolution frameworks in emerging market countries, especially

LEFT: Traders and specialists on the floor of New York Stock Exchange. RIGHT: Repossessed house for auction, Long Island, New York.

35 Factual updates describe developments that are relevant to compliance with standards and codes but do not reassess the ratings in the initial FSAP.

36 These numbers refer to FSSAs discussed by the Board during FY2008.

37 The Communiqué, PR 07/236, can be found in Appendix III on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/cm/2007/102007a.htm.

those that have either large current account deficits financed by debt-creating flows or financial sectors dominated by banks from mature markets or both. Although emerging market countries have thus far proved resilient to the turmoil in financial markets, the risk of contagion is significant in countries with these characteristics.

FINANCIAL SECTOR ASSESSMENT PROGRAM

Assessments under the FSAP, a joint initiative of the IMF and the World Bank, are an important input into surveillance, and the Fund continues to carry them out selectively. The FSAP was introduced in 1999 to provide member countries, on a voluntary basis, with a comprehensive evaluation of their financial systems and provides the basis for the IMF's Financial System Stability Assessments (FSSAs)—assessments of risks to macroeconomic stability stemming from the financial sector, including the latter's ability to withstand macroeconomic shocks. Regional FSAPs are also undertaken for currency unions, notably where significant regulatory and supervisory structures are at the regional level. Regional FSAPs have been completed for CEMAC and ECCU, and an FSAP for WAEMU was under way at the end of the Fund's financial year.

With a total of 121 initial assessments now completed or under way, the IMF and the World Bank are increasingly focusing on FSAP updates. The core elements of updates include financial stability analysis, factual updates of the observance of standards and codes included in the initial assessment,[35] and a reassessment of key issues raised in the initial assessment.

In FY2008, 17 FSAPs were completed, of which 12 were updates;[36] another 45 (of which 24 are updates) are either under way or agreed and being planned.

Collaboration with other institutions

The Fund also works closely with other organizations on financial sector issues. It has increased its collaboration with the World Bank in this area in the context of the Joint Bank-Fund Management Action Plan (see Chapter 5). It has strengthened its analysis of vulnerabilities in advanced economies and collaboration with standard setters (such as the Basel Committee on Banking Supervision), central banks, and finance ministries in conjunction with the FSF and the G-20. It prepared a Global Financial Stability Note for the FSF's March 2008 meeting and has sponsored or cosponsored a number of conferences and seminars on financial sector issues (Box 3.5).

Vulnerability Exercise

The Vulnerability Exercise established in 2001 provides regular cross-country assessments of vulnerabilities and crisis risks in emerging market economies. The Fund developed a new methodology in FY2008 that enables it to distinguish between underlying vulnerabilities and crisis risks in emerging market countries, thereby facilitating the identification of underlying weaknesses in a benign environment when crisis risk is low. It intends to extend this exercise to mature markets. The Spring 2008 Vulnerability Exercise focused on the impact of global turmoil on emerging market economies, and the risks that asset price booms could end in sharp corrections and that a decline in capital inflows could precipitate a further downward spiral of asset prices, loan quality, and growth prospects.

Sovereign wealth funds

Sovereign wealth funds are becoming increasingly important players in the international monetary and financial system, and their assets have increased to an estimated \$1.9–\$2.8 trillion—this is in addition to the dramatic growth of international reserve holdings, which reached \$6 trillion at the end of 2007. SWFs offer various economic and financial benefits—in the home country, they facilitate the intergenerational transfer of wealth, help prevent boom-bust cycles, contribute to fiscal stability, and allow for better portfolio diversification of sovereign assets, while they can have a stabilizing influence in global financial markets and enhance liquidity, as evidenced by SWFs' recent injections of capital into several large banks (see Chapter 2)—but they also pose challenges for policymakers.

At the 2007 Annual Meetings, while recognizing the positive role of SWFs in enhancing market liquidity and financial resource allocation, the IMFC in its Communiqué welcomed the IMF's analysis of issues for investors and recipients of flows from SWFs, including a dialogue on identifying best practices.[37] In November 2007, the Fund convened the first annual roundtable of sovereign asset and reserve managers in Washington, D.C., to facilitate the exchange of ideas and experiences in the management of reserves

BOX 3.4

Summary of MCM working group policy recommendations

FINDINGS	LESSONS AND RECOMMENDATIONS
Risk-management practices	
Risk-management practices in many financial institutions reflected shortcomings of both judgment and governance. Institutions relied too heavily on model-based strategies that were based on limited historical data, without due regard for their limitations. Hedging strategies were overly concentrated and, especially in the case of structured financial products, inadequate attention was paid to tail and liquidity risks.	Risk managers should challenge aggressively the assumptions underlying risk-management and pricing models and scrutinize their firms' risk profile, including hedging strategies, counterparty risk, and possible second-round effects from market shocks. Senior managers need to ensure that internal governance structures are robust and that information and decision-making responsibilities are well defined and appropriate. Supervisors need to take a more active role in monitoring risk management and encourage more rigorous stress testing, especially during good times. Regulators may wish to consider whether the opacity and complexity of structured credit products such as ABS CDOs (collateralized debt obligations consisting of portfolios of bonds of asset-backed securities) undermine market discipline and require prudential or other measures, while guarding against the risk of overregulation.
Valuation, disclosure, and accounting	
The accounting treatment of structured products and shortcomings in valuation models and financial reporting contributed to the depth and duration of the crisis.	Supervisors should ensure that financial institutions develop robust pricing, risk-management, and stress-testing models. Consideration should be given to raising prudential norms (for example, capital buffers) for structured financial products. Supervisors should promote better internal processes within regulated entities for managing valuation-modeling risk. Cross-border convergence of accounting and regulatory standards, as well as of bank disclosure requirements, should be sought, especially where global financial institutions are involved. Disclosure of off-balance-sheet holdings, SIVs (structured investment vehicles), and conduits should be enhanced. Steps could be taken to improve price discovery and liquidity of hard-to-value securitized instruments—for example, greater standardization and development of a centralized registry.

FINDINGS	LESSONS AND RECOMMENDATIONS
Credit-rating-agency practices	
Credit-rating methodologies failed to capture the risks embodied in structured products. Investors in structured products relied too heavily on ratings and did not appreciate the products' vulnerability to sharp price changes and multiple-notch downgrades.	Credit-rating agencies should improve rating methods and practices. At a minimum, they should introduce differentiated ratings for structured products, disseminate information on the susceptibility of the ratings of such products to downgrades, and disclose more information about rating methodologies. Approval and licensing procedures could be used to reduce potential conflicts of interest in the credit-rating industry and spur improvements in transparency and the disclosure of rating methodologies. National authorities and the major international standard setters should review the use and effectiveness of credit ratings in prudential regulation, especially in light of possible changes to the ratings scales applied to structured products.
Supervision and crisis management	
Consolidated supervision was inadequate, and supervisors did not adequately account for the risks associated with new financial instruments, nor did they address deterioration in underwriting standards. Gaps in crisis management and bank resolution frameworks were also exposed.	The Basel II framework will permit a more risk-sensitive approach to supervision, and countries with internationally active banks will need to adopt it quickly. But the transition to Basel II will need to be carefully managed since partial or incomplete implementation would pose risks; the application of capital floors may need to be extended; and particular attention should be paid to the impact analysis from the parallel run period. Supervisory practices, such as the frequency of on-site supervision and the use of external auditors, need to be strengthened, and supervisors need to be given adequate resources to perform their duties effectively. Consolidated supervision and prudential reporting should be applied to off-balance-sheet entities, with more attention to reputational risks and contingent liabilities. Bank resolution and deposit insurance frameworks need to be strengthened, and interagency coordination needs to be more effective. Central banks should remain well informed and involved. Minimum underwriting and consumer protection standards should apply to all financial intermediaries to limit excessive risk taking and regulatory arbitrage.
Central bank liquidity	
Shortcomings in existing emergency liquidity frameworks led to disruptions in interbank markets and exacerbated the turmoil.	Central banks need to be able to lend to a sufficiently broad set of counterparties and accept a sufficiently broad range of collateral while avoiding excessive counterparty/credit risk. Care is needed to avoid unduly stigmatizing the use of central bank liquidity. There would be merit in improving collaboration among central banks, including by establishing a more permanent set of emergency swap lines to address problems of liquidity in foreign currency, and in seeking greater convergence in operational frameworks.

BOX 3.5

Collaboration and outreach on financial sector issues

During FY2008, the IMF sponsored or cosponsored a number of conferences and seminars on financial globalization and financial stability.

In December 2007, the IMF Regional Office for Asia and the Pacific (OAP), the 21 COE-Market Quality Project of Keio University, and the Financial Research and Training Center of Japan's Financial Services Agency hosted the conference "Financial Stability and Financial Sector Supervision: Lessons from the Past Decade and Way Forward," in Tokyo. The conference brought together a select group of senior officials from the Asia-Pacific region, international financial institutions, academics, private sector representatives, and other stakeholders to review the progress that had been made in banking reform and financial sector supervision and examination over the last 10 years. Discussions focused on the readiness of financial systems in developing countries in the region to cope with ongoing changes in the global financial landscape, including through an effective implementation of the Basel II standards.

The Fund also cosponsored seminars and conferences with member countries and think tanks. In September 2007, it cohosted with the U.S. Federal Reserve Bank of Chicago the "Tenth Annual International Banking Conference: Globalization and Systemic Risk," which provided a forum where policymakers from advanced and emerging market countries and academics could discuss the current landscape of cross-border banking activity; how systemic risk may be enhanced or contained by globalization; the potential sources of systemic risk (particularly banks, insurance companies, pension funds, hedge funds, and other capital market participants); regulatory efforts to address systemic concerns; and policy alternatives that need to be considered. In January 2008, the Fund cohosted a seminar with the Brookings Institution in Washington, D.C., "Global Downturn? The World Economy in 2008."[1] In April 2008, it cosponsored the Conference on International Macro-Finance in Washington, D.C., in collaboration with the World Economy and Finance Research Programme of the U.K. Economic and Social Research Council. Participants included, in addition to IMF staff, representatives from central banks of several member countries and leading academics. The conference served as a forum where participants could present recent theoretical and empirical research narrowing the gap between "open-economy macro" and "finance" approaches to international financial issues.

1 The transcript of the seminar is available on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/tr/2008/tr080131.htm.

LEFT: Skyline of Abu Dhabi, United Arab Emirates. RIGHT: Transporting vegetables in Phnom Penh, Cambodia.

and other sovereign assets. The roundtable was attended by high-level delegations from central banks, finance ministries, and sovereign asset managers from 28 countries. Discussions covered trends in reserve accumulation and their implications for central bank balance sheets.

At the Executive Board's discussion of SWFs in March 2008,[38] most Executive Directors considered that the Fund was well placed to facilitate and coordinate the development of generally agreed principles and practices for SWFs and stressed that this work should go hand in hand with work being undertaken at the Organization for Economic Cooperation and Development (OECD) and elsewhere. Executive Directors supported an inclusive, collaborative approach with SWFs that would involve relevant members and stakeholders, and agreed that these principles and practices would be adopted on a voluntary basis.

In its April 2008 Communiqué,[39] the IMFC welcomed the IMF's initiative to work as a facilitator and coordinator with SWFs in developing a set of best practices and stated that it looked forward to reviewing the progress made at its next meeting.

On April 30–May 1, 2008, representatives of SWFs met at IMF headquarters in Washington, D.C., with representatives from the countries in which they invest, the OECD, and the European Commission. The SWFs formally established an international working group that is tasked with developing by October 2008 a common set of voluntary principles for SWFs, drawing on the existing body of principles and practices, that properly reflect their investment practices and objectives.[40] The IMF will provide the secretariat for the working group, which is composed of representatives from 25 IMF member countries. The working group is cochaired by a senior representative of the Abu Dhabi Investment Authority and the Director of the IMF's Monetary and Capital Markets Department, who were selected by the participating SWFs.

Anti-money laundering/combating the financing of terrorism

The Fund remains firmly engaged in AML/CFT work but is concentrating on those areas where it has the greatest comparative advantage, that is, assessments of countries that are systemically important or that present serious money-laundering or terrorist-financing risk—for example, emerging economies and middle-income countries whose financial systems have developed faster than their AML/CFT safeguards. This work has strong synergies with the Fund's other financial sector assessment work, and the Fund is continuing to integrate AML/CFT issues into its broader surveillance mandate, exploring the relationships between money laundering, informal sectors, and the mainstream economy. The Fund's AML/CFT technical assistance work supports its assessment work. Going forward, it will be more demand-driven and will rely primarily on external funding.

Financial soundness indicators

Financial soundness indicators (FSIs) are a relatively new body of economic statistics that are used, along with other economic and financial indicators, to assess the financial strength and vulnerabilities of a country's financial sector. The IMF worked closely with national agencies and regional and international institutions to develop a set of core and encouraged FSIs. The

38 See "IMF Executive Board Discusses a Work Agenda on Sovereign Wealth Funds," PIN 08/41, on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pn/2008/pn0841.htm. A background paper prepared by the staff, "Sovereign Wealth Funds—A Work Agenda," can also be found on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/pp/eng/2008/022908.pdf.

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

40 The international working group's Web site, www.iwg-swf.org/, which was launched in June 2008, provides group members with access to confidential working documents. It also makes available to interested parties public information issued by the group and links to SWF Web sites. Inquiries can be sent to the IMF through the site.

41 See "IMF Executive Board Concludes Financial Soundness Indicators—Experience with the Coordinated Compilation Exercise and Next Steps," PIN 07/135, on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pn/2007/pn07135.pdf.

42 Further information on the Standards and Codes Initiative and copies of country assessments can be found on the IMF's Web site, at www.imf.org/external/np/rosc/rosc.asp.

Executive Board endorsed the FSIs in 2001 and a work program in 2003 aimed at increasing the capacity of member countries to compile FSIs and expanding reporting and analysis of FSIs in the work of the Fund. As part of this work program, the IMF produced the *Financial Soundness Indicators Compilation Guide* and launched a voluntary Coordinated Compilation Exercise (CCE) in 2004. The 62 participants in the CCE undertook to compile the 12 core FSIs and as many of the 28 encouraged FSIs as possible and to provide them, the underlying data series, and related metadata to the IMF for dissemination. FSIs are routinely monitored by the IMF as part of its enhanced surveillance of financial systems and are frequently included in staff reports and FSAP reports.

In November 2007, the Executive Board reviewed the experience with the work program and discussed proposals for taking the work on FSIs forward.[41] Executive Directors were of the view that FSIs represented an important starting point for analysis of financial stability and a key element of the IMF's financial soundness assessment toolkit. They urged that FSIs continue to be a standard part of surveillance, FSAP reports, and the IMF's Vulnerability Exercise, and welcomed the reporting of FSIs in staff reports. Noting that FSIs need to be interpreted with caution, given the diversity of the accounting, regulatory, and legal systems that underpin them, the Board called for further progress on improving cross-country comparability and encouraged continued efforts by the IMF and other international agencies to harmonize data compilation methodologies and reporting. Executive Directors saw clear value in the regular collection and dissemination of FSIs by the IMF, with the creation of a centralized public FSI database that would be available to member countries, international institutions, and markets. They agreed that countries should be encouraged—but not required—to report FSIs to the IMF.

FRAMEWORK OF DATA PROVISION FOR SURVEILLANCE AND OTHER DATA INITIATIVES

Data provision to the Fund for surveillance purposes

A review by IMF staff of the policy framework for data provision for surveillance, submitted to the Executive Board at the end of FY2008 and discussed in early FY2009, considered that the overall framework remained appropriate, but suggested efforts to clarify staff's assessments of data adequacy, strengthen data reporting for assessments of external stability, improve country participation and coverage for financial sector data initiatives, and take appropriate action in cases where members, despite adequate capacity, fail to provide data.

Fiscal and data transparency

The need for monetary and financial statistics that are accurate, comprehensive, comparable across countries, and widely available on a timely basis has been underscored by modern episodes of instability in financial markets, including the recent stresses in the loan and securities markets. During FY2008, the Fund undertook several initiatives to enhance the transparency and quality of financial sector data in its member countries (Box 3.6). It reconvened the Working Group on Securities Databases and hosted a workshop organized by the Irving Fisher Committee on Central Bank Statistics. It published *Monetary and Financial Statistics: Compilation Guide*, a companion to the *Monetary and Financial Statistics Manual*. The new Guide is intended to help countries compile high-quality data in accordance with current best practices. During FY2008, the number of economies reporting international investment position data for the Fund's statistical publications continued to increase, reaching 113 at end-2007.

The Executive Board approved in May 2007 the Fund's revised *Code of Good Practices on Fiscal Transparency*, a central element in IMF actions to promote transparency and good governance. The revisions reflected a broad consultative process, in which country authorities, civil society organizations, international institutions, academia, and the private sector took part. Revised versions of the *Manual on Fiscal Transparency* and the *Guide on Resource Revenue Transparency* were also published. Assessments of practices under the *Code of Good Practices on Fiscal Transparency* have so far been published for 86 countries as part of the voluntary Standards and Codes Initiative, which was launched in 1999.[42] Fiscal transparency is one of 12 topics covered by the Initiative, under which the IMF and the World Bank respond to member countries' requests for summaries of their observance of good-practice standards in three broad areas—transparent government operations and policymaking, financial

BOX 3.6

Initiatives on financial sector data

Well-functioning local-currency bond markets can contribute to strong and sustainable economic growth and financial stability in emerging market and developing countries, but internationally comparable data on bond markets are limited. In 2007, the finance ministers of the Group of Eight (G-8) countries called on the IMF and other international organizations to improve the quality, comparability, and consistency of these data.

In response, the IMF reconvened the Working Group on Securities Databases, which it chairs, to discuss the development of a global securities database. The other members of the Working Group when it was established by the IMF in 1999 were the Bank for International Settlements (BIS) and the European Central Bank (ECB). Its work was put on hold in 2001 until the ECB's development of a Centralized Securities Database was more advanced. In September 2007, representatives from the BIS, ECB, World Bank, Deutsche Bundesbank, Bank of Mexico, and U.S. Federal Reserve met at IMF headquarters to take stock of the available data on local debt markets in emerging market and developing countries and to identify any gaps. Participants established that the BIS and ECB both had databases on domestic and international debt securities that could be developed to meet the requirements of users of statistics. Following up on this meeting, in March 2008 the IMF hosted a workshop organized by the Irving Fisher Committee on Central Bank Statistics. Participants in the workshop, who included representatives from international and regional organizations as well as from central banks and statistical offices in a wide range of countries, agreed on the need for a guide on compiling securities statistics, since there is as yet no international standard in this area. The guide will focus initially on debt securities but will eventually be expanded to cover other securities and securities holdings.

In addition, in April 2008, the IMF published the *Monetary and Financial Statistics: Compilation Guide*, aimed at providing direct assistance to national-level data compilers responsible for implementing the methodological and statistical frameworks contained in the IMF's *Monetary and Financial Statistics Manual*, which was published in 2000. By including the compilation of flow data, the *Guide* and the *Manual* represent a major advance in the guidance the IMF has been providing to countries since 1948 on monetary statistics; the focus had previously been on the compilation and reporting of balance sheet data (end-of-month stocks) for the central bank and other depository corporations. The *Guide* focuses on cross-country harmonization of source data and methodology for compilation and presentation of statistics. It also describes the unified framework for countries' reporting of monetary data to the IMF. In 2004, the Fund introduced the Standardized Report Forms (SRF) for countries' reporting of balance sheet data for depository corporations, insurance corporations, pension funds, and other institutional types of financial corporations. Thus far, more than 100 countries/territories have established monthly reporting of SRF data, and time series from these data are published in the IMF's quarterly *International Financial Statistics: Supplement on Monetary and Financial Statistics*. The *Guide* also introduces illustrative supplementary data that include subcategories—by type of contract—for financial derivatives. The financial statistics described in the *Guide*, which record the distribution and redistribution of financial assets and liabilities among the sectors of an economy, are an important input to the IMF's balance sheet approach to analyzing a country's vulnerability to external or internal shocks.

Finally, in FY2009, the Fund will also initiate regular collection and dissemination of FSIs, as described on pages 35 and 36.

sector standards, and market integrity standards for the corporate sector. The assessments are designed to help countries strengthen their economic institutions, to inform the work of the IMF and the Bank, and to inform market participants (see CD-Box 3.1 on the CD-ROM).[43]

In February 2008, the IMF and the World Bank released new, enhanced versions of the Quarterly External Debt Statistics (QEDS) database and the Joint External Debt Hub (JEDH). The QEDS database, which was launched in 2004, brings together external debt statistics that are normally published individually by countries that subscribe to the IMF's Special Data Dissemination Standard (SDDS). To further enhance the availability of external debt data, the World Bank and the IMF invited a group of low-income countries that participate in the IMF's General Data Dissemination System (GDDS) to report a simplified quarterly set of data focusing on the external debt of the public sector. Fourteen countries have accepted the invitation, and 12 of them have already started providing the requested data. The intention is to expand the number of reporting countries over time.[44] The JEDH is a joint undertaking of the Bank for International Settlements (BIS), the IMF, the OECD, and the World Bank. It represents a further step by the institutions involved to facilitate and encourage worldwide dissemination of external debt data by as many countries as possible.[45]

Coordinated Direct Investment Survey

In 2007, the IMF decided to undertake a Coordinated Direct Investment Survey in collaboration with its Inter-Agency Task Force partners, including the OECD, the Statistical Office of the European Communities, the European Central Bank (ECB), and the United Nations Conference on Trade and Development. All Fund member countries and a few nonmembers were invited to participate. As of April 2008, 135 countries had indicated a willingness to participate in the survey. The survey will collect information on outstanding direct investment positions, broken down by equity and debt, and then by debt assets and liabilities, by counterpart country as of the end of 2009. The survey will also capture world totals and the geographic distribution of positions, thereby contributing to improved understanding of globalization. The first results are expected to be available by the end of 2010 or early in 2011 and to be published by the IMF. A task force was formed in 2007 to assist the IMF in preparing a guide for countries responding to the survey.[46] The survey is the first such undertaking by the IMF in a coordinated manner on direct investment data. It is, to a large extent, modeled on the very successful Coordinated Portfolio Investment Survey (CPIS), which has been conducted under the auspices of the IMF on an annual basis since 2001.[47]

The Data Standards Initiatives

Data standards continue to play an important role in strengthening Fund surveillance. Implementation of the Fund's Data Standards Initiatives is progressing, with 64 SDDS subscribers and 92 GDDS participants, together representing about 85 percent of the Fund's membership. In February 2008, in an informal seminar, the Executive Board discussed a paper reviewing 10 years of experience with the GDDS, which points to possible future directions and emphasizes data dissemination and plans for improvement that focus on the periodicity and timeliness of data. An outreach program with member countries is in progress (two consultations were held in April 2008, one in South Africa and the other in Thailand). A Seventh Review of the Fund's Data Standards Initiatives will be discussed by the Executive Board in the fall of 2008.

THE TRIENNIAL SURVEILLANCE REVIEW

Over the past 30 years, the Executive Board has reviewed the IMF's surveillance work at regular intervals.[48] At a Board briefing in April 2008 based on an Issues Note prepared by staff, Executive Directors began discussing the design of the Triennial Surveillance Review, which will provide them with an opportunity to discuss strategic issues related to refocusing the Fund's surveillance, including focus, quality of analysis in key areas—macrofinancial linkages and a multilateral perspective in bilateral surveillance—candor and consistency in assessing external stability, and effectiveness of surveillance communication. The Review is to include a Statement of Surveillance Priorities, which is expected to help focus surveillance across the Fund, underpin policy dialogue with members, and enhance accountability.

43 See "IMF Launches Revised Fiscal Transparency Code and Manual," PR 07/95, on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pr/2007/pr0795.htm. The Code and the Manual are also available on the IMF's Web site, at www.imf.org/external/pp/longres.aspx?id=4175 and www.imf.org/external/pp/longres.aspx?id=4177, respectively.

44 The SDDS was established in 1996 to guide countries that have or seek access to international capital markets and that already meet high standards for the quality of their statistical data. The GDDS was established in 1997 to help countries improve their statistical systems and is open to all IMF members. Both are voluntary, but once a country subscribes to the SDDS, observance of the standard is mandatory. See CD-Box 3.1 on the CD-ROM and *The IMF's Data Dissemination Initiative After 10 Years*, at www.imf.org/external/pubs/ft/books/2008/datadiss/dissemination.pdf.

45 See "IMF and World Bank Expand Databases on External Debt Statistics," PR 08/37, on the CD-ROM or on the IMF's Web site, at www.imf.org/external/np/sec/pr/2008/pr0837.htm.

46 The guide can be found at www.imf.org/external/np/sta/cdis/index.htm.

47 The data on the CPIS can be found at www.imf.org/external/np/sta/pi/cpis.htm.

48 Under the 1977 Surveillance Decision, reviews of the surveillance procedures and the implementation of surveillance were conducted biennially from 1988 to 2004. In accordance with the Medium-Term Strategy's call for streamlining IMF procedures, the new 2007 Decision provides for triennial reviews.