Restoring Global Financial Stability

Restoring Global Financial Stability

The extraordinary global financial crisis posed a host of serious policy challenges to most Fund members, as well as systemic risks to the global economy. The full attention of the IMF was directed toward addressing the policy challenges raised by the crisis, including helping governments prepare a full policy framework in countries already in crisis, and for other vulnerable countries, strengthening contingency planning and crisis preparedness and intensifying surveillance. In collaboration with other international bodies and standard setters, the Fund immediately identified the core macroeconomic and financial policy response needed to help minimize the economic and social costs of the crisis. It then worked to encourage early action, promoted dialogue within the membership, and started the critical task of examining the causes of, and gleaning lessons from, the crisis. The Fund helped members directly with financing and policy advice, placing greater emphasis on macrofinancial linkages, contagion risks, financial safety nets, and crisis preparedness and management. It also advised countries to provide support to economic activity wherever space for such support was available.

In the first half of 2008, the Fund's energies in regard to crisis response were directed toward assisting member countries, particularly low-income countries, in dealing with the effects of the food and fuel price shocks. Emphasis then shifted to the global crisis in financial markets as it escalated late in 2008, with record levels of Fund lending approved in FY2009 as a result of the intensity of the crisis. The Fund's swift response was aided in some cases by the activation of the emergency financing mechanism, which enabled the Executive Board to approve financial support for member countries within days of receiving the request. The intensified lending naturally focused attention on the adequacy of the Fund's lending instruments, which were subjected to a thorough internal review in the second half of the financial year that culminated in a major overhaul of Fund lending to realign it more closely with members' ongoing needs. The increased lending also directed attention, both inside and outside the Fund, to whether the organization had adequate financial resources to meet the likely level of need among Fund members, resulting in pledges of support from various bilateral sources and a commitment, in April 2009, by the G-20 to a tripling of the Fund's lending resources.

Amidst efforts to meet the immediate needs of member countries, the IMF also began assessing the causes of the crisis and the mechanisms of its transmission across the globe, distilling lessons to help ensure that a similar crisis does not recur. Staff analysis throughout the year informed the Board's discussions on initial lessons from the crisis in February 2009, which provided insights into policy and regulatory failures that contributed to the crisis and identified immediate priorities to be addressed and key areas to help prevent future crises. Developments in the world economy were continually monitored as the crisis continued to unfold and assessments were made of their effects on member countries, and IMF staff regularly updated the Executive Board on developments in regions and individual countries.

Among the many issues raised by the crisis was the role of Fund surveillance, specifically, whether surveillance could have done more to help avert the crisis and what steps might be taken to strengthen the effectiveness of the organization and help prevent a recurrence. The conclusion of the 2008 Triennial Surveillance Review in October provided the Board with an opportunity to assess the Fund's surveillance comprehensively in this context and yielded the IMF's first-ever Statement of Surveillance Priorities. Emphasis was also placed during the year on ways of integrating financial sector issues more systematically into surveillance (particularly the Fund's Article IV consultations with its member countries), with the Board devoting an informal seminar in February 2009 to the topic. Plans were made to extend the Fund's annual vulnerability exercise to advanced economies, and reviews of member countries' provision of data to the Fund highlighted the importance of data coverage and adequacy in crisis prevention and response. The Fund's core work in the areas of bilateral, multilateral, and regional surveillance continued even as the Fund concentrated attention and resources on helping manage and resolve the crisis.

RESPONSE TO THE CRISIS

The deepening crisis

The IMF had highlighted the growing risks to global economic and financial stability by the end of 2007.[5] The Fund continued to focus on these risks and their consequences at the outset of FY2009, in particular, the deepening concerns about the stability and soundness of financial markets worldwide and the impact on member countries—especially low-income countries—of the jump in food and fuel prices in the first half of 2008. Additionally, the Fund's ongoing bilateral and multilateral surveillance became increasingly focused on financial risks. After October 2008, with the very rapid deterioration of the global financial and economic environment, and the reversal of the surge in food and fuel prices beginning midyear (and culminating in their receding to five-year lows, in nominal terms, by the fourth quarter of 2008), attention was focused on providing emergency financial assistance to countries affected by the financial crisis—especially emerging market countries—and on ensuring that the Fund had both the right instruments and adequate financial resources to meet that crisis. The Fund was also intensely engaged in assessing the appropriate policy responses in advanced countries—for example, fiscal and monetary stimulus (the latter including unconventional measures) and repairs to financial sectors—while encouraging countries to avoid protectionism.

Food and fuel price increases

Responding to what proved to be a relatively short-lived, although very disruptive, spike in food and fuel prices, an informal Board briefing in June 2008 discussed the macroeconomic impact of and policy responses to food and fuel price increases.[6] The spike had especially severe repercussions for the Fund's low-income members, and the institution responded by increasing financial assistance to those countries to mitigate the price shocks. Arrangements under the IMF's Poverty Reduction and Growth Facility were augmented for a number of low-income countries to assist them in coping with the increases (see "Support for Low-Income Countries" in Chapter 4). Attention was also focused on the growing risks affecting emerging markets, and in July 2008, the Board held a preliminary discussion on macrofinancial and cross-border risks for emerging market economies. A public seminar, attended by more than 100 representatives from the media, civil society organizations, and academia, was also held in early July 2008, in conjunction with the release of staff reports assessing the effects of the surge in commodity prices on the economies of low-income and emerging market countries (see Web Box 3.1).[7] The seminar concluded that the impact of surging oil and food prices, while being felt universally, was most severe for import-dependent poor and middle-income countries confronting balance of payments problems and higher inflation, with the poor in those countries facing acute difficulties.

The crisis in financial markets

Recognizing that the crisis was beginning to take on global dimensions, the IMF at midyear focused its work on understanding and drawing lessons to date, strengthening collaboration with the Financial Stability Board, and building on FSB recommendations.

By September 2008, the global crisis had entered a new phase, becoming rapidly and significantly worse. The IMF responded by identifying the policy challenges, including the need for increased emphasis on macrofinancial linkages, reforming its lending instruments, reviewing its financing role in member countries and the adequacy of its resources, and providing emergency lending to countries affected by the crisis. The Managing Director, noting that the crisis was spreading to emerging markets, emphasized in October 2008 the Fund's readiness to act quickly using its emergency financing mechanism (see Box 3.1). The Executive Board subsequently approved requests for expedited financial support from seven countries under this mechanism in late 2008 and early 2009. In the second half of FY2009, IMF lending reached unprecedented levels (see Box 3.2 and "Financial Support").

At the October 2008 Annual Meetings, the IMFC called upon the IMF to take the lead in drawing policy lessons from the crisis and recommending actions to restore confidence. In addition, at an emergency summit in November 2008, G-20 leaders asked the Fund to help coordinate the effort to develop a possible new financial architecture, drawing on lessons from the crisis. At a second meeting in April 2009, G-20 leaders underscored the need for a new financial architecture and pledged additional resources to the Fund to help countries deal with the crisis.

Welcoming the opportunity to take stock of the IMF response to the crisis, in an October 2008 Board discussion on IMF collaboration with the Financial Stability Board,[8] Executive Directors stressed the need for continued close collaboration among national authorities, standard setters, international financial agencies, and the private sector, noting the Fund's key role as the leading international institution for macrofinancial analysis. They supported the increased focus of the Fund's surveillance and financial sector work on policy challenges raised by the financial crisis and emphasized greater priority for assisting members in identifying and remedying gaps in financial regulation and supervision. Encouraged by the close collaboration with the FSB since its establishment, Executive Directors saw merit in strengthening that collaboration and in exploring concrete modalities for doing so, including with respect to financial stability assessments and opportunities for joint IMF-FSB outreach.

As part of its ongoing work with the FSB, the Fund cosponsored with the FSB in October 2008 a high-level meeting on the financial turmoil and policy responses (see Web Box 3.2). The meeting reviewed the main challenges and risks faced by mature financial markets and analyzed the impact on, and key transmission channels to, emerging markets. The Fund also collaborated with the FSB on developing an early warning exercise, and an

BOX 3.1

The IMF's emergency financing mechanism

The IMF's emergency financing mechanism, established in 1995, enables rapid approval of IMF lending to its member countries. Through the emergency mechanism, the IMF's Executive Board can act more quickly than for a normal IMF lending program. The emergency procedures under the mechanism are expected to be used only in rare circumstances that represent or threaten to give rise to a crisis in a member's external accounts requiring immediate response from the Fund. The conditions for activation of emergency procedures include the readiness of the member to engage immediately in accelerated negotiations with the Fund, with the prospect of early agreement on—and implementation of—measures sufficiently strong to address the problem.

The mechanism had been used on only five occasions prior to the global crisis: in 1997 during the Asian crisis for the Philippines, Thailand, Indonesia, and Korea, and in 2001 for Turkey. In FY2009, as a result of the suddenness and intensity of the global downturn, an additional seven countries (Armenia, Georgia, Hungary, Iceland, Latvia, Pakistan, and Ukraine) received expedited financial assistance from the Fund via the mechanism.

Under the emergency procedures, IMF management informs the Executive Board of the intention to activate emergency procedures and provides reasons. A short written report is circulated as soon as feasible, describing the member's economic situation. Once understandings with the authorities have been reached on a program, the IMF staff report is circulated, and the Board considers the request for a program within 72 hours. The member's past cooperation with the IMF has a strong bearing on the speed with which the Fund can assess the situation and agree on necessary corrective measures.

informal Board discussion on the proposed procedure for the exercise was held in February 2009 (see "Follow-Up on Surveillance Priorities").

Putting in place the instruments to meet challenges posed by the crisis

One of the IMF's key purposes is to provide financial assistance, under adequate safeguards, to members facing balance of payments problems. Fund lending has a unique role in crisis resolution and contributes to global financial stability by mitigating the risk that members' problems will erupt into full crisis and spill over into other countries. Thus, it is essential that the Fund's lending facilities be effective for the needs of the day.

As the crisis deepened, the Executive Board had intense discussions on modernizing the Fund's lending instruments and on how best to tailor the Fund's instruments to members' needs.[9] These discussions culminated in the approval in March 2009 of a number of far-reaching reforms.

The March reforms

To enable the IMF to better meet members' needs in the context of the crisis and strengthen its capacity to prevent and resolve crises, the Executive Board approved a major overhaul of the Fund's nonconcessional lending framework in March 2009.[10] This comprehensive overhaul was the culmination of numerous Board discussions and extensive staff work during the preceding 18 months to assess and determine the reforms that would best enable the Fund to meet members' ongoing needs. The reforms approved included modernizing IMF conditionality for all borrowers, introducing a new Flexible Credit Line, enhancing the flexibility of the Fund's traditional Stand-By Arrangement (SBA), doubling normal access limits for nonconcessional resources, simplifying cost and maturity structures, and eliminating certain seldom-used facilities (see Box 3.3). A review and reform of concessional lending instruments for low-income members was pursued as a complementary step (see "Reassessing LIC Financing and Debt Sustainability" in Chapter 4).

The reforms are expected to enhance the effectiveness of the IMF's nonconcessional lending facilities in meeting members' financing needs, while preserving adequate safeguards for Fund resources, by modernizing the conditionality framework applying to all Fund arrangements (including those that are concessional), increasing access limits on nonconcessional lending, and reforming the pricing of high and precautionary access to nonconcessional lending. All aspects of the IMF's non-concessional lending instruments and policies were assessed: the existing General Resources Account (GRA) facilities, the conditionality framework, access levels, charges and fees, and maturities. By enhancing instruments for precautionary lending and tailoring the use of Fund resources to the strength of members' policies and fundamentals, the reforms aim to encourage members to approach the Fund early, thereby reducing the likelihood of crises or mitigating their ultimate costs. Together with a substantial increase in the Fund's resources (see "Making Sure the Fund Has Adequate

BOX 3.2

Unprecedented Fund lending commitments in FY2009

The intensification of the global financial crisis led to a record level of IMF lending commitments in FY2009, with numerous loan approvals expedited via the Fund's emergency financing mechanism. The Fund approved loans amounting to SDR 65.8 billion to 15 member countries through its nonconcessional facilities, with all but one of these arrangements approved in the second half of the year. Similarly, the Fund approved loans or augmentations to existing arrangements for 26 countries totaling SDR 1.1 billion through its concessional lending facilities, which offer financing to low-income countries at a subsidized interest rate. The amounts approved were unprecedented in the Fund's history in such a short time.

The heavy demand on Fund resources raised concerns about the adequacy of those resources to meet the crisis, prompting pledges of support from several member countries and a commitment from the G-20 in April 2009 to triple the Fund's nonconcessional lending resources and double its concessional lending capacity (see "Making Sure the Fund Has Adequate Resources to Meet the Crisis"). The increased demand also played a role in the ongoing review of the Fund's lending toolkit, which led to a major overhaul of Fund lending facilities in March 2009 (see "Putting in Place the Instruments to Meet Challenges Posed by the Crisis").

BOX 3.3

Key elements of the IMF's nonconcessional lending reform

- *Modernizing the conditionality framework* to ensure that conditions linked to IMF loan disbursements are sufficiently focused and adequately tailored to the varying strengths of members' policies and fundamentals. This is being achieved by making greater use of preset qualification criteria (ex ante conditionality) and introducing greater flexibility in the modalities of traditional (ex post) conditionality. In addition, structural reforms are now monitored in the context of program reviews, rather than through the use of structural performance criteria, which has been discontinued in all Fund arrangements, including those with low-income countries.

- *Establishment of the Flexible Credit Line*, designed to provide large and up-front financing to members with very strong fundamentals and policies. Access to the FCL is restricted to those members that meet strict qualification criteria:

  - a sustainable external position;
  - a capital account position dominated by private flows;
  - a track record of steady sovereign access to capital markets at favorable terms;
  - when the arrangement is requested on a precautionary basis, a reserve position that—notwithstanding potential balance of payments pressures that justify Fund assistance—remains relatively comfortable;
  - sound public finances, including a sustainable public debt position determined by a rigorous and systematic debt sustainability analysis;
  - low and stable inflation, in the context of a sound monetary and exchange rate policy framework;
  - absence of bank solvency problems that pose an imminent threat of a systemic banking crisis;
  - effective financial sector supervision; and
  - data transparency and integrity.

Because of the strict qualification criteria, drawings under the FCL are not tied to policy goals agreed with the country. The flexibility built into the design of the FCL relates to its uncapped access, its long repayment terms (3¼–5 years), its unrestricted renewals, and its dual use for contingent (precautionary) and actual balance of payments needs.[1]

- *Enhancements to the Stand-By Arrangement*—the Fund's workhorse lending instrument for crisis resolution—that provide flexibility and ensure its enhanced use also as a crisis prevention instrument by members that may not qualify for the FCL. The modified SBA framework provides increased flexibility by allowing front-loading of access and reducing the frequency of reviews and purchases where warranted by the member's policies and the nature of the balance of payments problem faced by the member.

- *Simplification of the Fund lending toolkit* through elimination of certain facilities that were little or never used—the Compensatory Financing Facility, the Supplemental Reserve Facility, and the Short-Term Liquidity Facility—since they were aimed at narrowly defined balance of payments problems.

- *Doubling of access limits* to 200 percent of quota on an annual basis and to a cumulative limit of 600 percent of quota. These higher limits give confidence to countries that they will have access to adequate resources to meet their financing needs. There continues to be scope for access above these limits, for example, through the FCL, or following intensified scrutiny under the exceptional access framework, which was also overhauled.

- *Adapting and simplifying cost structures* of high-access and precautionary lending across facilities. Surcharges continue to enable the Fund to build reserves to mitigate credit risks, and the revised surcharge schedule also increases price incentives to make early repayments. The previous time-based repurchase expectations policy has been repealed. The commitment fee schedule is adapted to help contain risks to Fund liquidity from large-scale precautionary lending (which is facilitated by the creation of the FCL and the reforms to high-access precautionary SBAs).

1 As part of its response to the continuing deterioration in the global economic environment, in late October 2008, the Fund created the Short-Term Liquidity Facility (SLF), intended as a quick-disbursing facility for market-access countries with very strong economic policies facing temporary liquidity problems in global capital markets. However, when the Fund further refined its instruments to address the needs of this group in March 2009, the Executive Board approved the Flexible Credit Line, which encompasses all of the features of the SLF and so supersedes it.

Resources to Meet the Crisis"), the reforms provide a strong platform from which the Fund can respond robustly to help members tackle the current as well as future crises.

Executive Directors generally considered the overall package to be a satisfactory compromise that balances the diverse interests of the membership. With regard to the FCL, Executive Directors agreed that the FCL should be reviewed in two years, or earlier if commitments under the FCL reached SDR 100 billion. Executive Directors also supported making high-access precautionary SBAs available on a more regular basis and making their design more flexible. They considered reforms to the surcharge system and repurchase expectations as striking a balance between simplifying the cost and repayment structures for Fund lending, and mitigating credit and liquidity risks and encouraging timely repayment of Fund resources.

Fund members responded rapidly to the facilities reform. In the weeks following the announcement of the revamped facilities in late March 2009, Mexico, Poland, and Colombia made requests for arrangements under the FCL. In mid-April 2009, the Fund approved the first FCL arrangement of US$47 billion for Mexico—the largest arrangement in IMF history. (The requests by Poland and Colombia for FCL arrangements, received a few weeks after Mexico's, were under discussion as the Fund's financial year ended but were subsequently approved in early FY2010.)

Making sure the Fund has adequate resources to meet the crisis

A key question raised by the global crisis was whether the IMF's resources were sufficient to meet the financing needs of its member countries. The Executive Board discussed this issue in early 2009, and a substantial increase in the Fund's lending resources was subsequently agreed to by the IMFC at its Spring Meeting (see Box 3.4 and Web Box 3.3). A related issue, the adequacy of the Fund's precautionary balances, was considered by the Executive Board in late 2008 in the context of higher Fund lending (see Box 3.5).

The Executive Board began discussing options for supplementing Fund lending resources in early February 2009. [11] Executive Directors emphasized that the Fund should be fully prepared to play a central role in the provision of balance of payments support, with most considering it prudent to err on the side of preparedness and agreeing that a near-doubling of the Fund's precrisis lending capacity would be appropriate, at least on a temporary basis.

While reaffirming that quotas are and should remain the basic source of the Fund's financing, Executive Directors concurred that reaching agreement on a general quota increase would take time, making such an increase unsuitable as an option for addressing near-term needs. Many nevertheless favored a general increase in quotas and called for advancing the timetable for discussions on the Fourteenth General Review of Quotas. (In April 2009, the IMFC agreed to advance the deadline for the review to January 2011, echoing an earlier call by G-20 leaders for completion by that deadline.) Executive Directors agreed that Fund borrowing from the official sector was the most appropriate approach to supplementing Fund resources in the short run, with various borrowing modalities—bilateral loan agreements, placement of Fund notes in the official sector, and enlargement and expansion of the New Arrangements to Borrow (NAB)—all viewed as worthy of further consideration.

The G-20 summit in early April 2009 supported a dramatic increase in IMF lending resources. At the summit, the G-20 industrial and emerging market economies reaffirmed the IMF's central role in the international financial system, agreeing to increase the resources available to the IMF through immediate financing from members of US$250 billion, subsequently incorporated into an expanded and more flexible NAB, increased by up to US$500 billion. In addition to this targeted tripling of the Fund's precrisis lending capacity, the G-20 leaders agreed to inject extra liquidity into the world economy via a US$250 billion general allocation of SDRs. In April 2009, the IMFC supported the G-20 leaders' call for an increase in the resources available to the IMF and the general allocation of SDRs.

The targeted immediate doubling of the IMF's precrisis lending capacity through bilateral financing from members was intended to help prevent a deepening of the crisis and support the global recovery and included resources that had already been pledged bilaterally. In February 2009, Japan agreed to provide the IMF with an additional US$100 billion—the single-largest supplemental financing contribution by an IMF member country ever—to bolster the Fund's lendable resources during the global economic and financial crisis.[12] European Union member states pledged an additional US$100 billion (EUR 75 billion) in March 2009. The funds from Japan and the European Union member states, along with additional funding pledged around the time of the G-20 summit (Canada, Norway, and Switzerland), as well as commitments from other sources, were expected to increase Fund resources by at least US$250 billion, in line with the G-20's commitment.

The bilateral agreements were expected to be incorporated subsequently into an expanded and more flexible NAB, increased by up to US$500 billion. The proposed modifications to the NAB sought to make it a much stronger backstop to the Fund's regular financing mechanism by expanding the number of participants from the existing 26, enlarging the aggregate total credit arrangements to up to US$550 billion (including the existing NAB of about US$50 billion), and making the NAB more flexible. The Fund subsequently began working with current and potential participants to advance these reforms quickly.

Similar efforts were undertaken to double the Fund's concessional lending capacity to meet the financing needs of low-income countries. The G-20 also supported such a move, and work advanced toward that end (see "Support for Low-Income Countries" in Chapter 4).

A proposal by the G-20 for a large general allocation of SDRs was also promoted that, while not increasing the Fund's lending

BOX 3.4

Where the IMF gets its money

Most resources for IMF loans are provided by member countries, primarily through the IMF's regular quota-based financing mechanism.[1] Each member of the IMF is assigned a quota, based broadly on its relative size in the world economy, which determines its maximum contribution to the IMF's financial resources. Upon joining the IMF, a country normally pays about one-quarter of its quota in the form of reserve assets, that is, widely accepted foreign currencies (such as the U.S. dollar, euro, yen, or pound sterling) or Special Drawing Rights.[2] The remaining three-quarters is paid in the country's own currency. Quotas are reviewed at least every five years; the Thirteenth Review of Quotas was completed in January 2008.

The IMF can use its quota-funded holdings of currencies of members with a strong balance of payments and reserve position to finance lending. The IMF's holdings of these currencies, together with its own SDR holdings, make up its own usable resources. If needed, the IMF can supplement its own usable resources through borrowing. Under its two standing multilateral borrowing arrangements—the New Arrangements to Borrow and the General Arrangements to Borrow—a number of member countries and institutions stand ready to lend additional funds to the IMF, up to a total of SDR 34 billion (about US$52 billion) as of end-April 2009. These arrangements were renewed in 2007 for another five-year period beginning in 2008. In addition, in February 2009 the IMF concluded a bilateral borrowing agreement with Japan, and towards the end of FY2009, other members pledged to bolster the IMF's lending capacity through bilateral borrowing arrangements (see chapter text).

Detailed information on various aspects of the IMF's financial structure and regular updates of its financial activities are available on the IMF's website at www.imf.org/external/fin.htm.

1 For further information, see "Where the IMF Gets Its Money—A Fact Sheet," available on the IMF website at www.imf.org/external/np/exr/facts/finfac.htm.
2 For an explanation of Special Drawing Rights, see "Special Drawing Rights—A Fact Sheet," available on the IMF website at www.imf.org/external/np/exr/facts/sdr.htm.

BOX 3.5

What are precautionary balances at the IMF?

The IMF maintains, as precautionary balances, (1) retained earnings held in the Fund's general and special reserves, which are readily available to absorb financial losses, including credit or income losses, and (2) the balance in the Special Contingent Account (SCA-1), a targeted balance designed specifically to protect the Fund against losses arising from the failure of a member to repay its overdue principal obligations.

Precautionary balances provide an essential buffer to protect the Fund against losses arising from both credit and income risks and also represent an important source of income. An adequate level of precautionary balances is therefore essential to protect the value of reserve assets that members place with the Fund and would also be critical if the Fund were to borrow substantially to supplement its resources (as it has made arrangements to do; see chapter text).

In December 2008, the Board reviewed the role and adequacy of the IMF's precautionary balances. Executive Directors noted that the rapid increase in Fund credit associated with the global financial shock had shifted the balance of risks sharply from income risk to credit risk. They agreed that the existing target for precautionary balances of SDR 10 billion would be retained for the time being, but a number observed that it may need to be raised if lending expands significantly and remains high. The Board also endorsed the development of a more transparent and rules-based framework for reserve accumulation, stressing that considerable judgment will continue to be needed, given the unique nature of the Fund's lending operations.


Vegetables being unloaded from trucks in Burundi.

capacity, would help members cope with the crisis by increasing their reserves. Executive Directors were briefed informally on the proposed SDR allocation in April 2009, and that same month, the IMFC called on the IMF to put forward a concrete proposal assessing the case for the general allocation and describing how it could be implemented, to be effective well before the 2009 Annual Meetings.

Financial support

Regular financing

The global financial crisis and resulting balance of payments pressures on many members led to a sharp increase in IMF financing and financing commitments in FY2009. Details on the lending facilities drawn are provided in Tables 3.1 and 3.2 and Figure 3.1, and the IMF's financing process is described in Box 3.6. An unprecedented number of arrangements were approved in FY2009 (see Figure 3.2) using the Fund's emergency financing mechanism (see Box 3.1). Large exceptional-access SBAs were approved as part of sizable financing packages that involved coordination with other sources of financing, including the European Union, the World Bank, and other bilateral loans. Four of the approved SBAs were initially precautionary with exceptional access. One arrangement was approved under the Fund's new Flexible Credit Line (see "Putting in Place the Instruments to Meet Challenges Posed by the Crisis"). Repayments to the General Resources Account totaled SDR 1.8 billion, of which 85 percent reflected obligations under SBAs. Repurchases on an expectations basis were eliminated on April 1, 2009, as part of the Fund's reform of its lending toolkit (see "Putting in Place the Instruments to Meet Challenges Posed by the Crisis.")

Concessional financing and debt relief

As of April 30, 2009, the economic programs of 28 member countries were supported by either PRGF or ESF–High Access Component arrangements, with commitments totaling SDR 1.8 billion and undrawn balances of SDR 0.8 billion. Total concessional loans outstanding of 56 low-income members amounted to SDR 4.1 billion at April 30, 2009. Information regarding new arrangements and augmentations of access under the Fund's concessional financing facilities is provided in Table 3.3 and Figure 3.3.

Debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) is another important ongoing IMF endeavor.[13] During FY2009, two member countries (Côte d'Ivoire and Togo) reached their decision points under the enhanced HIPC Initiative, and Burundi reached its completion point.[14] As of April 30, 2009, 35 countries had reached their decision points under the initiative; of these, 24 had reached their completion points. Those countries that reach their completion points qualify for debt relief under the MDRI. In total, the IMF has committed SDR 2.3 billion and disbursed SDR 1.8 billion under the HIPC Initiative and has provided debt relief of SDR 2.3 billion under the MDRI.

TABLE 3.1

IMF lending facilities

CREDIT FACILITY (YEAR ADOPTED)	PURPOSE	CONDITIONS	PHASING AND MONITORING[1]
CREDIT TRANCHES AND EXTENDED FUND FACILITY[3]			
STAND-BY ARRANGEMENTS (1952)	Medium-term assistance for countries with balance of payments difficulties of a short-term character.	Adopt policies that provide confidence that the member's balance of payments difficulties will be resolved within a reasonable period.	Quarterly purchases (disbursements) contingent on observance of performance criteria and other conditions.
FLEXIBLE CREDIT LINE (2009)	Flexible instrument in the credit tranches to address all balance of payments needs, potential or actual.	Very strong ex ante macroeconomic fundamentals, economic policy framework, and policy track record.	Approved access available up front throughout the arrangement period subject to completion of the midterm review for one-year arrangements.
EXTENDED FUND FACILITY (1974) (EXTENDED ARRANGEMENTS)	Longer-term assistance to support members' structural reforms to address balance of payments difficulties of a long-term character.	Adopt 3-year program, with structural agenda, with annual detailed statement of policies for the next 12 months.	Quarterly or semiannual purchases (disbursements) contingent on observance of performance criteria and other conditions.
SPECIAL FACILITIES			
EMERGENCY ASSISTANCE	Assistance for balance of payments difficulties related to the following:		None, although post-conflict assistance can be segmented into two or more purchases.
1. Natural Disasters (1962)	Natural disasters	Reasonable efforts to overcome balance of payments difficulties.	
2. Post-Conflict (1995)	The aftermath of civil unrest, political turmoil, or international armed conflict.	Focus on institutional and administrative capacity building to pave the way toward upper credit tranche arrangement or PRGF.	
FACILITIES FOR LOW-INCOME MEMBERS			
POVERTY REDUCTION AND GROWTH FACILITY (1999)	Longer-term assistance for deep-seated balance of payments difficulties of structural nature; aims at sustained poverty-reducing growth.	Adopt 3-year PRGF arrangements. PRGF-supported programs are based on a Poverty Reduction Strategy Paper prepared by the country in a participatory process and integrating macroeconomic, structural, and poverty reduction policies.	Semiannual (or occasionally quarterly) disbursements contingent on observance of performance criteria and reviews.
EXOGENOUS SHOCKS FACILITY (2006)	Short-term assistance to address a temporary balance of payments need that is due to an exogenous shock.		
1. Rapid-Access Component	Rapid assistance for actual balance of payment need whose primary source is an exogenous and sudden shock.	Commitment to appropriate policies; in exceptional cases, prior actions to address the shock.	Usually in a single disbursement.
2. High-Access Component	Assistance for exogenous shocks through a 1–2 year upper credit tranche program.	Adopt a 1–2 year program involving macroeconomic adjustment allowing members to adjust to the shock and structural reform considered important for adjustment to the shock, or for mitigating the impact of future shocks.	Semiannual disbursement on observance of performance criteria and, in most cases, completion of a review.

1 Except for the PRGF, the IMF's lending is mostly financed from the capital subscribed by member countries (these resources may be temporarily supplemented by borrowing if needed); each country is assigned a *quota* that represents its financial commitment. A member provides a portion of its quota in foreign currencies acceptable to the IMF—or SDRs (see "Special Drawing Rights (SDRs)—A Fact Sheet," available on the IMF website at www.imf.org/external/np/exr/facts/sdr.htm)—and the remainder in its own currency. An IMF loan is disbursed or drawn by the borrower *purchasing* foreign currency assets from the IMF with its own currency. Repayment of the loan is achieved by the borrower *repurchasing* its currency from the IMF with foreign currency (see Web Box 3.3 on the IMF's financing mechanism). PRGF lending is financed by a separate PRGF Trust.

2 The *rate of charge* on funds disbursed from the General Resources Account is set at a margin over the weekly interest rate on SDRs. The rate of charge is applied to the daily balance of all outstanding GRA drawings during each IMF financial quarter. In addition, a one-time service charge of 0.5 percent is levied on each drawing of IMF resources in the GRA, other than reserve tranche drawings. An up-front commitment fee (25 basis points on committed amounts of up to 200 percent of quota; 30 basis points for amounts in excess of 200 percent and up to 1,000 percent of quota; and 60 basis points for amounts in excess of 1,000 percent of quota) applies to the amount that may be drawn during each (annual) period under a Stand-By, Flexible Credit Line (on a pro rata basis for a 6-month FCL), or Extended Arrangement; this fee is refunded on a proportionate basis as subsequent drawings are made under the arrangement.

	REPURCHASE (REPAYMENT) TERMS		
ACCESS LIMITS[1]	CHARGES[2]	SCHEDULE (*YEARS*)	INSTALLMENTS
Annual: 200% of quota; cumulative: 600% of quota.	Rate of charge plus surcharge (200 basis points on amounts above 300% of quota; 300 basis points on amounts above 300% of quota for more than 3 years).[4]	3¼–5	Quarterly
No preset limit.	Rate of charge plus surcharge (200 basis points on amounts above 300% of quota; 300 basis points on amounts above 300% of quota for more than 3 years).[4]	3¼–5	Quarterly
Annual: 200% of quota; cumulative: 600% of quota.	Rate of charge plus surcharge (200 basis points on amounts above 300% of quota; 300 basis points on amounts above 300% of quota for more than 3 years).[4]	4½–10	Semiannual
Generally limited to 25% of quota, though larger amounts up to 50% can be made available in exceptional cases.	Rate of charge; however, the rate of charge may be subsidized to 0.5 percent a year, subject to resource availability.	3¼–5	Quarterly
280% of quota; 370% of quota in exceptional circumstances.	0.5%	5½–10	Semiannual
	0.5%	5½–10	Semiannual
Up to 50% of quota per shock. Limited to two shocks in 5 years.			
150% of quota (less any outstanding disbursements for the same shock under the rapid-access component).			

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

4 The new system of surcharges (shown in the table) went into effect as of August 1, 2009. The previous system of surcharges, introduced in November 2000, had the following schedule: 100 basis points above the basic rate of charge for credit outstanding over 200 percent of quota, and 200 basis points above the basic rate of charge for credit outstanding over 300 percent of quota. A member with credit outstanding in the credit tranches or under the Extended Fund Facility on, or with an effective arrangement approved before, August 1, 2009, had the option to elect either the new or the old system of surcharges.

Source: IMF Finance Department.

TABLE 3.2

Arrangements under main facilities approved in FY2009 (In millions of SDRs)

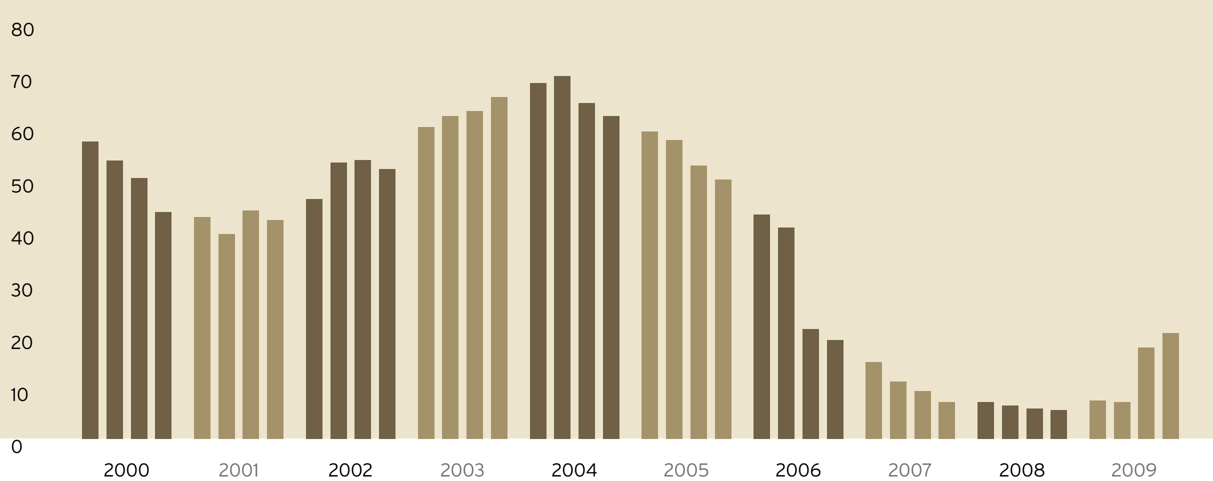
MEMBER	TYPE OF ARRANGEMENT	EFFECTIVE DATE	AMOUNT APPROVED
NEW ARRANGEMENTS			
Armenia[1]	28-month Stand-By	March 6, 2009	368.0
Belarus	15-month Stand-By	January 12, 2009	1,618.1
Costa Rica	15-month Stand-By	April 11, 2009	492.3
El Salvador	15-month Stand-By	January 16, 2009	513.9
Georgia[1]	18-month Stand-By	September 15, 2008	477.1
Guatemala	18-month Stand-By	April 22, 2009	630.6
Hungary[1]	17-month Stand-By	November 6, 2008	10,537.5
Iceland[1]	24-month Stand-By	November 19, 2008	1,400.0
Latvia[1]	27-month Stand-By	December 23, 2008	1,521.6
Mexico	12-month Flexible Credit Line	April 17, 2009	31,528.0
Mongolia	18-month Stand-By	April 1, 2009	153.3
Pakistan[1]	23-month Stand-By	November 24, 2008	5,168.5
Serbia	15-month Stand-By	January 16, 2009	350.8
Seychelles	24-month Stand-By	November 14, 2008	17.6
Ukraine[1]	24-month Stand-By	November 5, 2008	11,000.0
TOTAL			**65,777.3**

1 Approved under the Fund's emergency financing mechanism procedures.

Source: IMF Finance Department.

FIGURE 3.1

Regular loans outstanding, FY2000–FY2009 (In billions of SDRs)



Source: IMF Finance Department.

LESSONS FROM THE FINANCIAL CRISIS

Understanding what happened and drawing lessons for the future

The conclusions and lessons highlighted in Chapter 1 are among many to emerge from ongoing analysis by IMF staff and the Board in FY2009, particularly in the latter half of the year. Board activities in October 2008 and February 2009 built on staff work that examined, first, spillovers from the food and fuel price shocks and later, the global financial meltdown.

In October 2008, the Board looked at the transnational spillover and other effects of fiscal subsidies put in place in connection with surges in commodity prices, at a "Seminar on Fuel and Food Price Subsidies—Issues and Reform Options."[15] Executive Directors noted the rapid growth of subsidies following the surge in fuel and food prices, observing that price subsidies can have significant transnational spillovers through their impact on global warming, international prices, smuggling, and regional pollution, and discussed reform of such subsidies to improve effectiveness, reduce distortionary effects on the economy, and lessen fiscal costs, while protecting vulnerable groups.

Support was expressed for full pass-through of price increases to consumers to promote efficiency and contain negative external effects, though Executive Directors stressed that full pass-through must be accompanied by the implementation of compensatory measures to protect vulnerable groups, acknowledging that such implementation presents practical and political challenges in many countries. Noting that many low-income and emerging market countries lack the capacity to implement well-targeted safety nets and consequently have difficulty in passing through price increases, Executive Directors concurred that, in such countries, universal subsidies or tax deductions, which benefit higher-income households disproportionately, might have to be phased out gradually while more effective safety nets are put in place.

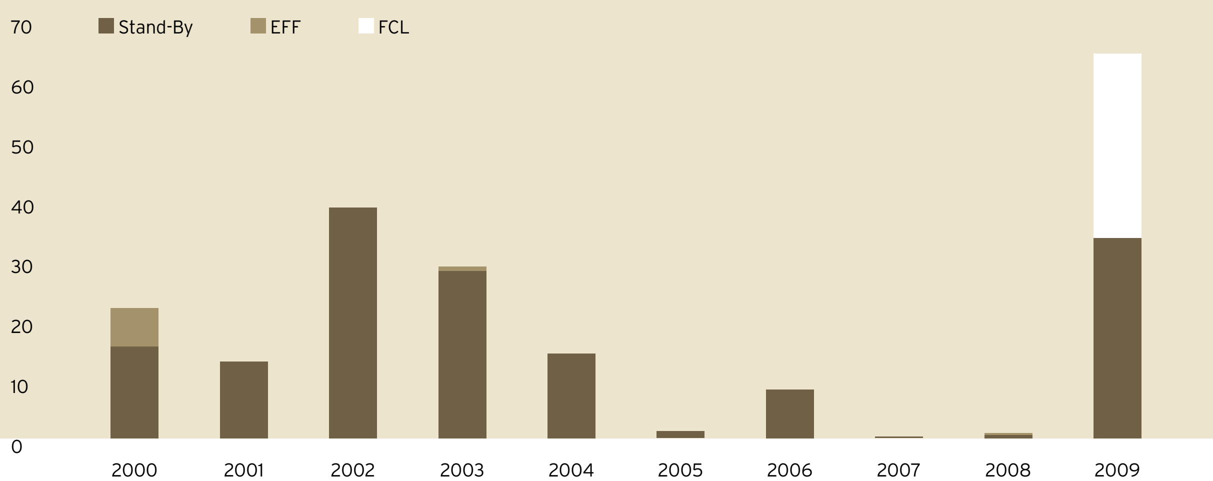
In February 2009, the Board discussed staff analysis, undertaken at the request of the IMFC, detailing initial lessons from the crisis.[16] Executive Directors stressed the preliminary nature of the discussion as well as the Fund's responsibility, given its mandate, to analyze the crisis and to work closely with other players—both national and international—to help restore global financial stability and economic growth.

Though views differed on the relative importance of the various causes of the crisis—failures in market discipline, financial regulation, macroeconomic policies, and global oversight—Executive Directors saw need for remedial actions across a broad front and at many levels, implying an ambitious agenda for policymakers and the need for coordinated action. They suggested that a

FIGURE 3.2

Arrangements approved during financial years ended April 30, 2000–09

(In billions of SDRs)



Source: IMF Finance Department.

range of reform priorities could be usefully considered in the area of financial regulation and supervision:

- expanding the perimeter of regulation to include a wider range of institutions and markets, with more effective cross-functional regulation and cooperation;
- reexamining existing regulatory and institutional practices with a view to reducing procyclicality;
- changing liquidity management practices and regulatory policies to ensure that financial institutions maintain larger liquidity buffers;
- strengthening public disclosure practices for systemically important financial institutions and markets, translating disclosures into effective assessments of institutional and systemic risk, and incorporating this information into early warning frameworks and the formulation of macroprudential policies;
- improving cross-border and cross-functional regulation and cooperation and promoting level playing fields across markets; and
- strengthening national liquidity frameworks and, at the international level, enhancing mechanisms for providing cross-border liquidity.

With regard to macroeconomic policies, many Executive Directors saw merit in expanding the mandate of monetary policy to include explicitly macrofinancial stability, rather than just price stability. A number of other Executive Directors, however,

BOX 3.6

How countries borrow from the IMF

A core IMF responsibility is providing financing to member countries experiencing balance of payments problems, enabling these countries to rebuild their international reserves, stabilize their currencies, continue paying for imports, and restore conditions for strong economic growth while undertaking policies to correct the underlying problems.[1] A member country may request IMF financial assistance if it has a balance of payments need—that is, if it has a balance of payments deficit or low levels of reserves. Though the volume of financing provided by the IMF has fluctuated significantly over time and a period of abundant capital flows and low pricing of risk throughout most of this decade resulted in substantial repayment of IMF credit, lending rose again starting in late 2008, as a result of global deleveraging in the wake of the financial crisis in advanced economies.

Upon request by a member country, IMF financing is usually provided under an "arrangement," which stipulates the specific policies and measures a country has committed to implementing to resolve its balance of payments problem. Once an arrangement is approved by the Fund's Executive Board, the financing is usually released in phased installments as the program is implemented.

Over the years, the IMF has developed various loan instruments, or "facilities," that are tailored to address the specific circumstances of its diverse membership. The Fund's facilities were the subject of careful consideration by the Executive Board in FY2009 to ensure that they continued to meet member needs (as detailed in "Putting in Place the Instruments to Meet Challenges Posed by the Crisis"). Table 3.1 provides details on the lending facilities through which the IMF makes financing available to its members.

All of the IMF's facilities, other than those offered to low-income countries at concessional rates, are subject to the IMF's market-related interest rate, known as the "rate of charge," and loans exceeding a certain threshold in terms of quota carry a surcharge. Eligible low-income countries may borrow at a concessional interest rate (0.5 percent) through the Poverty Reduction and Growth Facility and the Exogenous Shocks Facility. The IMF's emergency assistance to support recovery from natural disasters and conflicts is also offered in some cases at concessional interest rates.

The amount that a country can borrow from the Fund—its access limit—varies depending on the type of loan, but is a multiple of the country's IMF quota. This limit may be exceeded in exceptional circumstances. (One facility, the Flexible Credit Line, has no preset cap on access.) In the March 2009 reforms, the existing customary access limits under Fund facilities financed through the GRA were doubled, to 200 percent of quota on an annual basis and to a cumulative limit of 600 percent of quota (see "The March Reforms" and Box 3.3).

1 For additional information on the IMF's lending facilities, see the Fact Sheet on the topic available on the IMF's website at www.imf.org/external/np/exr/facts/howlend.htm; for up-to-date information on its lending arrangements, see "IMF Lending Arrangements," available at www.imf.org/external/np/fin/tad/extarr1.aspx.

TABLE 3.3

PRGF and ESF arrangements approved and augmented in FY2009 (In millions of SDRs)

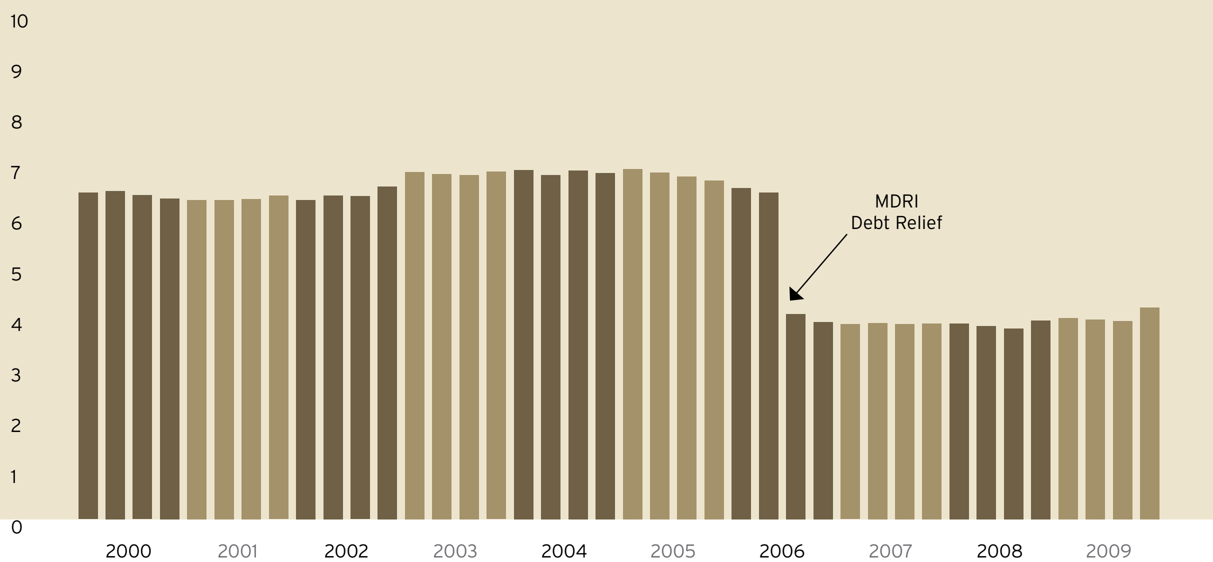
MEMBER	EFFECTIVE DATE	AMOUNT APPROVED
NEW THREE-YEAR PRGF ARRANGEMENTS		
Armenia[1]	November 17, 2008	9.2
Burundi	July 7, 2008	46.2
Congo, Republic of	December 8, 2008	8.5
Côte d'Ivoire	March 27, 2009	374.0
Djibouti	September 17, 2008	12.7
Mali	May 28, 2008	28.0
Niger	June 2, 2008	23.0
São Tomé and Príncipe	March 2, 2009	2.6
Tajikistan	April 21, 2009	78.3
Zambia	June 4, 2008	48.9
Subtotal		631.4
AUGMENTATIONS OF PRGF ARRANGEMENTS[2]		
Benin	June 16, 2008	9.3
Central African Republic	July 18, 2008	8.4
Gambia, The	February 18, 2009	6.2
Grenada	July 7, 2008	1.5
Guinea	July 28, 2008	21.4
Haiti	June 20, 2008	16.4
Haiti	February 11, 2009	24.6
Kyrgyz Republic	May 21, 2008	8.9
Madagascar	July 2, 2008	18.3
Malawi	July 14, 2008	10.4
Nicaragua	September 10, 2008	6.5
Sierra Leone	December 22, 2008	10.4
Togo	September 22, 2008	18.4
Subtotal		160.6
Total PRGF		791.9
NEW ESF ARRANGEMENTS		
Kyrgyz Republic (12-month)	December 10, 2008	66.6
Malawi (18-month)	December 3, 2008	52.1
Senegal (12-month)	December 19, 2008	48.5
Subtotal		167.2
DISBURSEMENTS UNDER ESF RAPID-ACCESS COMPONENT		
Comoros	December 15, 2008	2.2
Congo, Republic of	March 11, 2009	133.3
Ethiopia	January 23, 2009	33.4
Subtotal		168.9
Total ESF		336.1
TOTAL		**1,128.0**

1 Arrangement cancelled, March 6, 2009.
2 For augmentation only the amount of the increase is shown.

Source: IMF FInance Department.

FIGURE 3.3

Concessional loans outstanding, FY2000–FY2009 (In billions of SDRs)



Source: IMF Finance Department.

were of the view that monetary policy is too blunt an instrument to deal with asset price and credit booms and that overloading one instrument with too many different objectives must be avoided. Executive Directors agreed that prudential regulation should play a central role in addressing credit booms, and more generally, recognized the merits of authorities' adopting a broader macroprudential view and assigning a clear institutional mandate for macrofinancial stability. They generally considered that fiscal policy did not play a direct role in the run-up to the crisis; nevertheless, many Executive Directors observed that budget deficits in many countries had not been reduced sufficiently during the boom years when revenues were high, limiting the available fiscal space to fight the crisis. In several countries, the system of taxation promoted leverage and debt financing, increasing the vulnerability of the private sector to shocks. Most Executive Directors saw a need to revisit macroeconomic and structural policy responses to large imbalances, stressing consideration of financial and real spillovers, and to examine the scope for prudential measures to reduce systemic risk associated with capital flows.

Noting that inadequate warnings prior to the crisis—including, albeit not only, by the Fund—especially in the surveillance of systemically important advanced countries were a key failure in the architecture, Executive Directors generally considered that the Fund should have been more effective at identifying, communicating, and promoting coordinated responses to systemic risks to the global economy. Accordingly, efforts to strengthen surveillance must be intensified, with emphasis on covering all sources of systemic risk (in both advanced and emerging market countries) in an integrated manner and further analysis of poorly understood issues. Most Executive Directors welcomed work under way toward a joint early warning exercise with the Financial Stability Board, and many also underscored the importance of sharpening the Financial Sector Assessment Program.

Executive Directors noted that, given the need to share fiscal costs, there are no easy solutions to the problem of fragmented policy responses and spillovers among financial regulators, although they broadly agreed that it should be addressed. They also noted that resolving the problem of inadequate liquidity support and financing and insurance facilities to help countries weather turbulence in global capital markets cannot be the responsibility of the Fund alone; however, efforts under way to double the Fund's lending capacity should go a long way toward providing a solution.[17]

Having stressed the need for a global fiscal stimulus to boost aggregate demand, the Fund also began the process of assessing the risks posed by the large fiscal deficits in many countries. At a Board seminar on the state of public finances in February 2009,[18] Executive Directors acknowledged that fiscal policy in certain systemic countries would have to balance two opposing risks: the possibility of a deep and prolonged recession, which might require further government support to the financial sector and further stimulus to support demand, against the possibility of a loss of confidence in fiscal solvency. They highlighted the importance of formulating and communicating a clear and credible strategy for ensuring fiscal solvency over the medium term. This strategy should be based on four pillars: (1) reliance on temporary or self-reversing measures in fiscal stimulus packages; (2) medium-term fiscal frameworks envisaging a fiscal correction, once economic conditions improve; (3) growth-enhancing structural reforms; and (4) a firm commitment to contain the fiscal costs stemming from population aging. They observed that the Fund would continue to have an important role to play in monitoring fiscal developments across the membership.

Staying ahead of the next crisis

As the crisis continued to unfold, the IMF devoted significant effort to monitoring developments in the world economy, assessing their effects on member countries, and devising appropriate responses. Throughout the year, the Executive Board received regular updates, both formal and informal, from staff on an ongoing basis on developments in regions and individual countries, as well as through the World Economic and Market Developments Board presentations.

One particularly pressing issue that the Fund monitored closely throughout FY2009 involved the additional threat posed by the global financial crisis to the macroeconomic and financial stability of low-income countries, many of which were already under severe strain from high food and fuel prices.[19] As the global environment continued to change rapidly, the Fund carefully tracked the impact of many overlapping shocks that affect LICs differently depending on initial conditions, trade structures, and their financial links with the outside world. An informal Board meeting on this topic was held in June 2008, and a report on the impact of the crisis in the world's poorest nations, "The Implications of the Global Financial Crisis for Low-Income Countries,"[20] was issued to the Board and presented by the Managing Director at an event at the Brookings Institution in early March 2009. Also in March, the Board discussed changing patterns in low-income country financing and their implications for Fund policies on external financing and debt,[21] with most Executive Directors supporting staff proposals to move away from a single design for concessionality requirements toward a menu of options to reflect better the diversity of situations in LICs, in particular with regard to the extent of debt vulnerabilities and macroeconomic and public financial management capacity.

The Board held an informal seminar in early March 2009 on another issue raised to prominence by the financial crisis: legal, institutional, and regulatory frameworks that countries may put in place to deal with cases of bank insolvency, both in periods of financial stability and in systemic crises. It was observed that in such crises, the framework should allow for a flexible policy response that aims to protect the payments system, limit the loss of depositor and creditor confidence, and restore bank solvency, liquidity, and stability. Decisions would need to be taken quickly and often with limited information.

Advancing surveillance priorities

The stability of the global financial system was significantly tested in the prolonged and intense crisis of 2008–09. The severity of the crisis, the rapidity of its onset, and the pervasiveness of its spread and effects raised concerns about Fund surveillance that led to intensified Board efforts in FY2009 to monitor and assess its adequacy and ensure its effectiveness, most notably in the context of the completion of the Triennial Surveillance Review and the issuance of a first-ever Statement of Surveillance Priorities.

Identifying the Fund's economic and operational surveillance priorities

Just before the October 2008 Annual Meetings, the Board concluded its 2008 Triennial Surveillance Review—the first such review since the Board approved, in June 2007, a new Decision on Bilateral Surveillance—and issued a first-ever Statement of Surveillance Priorities identifying four economic priorities for Fund surveillance in 2008–11, as well as four operational priorities (see Box 3.7).[22]

Executive Directors considered that the refocusing of the IMF's surveillance had steered it in the right direction and generally concurred on the thrust of many of the review's findings and recommendations. Most broadly agreed that four areas—risk assessment, macrofinancial linkages, multilateral perspective, and external stability and exchange rate assessments—should be given priority in the Fund's surveillance over the next few years.

In the area of risk assessment, the Board noted that the Fund's surveillance was paying insufficient attention to risks and that communication about such risks had also sometimes been rather tentative. Many Executive Directors felt that surveillance communication should be bolder and should avoid excessive hedging, recognizing that such an approach does mean a risk of being proved wrong. A number underscored the need for greater candor in the Fund's assessment of risks to global financial stability emanating from advanced countries. Regarding macro-financial linkages, the Board noted that the Fund's increased attention to financial sector surveillance was beginning to pay off, particularly in identifying financial sector vulnerabilities. However, further progress was seen as needed to improve assessments of the relative likelihood and impact of key financial stability risks and to integrate analysis of financial sector and macroeconomic issues more generally, including across borders. Well-focused Financial Sector Assessment Program (FSAP) assessments would continue to be important and should be better integrated into Article IV reports.

Executive Directors observed that much more attention was being devoted to multilateral perspectives in Fund surveillance, but this work was not being used effectively enough and was not always well-matched with demand. Surveillance needed to better place countries in the global context by discussing cross-border economic linkages more explicitly, and lessons from cross-country experience needed to be brought out more effectively to inform Article IV consultations.

Empty deck chairs at a resort in Saly, Senegal.

BOX 3.7

IMF surveillance priorities, 2008–11

In October 2008, the IMF's Executive Board set four economic and four operational priorities to foster multilateral collaboration and guide IMF management and staff in the conduct of surveillance. These priorities look ahead three years, but may be revised if circumstances warrant. They guide the Fund's work within the framework for surveillance provided by the Articles of Agreement and the relevant Board decisions, including the 2007 Decision on Bilateral Surveillance.

ECONOMIC PRIORITIES

Resolve financial market distress. Restore stability and minimize the adverse impact of the current crisis in financial markets on the real economy.

Strengthen the global financial system by upgrading domestic and cross-border regulation and supervision, especially in major financial centers, and by avoiding the exposure of capital-importing countries, including low-income countries, to excessive risks.

Adjust to sharp changes in commodity prices. React to commodity price shifts in domestically appropriate and globally consistent ways, with emphasis on keeping inflationary pressures in check in boom phases and minimizing risks that could arise when prices fall.

Promote the orderly reduction of global imbalances while minimizing adverse real and financial repercussions.

OPERATIONAL PRIORITIES

Risk assessment. Refine the tools necessary to provide clear early warnings to members. Thorough analysis of major risks to baseline projections (including, where appropriate, high-cost tail risks) and their policy implications should become more systematic.

Financial sector surveillance and real-financial linkages. Improve analysis of financial stability, including diagnostic tools; deepen understanding of linkages, including between markets and institutions; and ensure adequate discussion in surveillance reports.

Multilateral perspective. Bilateral surveillance should be informed systematically by analysis of inward spillovers, outward spillovers (where relevant), and cross-country knowledge (as useful).

Analysis of exchange rates and external stability risks. In the context of strengthening external stability analysis, integrate clearer and more robust exchange rate analysis, underpinned by strengthened methodologies, into the assessment of the overall policy mix.

With respect to external stability and exchange rate assessments, the Board observed that since the adoption of the 2007 Surveillance Decision, work on exchange rate issues had strengthened significantly. However, it was noted that there was widespread skepticism about the consistency of treatment across countries and the methodological soundness of exchange rate assessments. In addition, the so-called fear of labeling under the 2007 Decision might have weakened the candor of some assessments. Further efforts would be needed to ensure that assessments are candid, evenhanded, and fully integrated into the broader assessment of external stability and overall macroeconomic policies—including the policy mix—and present transparently the analysis underlying the assessment.

Follow-up on surveillance priorities

An informal Executive Board seminar in February 2009 reviewed the key challenges in integrating financial sector issues into surveillance. The seminar covered major initiatives underway to close the gap between multilateral and bilateral surveillance, improve the coverage and quality of financial sector analysis in Article IV consultations, and strengthen the analytical framework and toolkit for studying macrofinancial linkages. These include closer collaboration with the FSB—notably through the early warning exercise; stronger cross-country perspective in Article IV consultations; and improved analysis of regional, thematic, and market issues. Efforts also involved dedicating additional resources in key Fund departments to analysis of macrofinancial linkages and building up the Fund's financial sector expertise through recruitment, mobility, and training policies. Many Executive Directors expressed their readiness to support modular FSAP assessments, and many saw merit in regional assessments under the program. A Board review of the joint Bank-Fund FSAP, as well as work on anti–money laundering and combating the financing of terrorism, is planned for FY2010.

Each year since 2001, the IMF has conducted a vulnerability exercise, to provide regular cross-country assessments of both underlying vulnerabilities (weaknesses in economic fundamentals) and near-term crisis risks in emerging market economies. Vulnerability assessments are based on (1) analyses of the global economic and financial market environment, (2) cross-country analyses of key vulnerability indicators and policy settings, and (3) analyses of the likely impact of various types of external shocks. In FY2009, at the request of the IMFC, the vulnerability exercise was modified to include advanced economies and was integrated with the joint IMF-FSB early warning exercise.

In conjunction with the FSB, the IMF plans to conduct an early warning exercise in the first half of FY2010 that aims to identify macrofinancial vulnerabilities at the global level, emphasizing potential spillovers across sectors, countries, and markets and providing policymakers with mitigation options. Combining a wide range of tools and perspectives, the exercise is expected to be instrumental in further integration of macrofinancial and regulatory perspectives into Fund surveillance. The Board discussed the proposed procedure for the exercise in February 2009, and the exercise was presented at the April 2009 IMFC meeting in a dry run. In the Board's discussion, Executive Directors supported the exercise but felt more discussion was needed on the modalities of cooperation with the FSB, how and when to engage the Board, and to what extent results should be disseminated.

Refocusing financial sector surveillance

Given the prominence of macrofinancial issues in the global crisis, increased emphasis was placed during FY2009, and continues to be placed, on better integration of macrofinancial analysis into the Fund's financial sector surveillance. As noted in the previous subsection, the Board held an informal seminar on integrating financial sector issues into surveillance in February 2009, and further work is planned in FY2010 as part of a scheduled review of the joint World Bank–IMF Financial Sector Assessment Program. Earlier in the year, the Board also discussed the IMF's collaboration with the Financial Stability Board in the context of the Fund's response to the financial crisis (see "The Crisis in Financial Markets").

With sovereign wealth funds (SWFs) rapidly gaining importance in the international monetary and financial system, the IMF has stepped up its work across a broad range of issues related to these state-owned funds, including their impact on global financial stability and capital flows. Representatives of SWFs met in Washington in April–May 2008, and an international working group was established at that time to formulate a set of principles for SWFs reflecting these funds' investment practices and objectives.[23] The working group's aim was to agree on a common set of voluntary principles for SWFs, drawing on the existing body of principles and practices, to help maintain the free flow of cross-border investment and open and stable financial systems. In September 2008, the working group presented the results of its efforts, a set of 24 voluntary principles (the "Santiago principles") designed to ensure an open international investment environment, to the IMFC, and the Executive Board reviewed and discussed the principles in an October 2008 session. Additionally, the IMF hosted a ministerial meeting in October 2008 of countries with SWFs and of recipients of SWF flows, attended by representatives of the Organization for Economic Cooperation and Development (OECD)—which has developed guidance for SWF recipient countries—and of the European Union.

In February 2009, the Fund convened at its headquarters the Second Roundtable of Sovereign Asset and Reserve Managers to discuss policy and operational issues confronting reserves and sovereign assets managers in the financial crisis (see Web Box 3.4).[24] High-level delegates from 32 countries and representatives from international institutions covered the implications of the crisis for reserve adequacy and reserve management, the use of foreign currency assets held by SWFs and their investment objectives, and how approaches to asset allocation might be affected by the crisis.

Financial Sector Assessment Program

The crisis focused considerable attention on the role that timely financial sector assessments can play in crisis prevention. The

BOX 3.8

Importance of statistics in the context of the crisis

Data on fiscal deficits and debt are expected to receive increasing attention over the next few years as the financial crisis reduces governments' revenues and increases their expenditures. At its April 2009 summit, the G-20, reflecting user concerns over data gaps, called for the IMF and the FSB to "explore gaps and provide appropriate proposals for strengthening data collection before the next meeting of G-20 Finance Ministers and Central Bank Governors." Indeed, the need to reinforce ongoing data transparency initiatives is a key message arising from the present crisis. In response to this need, the IMF has created and chairs an interagency group (whose members include the Bank for International Settlements, the European Central Bank, Eurostat, the Organization for Economic Cooperation and Development, the United Nations, and the World Bank) that aims to promote a collaborative and global view of economic and financial data needs in the light of the crisis.

The group's first action was to create a website (the Principal Global Indicators website) of financial, governmental, external, and real sector data on the G-20 economies, with links to data at websites of international and national agencies.[1] Additionally, the website responds to concerns that there is a need to improve the communication of official statistics.

Although the crisis was not a consequence of a lack of official statistics, it has revealed a number of data needs, in terms both of filling gaps and of addressing weaknesses. From consultations with users, the group has identified four significant areas of focus:

- *The financial sector*, not least those segments in which the reporting of data is not well established, such as nonbank financial corporations.

- *Balance sheets of nonfinancial sectors*, mainly the nonfinancial corporation and household sectors. In this context, issues of valuation, maturity analysis (remaining maturity), and frequency of international investment position data also arise.

- *Data on house prices and other housing-related data.* These data have been highly relevant to the crisis, but country practice in compiling these data is uneven.

- *A lack of information on ultimate risk/credit transfer instruments*, indicating where the risks lay and their scale. Although traditional frameworks remain relevant, the concepts of ultimate risk (including the use of off-balance-sheet structures and special-purpose vehicles) and credit risk transfers, including through structured products, need to be explored, because the lack of information on where the risks lay and their scale disguised interconnections among economies. This issue is multifaceted and includes developing conceptual frameworks, drawing on existing practice as far as possible.

The IMF has undertaken a number of other activities in relation to data issues highlighted by the crisis:

- In conjunction with the World Bank and the Task Force on Finance Statistics, the Fund is working to develop public debt data.

- Jointly with the Bank for International Settlements and the European Central Bank, the IMF produced Part I of the *Handbook on Securities Statistics*, the first publication of its kind to focus exclusively on debt securities statistics.

- The Fund updated its statistical manuals and guides, including the sixth edition of the *Balance of Payments and International Investment Position Manual*.

1 The website is available at http://financialdatalink.sharepointsite.net/default.aspx.

Financial Sector Assessment Program, launched in 1999, is a joint IMF–World Bank initiative to provide member countries with a comprehensive evaluation of their financial systems. The FSAP aims to alert national authorities to likely vulnerabilities in their financial sectors—whether originating from inside the country or from outside sources—and to assist them in the design of measures that would reduce these vulnerabilities. Sectoral developments, risks, and vulnerabilities are analyzed using a range of financial soundness indicators and macrofinancial stress tests. Other structural underpinnings of financial stability—systemic liquidity arrangements, the institutional and legal framework for crisis management and loan recovery, and transparency, accountability, and governance structures—are also examined as needed to ensure a comprehensive assessment of both stability and developmental needs. As part of the process, the FSAP provides assessments of observance of various internationally accepted financial sector standards, set within the broader institutional and macroprudential context.

As of April 2009, more than 140 countries, three-quarters of the IMF's membership, had participated or were participating in the FSAP. About two-thirds of the countries that had completed the process had agreed to post associated Financial System Stability Assessments on the IMF's website. At end-April 2009, 487 FSAP updates had been completed, and an additional 22 updates had been requested or were ongoing. In FY2009, 13 countries requested assessments under the program, and 26 assessments were completed. In November 2008, all G-20 members committed to undergoing an FSAP assessment.

For purposes of uniformity and cost-effectiveness, and to permit a more risk-focused approach to assessments, the Executive Board agreed in late May 2008 to integrate the IMF's offshore financial center (OFC) assessment program with the FSAP, with the integration to take effect in FY2010.[25] The OFC program, inaugurated in 2000, helped to strengthen regulation and supervision and to improve compliance with supervisory standards in offshore jurisdictions. Most Executive Directors supported the integration, emphasizing that it should not result in less rigorous assessment of OFCs or lead to a diminished Fund focus on OFC compliance with international standards. Executive Directors saw as a positive aspect of the integration that a broader range of issues would be covered under the FSAP compared with OFC assessments, strengthening the Fund's financial sector surveillance and contributing to a more effective oversight of the global financial system. Executive Directors agreed that as the FSAP was at that time available only to IMF members, its coverage would be extended to encompass the four nonmember jurisdictions covered by the OFC program.

Data provision and dissemination

The increasing integration of economies and markets demonstrated by the crisis emphasized the importance of having readily available, consistent, and relevant data both within and across countries. High-quality data are also crucial to Fund surveillance, and efforts to expand and improve the quality of available data have been ongoing for several years. Box 3.8 highlights the IMF's work as chair of an interagency group convened to strengthen global collaboration on data collection and dissemination in response to needs highlighted by the crisis. In FY2009, the Board reviewed members' progress in this area, noting that challenges remain in non-market-access developing countries and calling for increased candor in Article IV reports in regard to adequacy of data.[26]

In December 2008, the Board concluded the Seventh Review of the Fund's Data Standards Initiatives—the Special Data Dissemination Standard (SDDS), General Data Dissemination System (GDDS), and Data Quality Assessment Framework (DQAF)—which aim to increase the comprehensiveness and timeliness of statistical information available to markets and the public.[27] Executive Directors expressed broad satisfaction with the program and commended member country authorities for their efforts to promote adherence to the initiatives. They concurred with staff recommendations on accelerating work on financial indicators. Support was expressed for efforts to enhance quality aspects of the SDDS, and Executive Directors encouraged subscribers to undertake and publish periodic data quality assessments. They also supported recasting the GDDS to emphasize data dissemination and facilitate graduation to the SDDS.[28]

Among the many issues highlighted by the global crisis was the dearth of data on trade finance, which have not been systematically reported anywhere, making it difficult to analyze possible implications of phenomena such as the greater-than-expected decline in global trade beginning in the final quarter of 2008. In response to this lack of information, the IMF worked with the Bankers' Association for Finance and Trade to survey advanced, emerging market, and developing country banks about trade-financing conditions.[29] The survey focused on bank-intermediated forms of international trade finance such as letters of credit and trade lending. Responses were received from 40 countries, roughly evenly split between advanced countries and emerging markets.

Survey results tended to support anecdotal conclusions that the cost of trade finance had risen rapidly, while in some cases its availability had fallen. However, some of the decline in trade finance was revealed to be the result of the plunge in trade spawned by the recession, while some of the rise in costs was determined to be due to the higher probability of defaults from falling trade. Trade finance was found to be costlier and somewhat harder to obtain in emerging markets. The banks anticipate these trends to continue in 2009. The Fund continues to work with other organizations to monitor the situation.

Ongoing surveillance work

Surveillance—oversight of the international financial system and monitoring of economic and financial policies of member countries—is a core activity of the IMF, involving monitoring national, regional, and global economies to assess whether policies are consistent not only with countries' own interests, but also with the interests of the international community. During the surveillance process, the IMF highlights possible risks to stability and growth and advises on needed policy adjustments, helping the international monetary system serve its essential purpose of promoting monetary cooperation and financial stability, and facilitating the expansion and balanced growth of trade, thereby promoting sustainable economic growth. The IMF fulfills its surveillance mandate through bilateral, regional, and multilateral surveillance.

Bilateral surveillance

The centerpiece of the IMF's bilateral (or individual-country) surveillance is the Article IV consultation, normally held every year with each member of the Fund in accordance with Article IV of the Fund's Articles of Agreement (its charter).[30] A total of 123 Article IV consultations were completed during FY2009 (see Web Table 3.1).

Making the consultation process effective has proven key, particularly in the global crisis. In July 2008, the Board discussed staff proposals for new formats for Article IV staff reports to make outputs of surveillance more timely. Executive Directors cautioned that new formats should not weaken the overall consistency of presentation of the staff's views or compromise evenhandedness, and that they should provide a clear and objective presentation of the authorities' views.

As part of its surveillance function, the IMF provides advice to policymakers in member countries on sound policies and practices in a variety of areas. For example, a formal Board seminar held in June 2008, "Fiscal Risks—Sources, Disclosure, and Management," reviewed international experience with fiscal risks—defined as deviations of fiscal outcomes from what was expected at the time of the budget or other forecast—and expressed preliminary views on broad guidelines for policymakers, drawing on existing practices in a wide range of countries, for fiscal risk disclosure and management.[31]

Executive Directors noted that good fiscal transparency practices may facilitate market access and lead to lower borrowing costs in the long run and that the increased public scrutiny that comes with improved disclosure can be helpful for governments in ensuring proper assessment and recognition of risks. At the same time, it was noted that quantification of risks may not always be feasible or desirable, and in particular, disclosure of certain risks may engender moral hazard or harm the state's economic interests.

The 2007 Decision on Surveillance over Members' Exchange Rate Policies has greatly sharpened the focus of surveillance and the analysis of exchange rate issues and remains the framework for Fund surveillance in this regard. In the first full year of its implementation, however, it became apparent that some aspects of the guidance emanating from the Decision did not facilitate surveillance, and those are being amended accordingly.

Multilateral surveillance

The IMF continuously reviews global economic trends. Its key instruments of global surveillance are two semiannual publications, the *World Economic Outlook (WEO)* and the *Global Financial Stability Report (GFSR)*, along with interim updates for each that are issued at least twice a year. The WEO provides detailed analysis of the state of the world economy and evaluates economic prospects and policy challenges at the global and regional levels. It also offers an in-depth analysis of issues of pressing interest, such as the ongoing global economic crisis and recession and perspectives on recovery. The GFSR provides an up-to-date assessment of global financial markets and prospects and addresses emerging market financing issues in a global context. Its purpose is to highlight imbalances and vulnerabilities that could pose risks to financial market stability. Coverage of both of these publications (released in October and April every year) is presented in Chapter 2.

Regional surveillance

Regional surveillance supplements the IMF's bilateral and multilateral surveillance and involves examination of policies pursued under regional arrangements such as currency unions—including the euro area, the West African Economic and Monetary Union (WAEMU), the Central African Economic and Monetary Community (CEMAC), and the Eastern Caribbean Currency Union (ECCU). In addition to its Article IV consultations with individual members, the IMF conducts formal discussions with representatives of currency unions, since members of such unions have devolved responsibilities over two central areas of Fund surveillance—monetary and exchange rate policies—to these regional institutions. In FY2009, the Executive Board conducted assessments of common policies of countries belonging to WAEMU as well as of euro area policies. It also discussed a staff paper on the choice of the exchange rate regime among member countries of the GCC.[32]

WAEMU

The Executive Board concluded its discussions on common policies of WAEMU member countries in late May 2008. Executive Directors noted that economic performance in the region—albeit with substantial variation among member countries—had continued to improve, but that growth remained well short of what was needed to substantially reduce poverty, calling for renewed vigorous efforts to pursue reforms aimed at strengthening economic performance and reducing poverty. It was observed that the surge in food and fuel prices in the first half of 2008 was eroding real incomes and hurting the poor. Executive Directors noted that the exchange regime of the CFA franc had served the WAEMU zone well, but most Executive Directors considered that several years of real appreciation had weakened competitiveness and contributed to lackluster economic growth and export performance.

Executive Directors encouraged the authorities to monitor real exchange rate developments closely and to better coordinate fiscal and monetary policies in order to support the fixed exchange rate regime and reduce pressure on the real exchange rate. Structural obstacles—including infrastructure gaps, an underdeveloped financial sector, a poor business environment, and incomplete regional integration—had continued to drag down the region's growth performance. Executive Directors emphasized the importance of accelerating structural reforms to improve regional growth prospects and make progress toward the Millennium

Cocoa harvest in Côte d'Ivoire.

Development Goals. They noted that the recent assessment under the regional Financial Sector Assessment Program had found that the banking system was increasingly vulnerable to macroeconomic and sectoral shocks, exhibited weak compliance with prudential requirements, and had low capitalization. They encouraged the authorities to promote regional financial integration, including by strengthening the framework for managing regional liquidity, and to devolve public ownership in commercial banks.

Executive Directors also encouraged stronger progress on regional integration, welcoming the decision to remove barriers to intra-WAEMU trade and calling on authorities to move quickly in this effort. They expressed the hope that the WAEMU common external tariff would soon be extended to all of the Economic Community of West African States (ECOWAS). While supporting progressive regional economic integration, Executive Directors considered premature the announced goal of establishing a monetary union at the ECOWAS level by the end of 2009 and called on the authorities to ensure that the minimum conditions for a successful and beneficial monetary union were met to build a solid foundation for a common currency before it was created.

Euro area

In a July 2008 meeting that concluded the Article IV consultation on euro area policies, Executive Directors noted that 10 years after its launch, the European Monetary Union (EMU) was a distinct success, and they commended the EMU's macroeconomic policy framework for bringing internal and external stability. Economic fundamentals were observed to have improved, although continued efforts were felt to be needed to build a more vibrant economic union. Executive Directors observed that monetary policy needed to balance the risk of a broad-based increase in inflation with the prospect of gradually building disinflationary forces due to slowing activity.

Executive Directors agreed that the policy frameworks of the European Central Bank (ECB) had served it well in coping with a difficult environment and that the key challenge going forward would be to restore the depth and orderly functioning of interbank markets. They noted that the ongoing work on enhancing the ECB's monetary analysis would help further strengthen the monetary policy framework, and several suggested that this could lead in due course to a unified presentation of policy decisions that integrates monetary and economic analysis. They welcomed the steps taken to strengthen the EU's financial stability framework, given the significant financial linkages and the EU's commitment to building a single market for financial services.

In the near term, Executive Directors stressed the need for further improvements in information sharing among supervisors and central banks, including the ECB. They observed that the rules-based fiscal framework offered by the Stability and Growth Pact had generally improved fiscal discipline and served the euro area well. However, it was noted that about half of the euro area countries still faced persistent challenges in meeting their medium-term fiscal objectives. Progress with respect to lowering general government deficits and debt would, it was felt, be key for these countries in order to better meet the population-aging-related fiscal challenges that are expected to mount rapidly after 2010. More generally, Executive Directors noted that stronger national fiscal rules and domestic governance mechanisms could help achieve more predictable and efficient fiscal policies in countries facing relatively high public sector deficits and debt.

GCC Monetary Union

Executive Directors had a preliminary exchange of views on the choice of the exchange rate regime for the planned monetary union by Gulf Cooperation Council (GCC) countries in late October 2008, based on staff analysis of likely challenges and alternatives.

Observing that much had changed in the global economy since the analysis was conducted—in particular, the halving of oil prices, the strengthening in the U.S. dollar, and the global downturn—they stressed that the determination of the appropriate exchange rate regime would depend on economic developments at the time of establishment of the monetary union and should be guided by forward-looking considerations and longer-term objectives.

The costs and benefits of four exchange rate regimes—single currency (U.S. dollar) peg, managed float, basket peg, and pegging to the export price of oil—were explored. Noting that the peg had contributed to macroeconomic stability in the face of significant volatility in oil prices, Executive Directors remarked that continuation of the peg to the U.S. dollar would offer several advantages, including established credibility through a well-understood nominal anchor and lower transactions costs. Nonetheless, they observed that questions about its suitability had arisen, owing to higher inflation among GCC countries, depreciation of the U.S. dollar against major currencies, and desynchronized business cycles coupled with reductions in U.S. policy interest rates. A managed float could allow greater monetary independence to control inflation and facilitate real exchange rate adjustment to real shocks, and many Executive Directors viewed a more flexible exchange rate regime as a longer-term possibility, as additional exchange rate flexibility could be warranted as the GCC economies became less dependent on oil and more heterogeneous over time and if the business cycles of GCC countries and the United States continued to diverge. On the other hand, greater exchange rate volatility could increase costs related to international transactions and would also require the establishment of a credible central bank with effective monetary instruments and harmonized regulation and supervision in GCC financial markets. Many Executive Directors agreed with staff that achieving monetary union by 2010 would be a challenge, and Executive Directors encouraged staff to continue to support the efforts of the GCC countries toward their monetary union, including through further staff analysis.

Regional Economic Outlooks

To provide a more in-depth regional analysis and amplification of the issues raised in the *World Economic Outlook*, biannual *Regional Economic Outlooks* (REOs) are typically prepared for five major world regions, discussing economic developments and key policy issues in Asia and the Pacific, Europe, the Middle East and Central Asia, sub-Saharan Africa, and the Western Hemisphere. Publication of the REOs in FY2009 was coordinated with extensive outreach events in several countries in each region, such as seminars for government officials and academics, media briefings, and interviews with IMF officials. Press releases summarizing REO findings were posted on the IMF's website along with the full text of the REOs themselves, as well as transcripts and webcasts of press conferences held upon publication.[33]