Surveillance in action during FY2005

CHAPTER | 1

Surveillance is one of the IMF's three main activities, the other two being financial and technical assistance to its member countries. But whereas financial and technical assistance—discussed in Chapters 3 through 6—are provided only to countries that request and need them, the IMF's surveillance applies continuously to the economies of all member countries and to the global economy and financial system. The IMF's responsibilities in this area, set out in Article IV of its Articles of Agreement, are to oversee the international monetary system to ensure its effective operation, and to oversee the compliance of each member country with its obligations to collaborate with the IMF and other members to promote an orderly and stable system of exchange rates, broader financial and economic stability, and sound economic growth. It is mainly through its surveillance operations that the IMF works to help prevent financial and economic crises.

The IMF conducts surveillance by monitoring economic and financial developments and consulting with the authorities of member countries. Surveillance is conducted at the global, country, and regional levels.

In its *global (*or *"multilateral") surveillance,* the IMF monitors economic conditions and developments in international capital markets and assesses the global effects of major economic and financial developments, such as oil market conditions or external imbalances. IMF management and staff also take part in economic policy discussions among finance ministers, central bank governors, and other officials in a variety of groups, such as the Group of Seven (G-7) major industrial countries, the Group of Twenty (G-20) industrial and emerging market countries, and the Group of 24 (G-24) developing countries.

In its *country (*or *"bilateral") surveillance,* the IMF maintains a dialogue with each member country on developments in its economy and on the national and international implications of its economic and financial policies.

In its *regional surveillance,* the IMF examines the policies pursued under regional arrangements, such as in the euro area, the Eastern Caribbean Currency Union (ECCU), and the West African Economic and Monetary Union (WAEMU), as well as the regional implications of global developments.

Following are some highlights of IMF surveillance in FY2005 (for a summary of key economic and financial developments in FY2005, see Box 1.1):

- The Executive Board's twice-yearly comprehensive assessments of the *World Economic Outlook*—in September 2004 and March 2005—focused particularly on policies to address global current account imbalances, the implications of an upturn in global interest rates, and oil market developments. In their March 2005 discussion, Directors saw solid growth ahead for the rest of the year, but with risks from an increasingly unbalanced expansion, a significant tightening of financial market conditions, and a further sharp rise in oil prices.
- The August 2004 and March 2005 Board reviews of financial market developments, as published in the twice-yearly *Global Financial Stability Report*, cited the increased resilience of the global financial system but also noted that the risks of market corrections had increased, owing to overabundant liquidity and lower risk premiums.
- At a seminar in March 2005 on oil market conditions, Directors agreed that the market was likely to remain tight for the foreseeable future, given the continued rise in global demand, the peaking of non-OPEC oil output, and the potential for supply disruptions.
- The IMF completed consultations with 130 individual member countries. In a number of cases, these consultations featured a strategic stocktaking, supported by ex post assessments in countries with Fund-supported adjustment programs over longer periods.
- Regional surveillance of currency unions in FY2005 included assessments by the Board of developments in the euro area, the Eastern Caribbean Currency Union, and the West African Economic and Monetary Union.

Global surveillance

The IMF's Executive Board conducts global surveillance through its reviews of world economic and financial market developments and prospects. These reviews are based partly on the staff's *World Economic Outlook* (*WEO*) reports and *Global Financial Stability Reports (GFSRs),* both of which

Box 1.1 Key economic and financial developments, May 2004–April 2005

Global economic growth in 2004, at 5.1 percent, was the strongest in three decades (Figure 1.1). Particularly heartening was the strong performance of many of the poorest countries, including in sub-Saharan Africa, where average growth was the highest in nearly a decade. After exceptionally strong growth in 2004, global growth moderated somewhat in early 2005 but remained solid. The overall picture, however, hides growing divergences across regions, with the United States and China continuing to lead the recovery followed by robust growth in emerging market and developing countries. By contrast, the recovery remained subpar in the euro area and Japan in mid- and late 2004. These developments were associated with widening current account imbalances and U.S. dollar depreciation. The growth of world trade volumes moderated after their early 2004 surge, bringing them back toward trend. Net private capital flows to developing countries increased as net portfolio investment and foreign direct investment (FDI) continued to rise in 2004.

Although the global recovery generally strengthened, growth continued to diverge among key countries. In the *United States*, the soft spot identified in the second quarter of 2004 had largely disappeared by year-end. The first quarter of 2005 saw some moderation, but the annual growth rate remained at 3½ percent. Real GDP growth in *China* remained very strong, with some slowdown in investment offset by increases in net exports and consumption. In *Japan,* the recovery stalled in mid- and late 2004; while it recovered strongly in the first quarter of 2005, temporary factors appear to have been at play. GDP growth in the *euro area* slowed in the course of 2004 but picked up slightly in the first quarter of 2005. High oil prices and the lagged effects of the appreciation of the euro took their toll on net exports, whereas low income growth and lackluster private consumption growth held domestic demand in check.

In FY2005, GDP growth accelerated in nearly all emerging market regions. In many cases, the recoveries became increasingly driven by domestic demand, with less dependence on the external environment.

Growth in *Latin America* continued to exceed expectations, aided by high commodity prices, improved external confidence, progress with structural reforms, and, in some cases, rebounds from earlier crisis-induced slowdowns. Growth picked up in Argentina, Brazil, and several other countries, but political uncertainties continued to undermine growth in others.

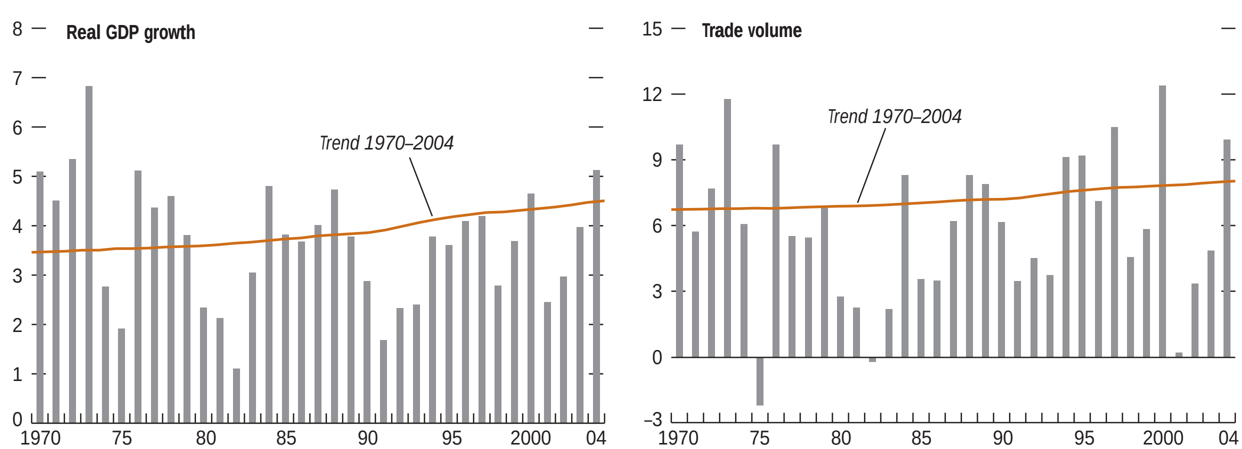
Growth in *emerging Asia*, excluding China, moderated somewhat during FY2005, reflecting the moderation in the global expansion, a correction in the semiconductor market, and higher oil prices. Developments in the first quarter of 2005 were dominated by the catastrophic tsunami and the associated devastating loss of human life and property in India, Indonesia, Sri Lanka, Thailand, and several other countries. However, in most cases—except Maldives and, to a lesser extent, Sri Lanka—the impact on GDP growth was small. Regional growth in early 2005 was relatively strong, with the expansion in China remaining robust. India's growth slowed modestly during FY2005, with the impact of uneven monsoons and higher oil prices offset by buoyant industrial activity and strong investment.

During FY2005, as a group, *central and eastern Europe* enjoyed the strongest growth since the beginning of transition. Current account deficits widened further as rapid credit growth and expansionary fiscal policies fueled imports. Net FDI inflows continued to represent an important source of funds, but more ambitious fiscal consolidation was needed in several countries, along with continued reform efforts to improve the business climate and encourage domestic saving. Rising oil prices throughout much of FY2005, as well as positive domestic factors, increased growth in the oil-exporting countries of the former Soviet Union. Oil importers in the region also experienced strong GDP growth stemming from robust domestic demand.

In 2004, growth in the *Middle East* benefited from rising oil prices and higher oil production in the face of increasingly thin margins of excess capacity. With oil prices remaining high in early 2005, the outlook remained positive. The situation permitted some of these countries to initiate needed reforms to boost medium-term growth and increase employment for their rapidly growing

Figure 1.1 World real GDP growth and trade volume

(Annual percent change)



working-age populations, but more needs to be done.

Growth in *Africa* strengthened during FY2005, supported by improved macroeconomic policies, favorable weather conditions, fewer conflicts, and debt relief under the HIPC (Heavily Indebted Poor Countries) Initiative. Higher prices for oil and, to a lesser extent, nonfuel commodities also helped sustain high growth in a number of commodity-exporting countries.

With the firming global economic recovery, demand for commodities continued to put pressure on prices—especially for fuels and most metals. Oil prices rose dramatically, surpassing levels seen the year before, owing to continued supply constraints as well as to higher demand. Consumer price inflation rose modestly in a number of countries, but long-term inflationary expectations remained anchored. The dollar depreciated during the fiscal year on a trade-weighted basis, but most of the movement occurred in the final quarter of 2004 with the dollar trading in a narrow range during early 2005. As before, appreciation of the euro and other industrial country currencies formed most of the counterpart to the dollar's slide. While some emerging market currencies appreciated against the dollar, others remained less flexible.

Monetary policies remained somewhat accommodative in most countries. However, with inflation rising, many countries, most notably the United States, raised interest rates. *Fiscal policies* were varied. Although the fiscal stance in the United States was broadly unchanged, the commitment to halving the deficit over the next four years remains firm. In the euro area, fiscal policies were broadly neutral, delivering almost no consolidation.

In the *major financial markets*, conditions remained benign. Favorable economic fundamentals, including expectations for solid, if slowing, growth, well-anchored inflation expectations, sustained corporate balance sheet strength in the advanced economies, and continued improvements in the credit quality of emerging market borrowers supported financial market stability. Against this backdrop, financial market volatility, government bond yields in mature markets, and global credit spreads remained low.

After rallying during FY2004, *global equity markets* remained trendless, trading in narrow ranges throughout the financial year, partly reflecting fears of slower growth because of rising oil prices (Figure 1.2). Actual market volatility and the volatility implied by options on a range of financial assets stayed low. The S&P 500 rose 10.4 percent before retracing most of these gains as interest rate expectations changed near the end of the financial year and high oil prices dampened confidence. European equities followed a similar pattern, rising 17.7 percent from their mid-2004 trough before surrendering part of those gains by the end of the financial year. In Japan, stocks rallied 12.3 percent from their October 2004 trough, as the growth of the Japanese economy strengthened, before falling back to end the year down 6.4 percent.

After a sell-off in May 2004, *emerging markets* enjoyed an exceptionally favorable economic and financing environment in the remainder of 2004 and early 2005. Interest rates and credit spreads remained low. With liquidity abundant, investor appetite for new issues from emerging market borrowers was quite strong, permitting a high level of issuance at low cost. Driven by improving fundamentals, a benign external environment, and abundant liquidity, the spread on the EMBI Global fell from 549 basis points in May 2004 to a near-record low of 322 basis points in March 2005 (Figure 1.3). Low nominal yields and strong investor demand facilitated increased bond issuance by emerging market borrowers, as many sought to lock in attractive financing costs by prefinancing their future funding requirements. Primary debt market issuance totaled some $49 billion in January–April 2005, covering nearly 80 percent of the financing needs of emerging market countries for the calendar year.

Primary issuance of equities in emerging markets was also strong during the financial year and continued to be dominated by Asia. Importantly, in FY2005, the investor base for emerging market issuers expanded; institutional investors globally found them attractive in view of low interest rates in mature markets and the attractive risk-adjusted returns as their credit ratings were upgraded across a broad spectrum. Another development worth noting was the interest of foreign investors in the domestic currency bonds of emerging market economies.

Figure 1.2 Equity market performance

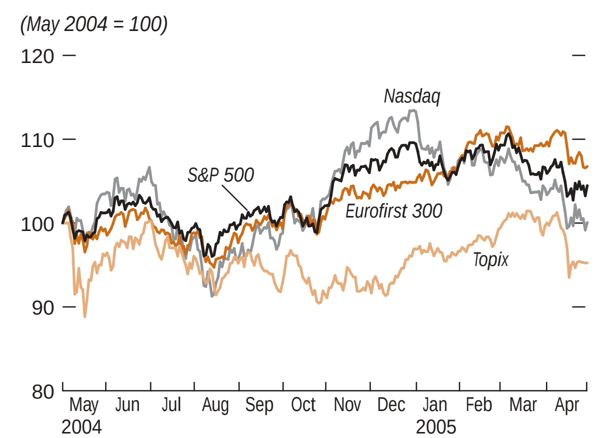
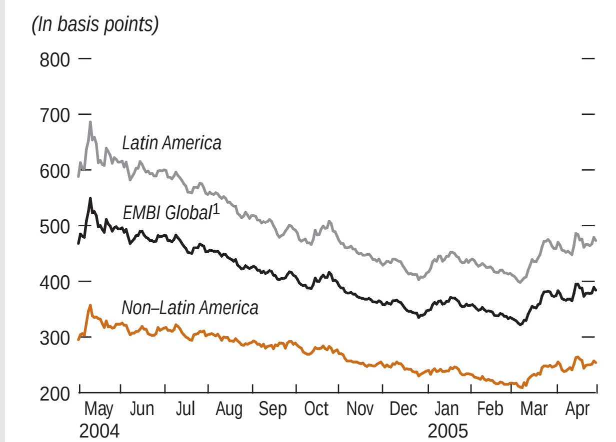


Figure 1.3 Sovereign spreads



[1]JPMorgan Chase & Co. Emerging Markets Bond Index Global.

Canada

Since the mid-1990s, Canada has had the fastest growth and strongest budget position of the large industrial countries. Its impressive performance has been supported by a strong macroeconomic framework comprising inflation targeting and the fiscal objective of a "balanced budget or better" and by reforms that include a restructuring of the employment insurance system, tax cuts, and trade liberalization. Canada's Article IV consultation with the Fund, which was completed in February 2005, focused on the challenges stemming from the rapid appreciation of the Canadian dollar and the aging of the Canadian population.

Domestic demand has remained robust, supported by buoyant household spending, employment gains, and increases in net wealth, while business investment has expanded rapidly, boosted by strong corporate earnings, low interest rates, and a decline in the cost of imported capital goods. However, the fast-paced appreciation of the Canadian dollar in the second half of 2004 weighed on net exports. As a result, the Bank of Canada kept monetary policy steady after moves to tighten it in September and October 2004. The year-on-year core inflation rate was a subdued 1¾ percent in April 2005, slightly below the 2 percent midpoint of the Bank of Canada's target range.

The goal of a "balanced budget or better" has continued to drive fiscal policy, which was strengthened in 2004 by the addition of a medium-term debt target. As a result, the ratio of government debt to GDP is projected to continue falling, helping Canada prepare for the fiscal costs of its aging population. However, the budget for Canada's fiscal year 2005 leaves little room for maneuver if unfavorable fiscal developments occur. With the public pension system on a sound financial footing, the country's main long-term fiscal challenge is to curb cost increases in the health care system. In addition, there remains considerable scope for further structural reform, including in the tax system and social programs, to increase economic efficiency and flexibility.

Canada-IMF activities in FY2005

February 2005	Completion of the 2005 Article IV Consultation discussions

are usually prepared and published twice a year, ahead of the meetings of the International Monetary and Financial Committee, for which they provide documentation. The *WEO* reports provide analysis of global economic prospects and the policies appropriate in different countries, while the *GFSRs* analyze developments and risks in international capital markets. The Board also holds more frequent and informal discussions of world economic and financial market developments, and IMF staff continuously monitor developments in mature and emerging financial markets, as well as economic developments globally.

World Economic Outlook

World Economic Outlook, September 2004

In their September 2004 discussion of the *World Economic Outlook*,[1] Executive Directors noted that the global recovery had remained solid, with economic growth for 2004 projected to reach its highest rate in nearly 30 years. The expansion was underpinned by continued accommodative macroeconomic policies, rising corporate profitability, and wealth effects from rising equity and house prices. Global growth remained driven by the United States, with strong support from Asia, particularly China. Activity in Latin America and some other emerging markets had also picked up strongly, the outlook for Africa had improved, and economic momentum was growing in the euro area. Directors called on policymakers to take advantage of the cyclical expansion to address key medium-term vulnerabilities by taking the following measures:

- Tackling global imbalances. Eliminating these would require medium-term fiscal consolidation in the United States to increase domestic saving; structural reforms to boost growth in Europe, Japan, and elsewhere; and steps toward greater exchange rate flexibility in Asia.
- Quickening the pace of structural reforms to boost economic flexibility and resilience, so that countries are well positioned to exploit the opportunities from globalization and the information technology revolution, while their resistance to future shocks is strengthened. Noting the key role of open markets in promoting competitiveness and efficiency, Directors looked forward to far-reaching trade liberalization under the Doha Round of trade negotiations.
- Strengthening medium-term fiscal positions in both industrial and developing countries. This would require a

[1]For the summary of the Board's discussion, see *www.imf.org/external/pubs/ft/weo/2004/02/pdf/annex.pdf;* the report can be found at *www.imf.org/external/pubs/ft/weo/2004/02/index.htm*.

combination of fiscal consolidation, while allowing automatic stabilizers to work; structural measures, including tax reform and stronger public expenditure frameworks, to improve debt sustainability; and reform of pension and health care systems.

In discussing the industrial countries in September 2004, Directors welcomed the staff's analysis of the *global boom in house prices* and the impact that rising interest rates in industrial countries might have on housing markets. Directors noted that the analysis, reflecting linkages in economic activity and interest rates, showed a remarkable degree of synchronization of house prices across industrial countries (although they recognized the limitations of the data). Given the importance of house prices for private consumption, through wealth and credit channels, many Directors suggested that policymakers should monitor developments in the housing market closely. A tightening of monetary policy during the transition to a more neutral policy stance could trigger a slowing or reversal of the growth in house prices.

Directors also welcomed the staff's analysis of *demographic change*. To meet the demographic challenges from population aging, industrial countries had to boost labor supply, saving, and productivity. Given the size of prospective demographic changes, this required a combination of reforms to be politically acceptable. Particularly important was the selection of reforms, especially with respect to pension and health care systems: they would have to be resilient to a wide range of possible future demographic changes. For developing countries, the key policy priorities were to increase the flexibility of labor and product markets and ensure that labor resources and savings were effectively utilized. These countries had to move early to lay the groundwork for eventual population aging, including by strengthening pension and health care systems. This was particularly challenging in countries whose medium-term fiscal positions were already strained. Directors agreed that the effectiveness of actions to facilitate movements of goods, capital, and labor smoothly and efficiently across countries would significantly influence the pace, and pattern, of global adjustment to different rates of population aging.

World Economic Outlook, March 2005

At their March 2005 discussion of the *World Economic Outlook*,[2] Executive Directors noted that the global expansion remained broadly on track, underpinned by generally supportive macroeconomic policies and benign financial market conditions. Following a strong performance in 2004, growth was expected to moderate to a more sustainable pace in 2005. At the same time, the expansion had become less balanced—with growth strong in the United States, China, and most emerging market and developing countries but disappointing in Europe and Japan.

Globally, inflationary pressures remained relatively subdued. With monetary tightening under way in most economies in advanced stages of recovery and generally moderate inflation expectations, inflation was expected to remain well contained. Still, Directors felt that inflation risks required careful monitoring, with due regard to rising unit labor costs in many industrial countries as labor markets tighten, and to monetary policy implementation in a number of emerging markets with strong external inflows.

Looking ahead, Directors felt that the more moderate but still solid global growth in 2005 would be underpinned by accommodative macroeconomic policies, improving corporate balance sheets, supportive financial market conditions, a gradual rise in employment, and continued strong growth in China. The key risks to the short-term outlook were

- the increasingly unbalanced nature of the expansion, with global growth significantly dependent on the United States and China;
- a significant tightening of financial market conditions, which could hurt U.S. domestic demand, prompt financial market deleveraging and asset price corrections more broadly, and lead to a deterioration in emerging market financing conditions; and
- a further sharp increase in oil prices (see below under "Oil market developments").

As to global current account imbalances, Directors were concerned about their further widening over the past year, and a number cautioned that this might increase the risk of abrupt movements in exchange rates. Directors noted that the strategy to support an orderly adjustment in these imbalances had been broadly agreed. Among the key elements were fiscal consolidation in the United States; steps toward greater exchange rate flexibility, supported by continued financial sector reform, in emerging Asia; and continued structural reforms to boost growth and domestic demand in Japan and Europe. Directors reiterated the collective responsibility of the membership to ensure that the strategy was implemented in a timely and effective manner.

A number of key medium-term issues that needed to be addressed were identified.

1. Fiscal positions in many countries remained very difficult, particularly against the backdrop of global population aging, and posed a threat to medium-term macroeconomic stability.
2. Structural reforms had to be advanced to remove rigidities and enable domestic economies to take full advantage of the opportunities provided by globalization.

[2]For the summary of the Board's discussion, see *www.imf.org/external/pubs/ft/weo/2005/01/pdf/annex.pdf;* the report can be found at *www.imf.org/external/pubs/ft/weo/2005/01/index.htm*.

3. Successful and appropriately ambitious trade liberalization on the part of all countries under the Doha Round—including improved market access for developing countries—was critical for supporting medium-term global growth. Key issues remained to be resolved in agriculture, and faster progress was needed in the area of trade in services.

4. Despite the improved growth performance of recent years, meeting the Millennium Development Goals (MDGs) posed an enormous challenge for most developing countries (see Chapter 4). Directors noted that 2005 was a critical year for the MDGs and called on these countries to press ahead with policy and governance reforms to strengthen their investment environments and private-sector-led growth, and on the advanced economies to support these efforts with substantially higher assistance.

Industrial countries

Among the industrial countries, Directors welcomed the continued strong performance of the *United States* economy, whose expansion was set to continue in 2005. With household saving close to zero, however, a retrenchment in private consumption remained a risk, particularly if house price increases were to slow. Given that inflationary pressures were relatively benign, a measured pace of monetary tightening remained appropriate, although incoming data would have to be monitored carefully in view of possible upside risks to the inflation outlook from labor market pressures or further oil price rises. Directors underscored the need for significant fiscal consolidation, with a view to ensuring medium-term sustainability and facilitating an orderly unwinding of global current account imbalances.

Directors expressed disappointment that the *euro area* economy lost momentum during the second half of 2004, although they expected a strengthening of growth in 2005. Further appreciation of the euro and high and volatile oil prices remained the key risks to the regional outlook. With inflationary pressures well contained, monetary policy should remain firmly on hold until a self-sustaining recovery was in place. As to fiscal policy, Directors saw existing policy as insufficient to deliver the budgetary adjustments required to cope with the fiscal pressures of population aging. Underscoring that a strong fiscal framework was an integral part of monetary union in Europe, Directors noted that reform of the Stability and Growth Pact should be implemented in a way that did not weaken fiscal discipline. Directors also stressed the importance of making further progress in implementing structural reforms, with a greater focus on addressing distortions in labor markets and promoting competition in product markets.

Directors noted that the *Japanese economy* had stalled in the last three quarters of 2004, reflecting weak global demand for information technology (IT) products and falling consumption spending, but recent data were more encouraging. With bank and corporate balance sheets in better shape, Directors believed that growth should regain some momentum in 2005, notwithstanding the downside risks from high oil prices and the possible adverse impact on exports of a sharp appreciation of the yen. While deflationary pressures had eased in recent years, Directors urged the Bank of Japan to maintain a very accommodative monetary policy stance until deflation was decisively beaten. Given Japan's high public debt and intensifying demographic pressures, fiscal consolidation remained a priority. Directors also stressed the need to continue to strengthen the banking and corporate sectors and to accelerate structural reforms—including measures to increase competition and improve labor market flexibility—to pave the way for sustained medium-term growth.

Emerging markets and developing countries

While the *Asian emerging market countries*' performance was strong in 2004, growth had slowed noticeably in most countries except China. In 2005, growth in the region was expected to be slightly weaker, with upside risks from higher-than-anticipated growth in China and downside risks from a more protracted correction in the IT sector or sluggish demand from Japan and Europe. Directors expressed their sympathy at the loss of life and property from the recent catastrophic tsunami (Box 1.2). Although reconstruction costs—and the impact on fiscal and external imbalances—would be very substantial, GDP growth would be only modestly affected in most countries. As to policy challenges facing the region, monetary tightening in most countries—except Korea where domestic demand growth remained weak—was already under way. While budget positions had generally improved, public debt remained high in a number of countries and more fiscal consolidation was needed. In addition, structural reforms were required in several countries to reduce vulnerabilities in the bank and corporate sectors and to boost investment.

In *Latin America*, Directors noted, growth had exceeded expectations. While the favorable external environment had supported activity, domestic demand was now leading growth. Despite a number of downside risks to the outlook—including unexpected increases in global interest rates or a prolonged slowdown in key export markets—Directors believed that the region would continue to grow robustly in 2005. They were encouraged by the improved fiscal performance in many Latin American economies, although public debt, while declining, generally remained high. They therefore stressed the need for fiscal consolidation and more measures to improve public debt sustainability. Directors agreed that the tightening of monetary policy in a number of countries in response to the recent uptick in inflation had been appropriate; they noted that exchange rate flexibility had played a key role in supporting monetary policy frameworks and improving the region's resilience to shocks.

The *emerging market economies of Europe* were experiencing their strongest growth since the beginning of transition and Directors welcomed the expected moderation in the pace of growth to more sustainable rates. Among the key risks facing these countries were a prolonged slowdown in western Europe and a further appreciation of the euro. Many Directors observed that strong domestic demand had led to a general widening of current account deficits, a key regional vulnerability. The policy requirements to reduce these deficits varied across countries. In the Baltics and southern and southeastern Europe, containing credit growth and improving private saving were key, while in central Europe ambitious fiscal consolidation and structural reforms were needed.

In the *Commonwealth of Independent States*, growth had been buoyant on the back of strong domestic demand and high energy and metals prices. While growth was expected to moderate in 2005, Directors saw the outlook as generally favorable. They cautioned, however, about risks to inflation and growth from capacity constraints and inadequate investment in a number of countries. Given the area's strong capital inflows, Directors were concerned that the pace of disinflation in the region might be slowing; they stressed the need for policymakers to manage prudently the revenue gains from oil and commodity exports while allowing greater flexibility in exchange rates.

In the *Middle East*, growth had been strong in the oil exporters, underpinned by increased export earnings from oil, sound financial policies, and progress with structural reforms. Directors urged policymakers to use the window of opportunity provided by high oil prices to press ahead with the reforms needed to boost medium-term growth and employment prospects and reduce vulnerabilities, including from high public debt levels in some countries. Increased public spending on high-return human capital development and infrastructure outlays, accompanied by an acceleration of structural reforms, could help place these economies on a higher sustained growth path and, by creating jobs, help improve social outcomes. Non-oil-producing countries in the region had also benefited from the positive effects of domestic reforms, as well as from the strong growth in oil-exporting countries in the region.

Sub-Saharan Africa had experienced the highest growth in a decade, underpinned by the strength of the global economy, high prices for oil and some other commodities, improved macroeconomic policies, and progress with structural reforms. Directors viewed the region's prospects for growth as generally favorable but cautioned about a number of downside risks. A less benign global economy and a further sharp depreciation of the U.S. dollar would adversely affect a number of countries. While higher oil prices would be beneficial for some countries, they would not be for others, and many countries would need to adjust to the elimination of world textile trade quotas. To sustain the improved growth performance in the region, Directors urged governments to advance their reform efforts by promoting private sector investment, developing infrastructure, and strengthening institutions (including better transparency, governance, and property rights). They called on the international community to support these policies with increased aid, debt relief, and improved market access.

Box 1.2 IMF assistance for countries affected by the tsunami of December 2004

The magnitude 9.0 earthquake and associated tidal waves that hit Indian Ocean countries in December 2004 constituted a natural disaster of tragic proportions. The estimated number of dead and missing was nearly 300,000, with roughly 1½ million people displaced. The human cost of this disaster was clearly beyond measurement.

In FY2005, the IMF and the World Bank assisted the governments of the countries affected in coping with the aftermath of the disaster. The World Bank, along with the Asian Development Bank and other international institutions, took the lead role in helping the authorities conduct damage and needs assessments. IMF staff focused on assessing the implications of the disaster for macroeconomic policy, including the effects on growth, as well as fiscal and external positions.[1] Both the IMF and the World Bank have also moved quickly to initiate the provision of emergency financial assistance and longer-term financial aid. (See Chapters 3 and 4 for information on IMF emergency assistance for natural disasters.)

[1]"Preliminary Assessment of the Macroeconomic Impact of the Tsunami Disaster on Affected Countries and of Associated Financing Needs," *www.imf.org/external/np/oth/2005/020405.htm.*

Global Financial Stability Report

Global Financial Stability Report, August 2004

At the Board's August 2004 discussion of global financial markets,[3] Directors welcomed the strengthening of global financial stability and of key financial intermediaries. The combination of broadening global economic growth and low inflation expectations had created a favorable environment for financial markets. Strong economic growth had boosted corporate and banking sector earnings, facilitated further balance sheet strengthening, and improved credit

[3]For the summary of the Board's discussion, see *www.imf.org/external/pubs/FT/GFSR/2004/02/pdf/annex.pdf;* the *Report* can be found at *www.imf.org/external/pubs/FT/GFSR/2004/02/index.htm*.

India

The IMF's policy dialogue with the Indian authorities during FY2005 stressed the need for rapid progress on a broad range of reforms to enable India to build on recent successes and realize its ambitious objectives—especially creating jobs and reducing poverty. The Fund urged the authorities to pursue fiscal adjustment, preempt inflationary pressures, accelerate trade liberalization and labor market reform, and further open the financial sector.

The authorities are taking steps to address these issues. They remain committed to meeting the medium-term targets of the fiscal responsibility law. India appropriately tightened monetary policy, lowered tariffs, opened up important sectors to foreign direct investment, and announced a road map for banking reform. For the first time, India agreed this year to the publication of the Fund's staff report on its Article IV consultation.

In addition, India participated in the Fund's pilot study on public investment. The study stressed the need to raise public savings, further improve the management of the public investment program, strengthen capital markets, address regulatory risks that limit private participation, and improve the accounting and reporting of debt-like obligations that arise under off-budget schemes for infrastructure funding.

India also received technical assistance from the Fund's Fiscal Affairs Department in setting up a state fiscal database and debt register, which will be critical in allowing the authorities to fashion a program for fiscal reform at the state level. The Fund stressed the need, in the short term, for India to develop the ability to consolidate states' accounts and, in the medium term, for the country to move to a computerized integrated financial management system.

India-IMF activities in FY2005

December 2004	IMF technical assistance mission on states' fiscal database
January 2005	Completion of India's Article IV consultation by the Fund's Executive Board
March 2005	Visit of Managing Director Rodrigo de Rato
April 2005	Issuance of Board paper, "Public Investment and Fiscal Policy—Lessons from the Country Studies"

quality. At the same time, subdued inflationary pressure had contributed to stability and relatively low yields in the major bond markets. This had also benefited emerging markets, boosting their growth prospects and credit quality and facilitating the availability of external financing at relatively low cost.

Nonetheless, Directors cited a number of important risks to the outlook:

- An unanticipated increase in inflation could transform the market's assumptions about the likely pace of tightening and result in market turbulence.
- There was potential for market instability arising from the continued large global external imbalances.
- Emerging market countries could be exposed to future external shocks. These countries should use the favorable financing environment to increase their resilience and press ahead with growth-enhancing structural reforms. Measures to reduce public debt to manageable levels and to improve the structure of public debt remained key priorities for many emerging markets.

The large inflows into *hedge funds* in recent years, particularly from institutional investors, indicated that these funds were an important investor group in global financial markets. Counterparty risk management by large banks and prime brokers with regard to hedge funds had strengthened in recent years, and hedge fund leverage was at relatively moderate levels. Still, most Directors agreed that more information about hedge funds and their market activities would be helpful in addressing questions about how this investor group could affect market stability.

Discussing the staff's analysis of the *pension fund industry*, Directors noted that the size and projected growth of pension funds highlighted their increasing importance for international capital markets and financial stability and their role as a long-term institutional investor. Directors acknowledged that the roles of state pensions, pension plans in the workplace, and individual saving plans in contributing to retirement pensions varied from country to country. Among workplace pension plans, well-designed defined-benefit, defined-contribution, and hybrid plans could all continue to play a role in encouraging efficient saving for retirement.

While the 2000–02 market downturn had exposed longer-term vulnerabilities at many pension funds, the recent partial recovery in funding ratios provided a window of opportunity for policymakers to introduce measures to encourage better risk-management practices and more stable funding strategies. Directors noted that employers and governments had become more aware of the pension-funding challenges posed by aging populations and the investment risks involved in funded pension plans. They underscored the importance of effective communication of pension challenges and policy priorities to ensure broad-based public understanding and support of pension reform efforts.

The Executive Board discussed the issue of *emerging market countries as net capital exporters,* in light of the conventional wisdom suggesting that capital normally flows from capital-rich mature markets to capital-scarce emerging markets. Directors noted that the shift of emerging markets as net capital exporters during 2002–04 was associated with an unprecedented increase in their net international reserves. This, in turn, was related to their pursuit of export-led growth policies, supported by competitive exchange rates. Directors acknowledged the challenges involved in establishing a general benchmark for what constituted a desirable level of international reserves, as circumstances and vulnerabilities differed from country to country. They considered that policymakers should continue to explore alternative methods to self-insure against sudden reversals in capital flows, including through financial sector reforms and the development of local securities markets, as well as ways to improve the management of international reserves.

Directors called on emerging market countries to establish a track record of consistently strong policies and reforms to enhance their risk-adjusted returns to attract stable inflows. An orderly resolution of global current account imbalances would also contribute to an environment conducive to sustained private capital flows to emerging markets.

Global Financial Stability Report, March 2005

In discussing world financial markets in March 2005,[4] Directors welcomed the further strengthening of the financial system in the previous six months, supported by solid global economic growth and continued improvements in balance sheets of the corporate, financial, and household sectors in many countries. Prospects for continued financial stability were based on the still favorable outlook for the world economy and the growing financial market sophistication that had helped spread risk. Nonetheless, low long-term interest rates and credit spreads could mask underlying vulnerabilities and pose risks of market reversals, especially for less creditworthy sovereigns and corporations. While these risks were generally expected to be manageable given the strength of financial institutions, Directors stressed the need for continued vigilant monitoring and timely policy measures.

Markets had remained orderly through the interest rate tightening cycle in mature markets, facilitated by the increasingly transparent communication strategies of major central banks. Abundant global liquidity and improving credit quality had kept mature market bond yields and financial market volatility low. Also contributing to relatively low long-term bond yields were expectations that inflation would remain under control, low corporate demand for net credit, and growing demand for long-term bonds by pension funds and life insurance companies. More generally, low short-term interest rates had encouraged investors to use leverage and move out along the risk spectrum in their quest for yield, buoying asset valuations and compressing credit spreads.

Directors noted that corporate balance sheet improvements in mature markets and the quest for yield had encouraged investors to increase their exposure to credit risk. This had contributed to falling corporate bond spreads and, possibly, to reduced investor discrimination. The growth of credit derivatives markets had facilitated the trading and hedging of credit risks, but many Directors acknowledged that the growth of the derivatives markets might expose some investors to the possibility of leveraged losses, which could be amplified by potential liquidity problems.

As to emerging financial markets, along with improvements in many of these countries' fundamentals, abundant liquidity and quest for yield were driving factors in recent developments. Spreads on emerging market debt had narrowed to near-record lows, and investors' appetite for emerging market financial assets had grown considerably. Directors generally expected financing prospects for emerging markets to remain solid, owing to benign financial market conditions and further improvements in the credit quality of emerging market borrowers.

Turning to risks, Directors noted that the long period of high liquidity and low volatility may have led to a sense of complacency on the part of some investors, and that compression of inflation and risk premiums left little room for error in terms of asset valuations. Against this backdrop, the risk that long-term market rates might rise abruptly required continued vigilance. While no single event may trigger such a rise, most Directors warned of the possibility of a combination or correlation of events. They cited the potential risks of a disorderly adjustment of global imbalances—possibly associated with a diversification of international investors away from U.S. dollar holdings—as well as the possibility of an unanticipated increase in inflation, particularly related to oil and other commodity prices.

To enhance global financial stability and mitigate potential risks, Directors considered a number of steps—in particular, the need for cooperative efforts and credible policy measures to enhance the market's confidence that global imbalances would be reduced in an orderly manner. At a microeconomic level, supervisors and regulators had to be vigilant to the risk profile of financial intermediaries and their expo-

[4]For the summary of the Board's discussion, see *www.imf.org/external/pubs/FT/GFSR/2005/01/pdf/annex.pdf;* the *Report* can be found at *www.imf.org/external/pubs/FT/GFSR/2005/01/index.htm*.

sure to abrupt market price shocks. Emerging market country authorities should continue to adopt prudent macroeconomic policies that reduce financing needs, while taking advantage of the prevailing benign conditions to fulfill their external financing requirements, improve the structure of their debt, and press ahead with efforts to develop local financial markets. In addition, structural reforms to enhance growth prospects remained a critical avenue for reducing debt-to-GDP ratios to more manageable levels.

Directors also considered the implications of the *transfer of risk to the household from the financial sector* and *trends in corporate finance in emerging markets.* Trends in the evolution of household balance sheets in different jurisdictions had benefited households in various ways, including through a significant growth in net worth relative to income, boosted by capital gains. At the same time, the shift away from bank and savings deposits to more market-sensitive assets had also exposed them to greater market risk. Planned reforms of public and private retirement benefits might imply that households would have even more responsibility going forward in managing their financial affairs. Such reforms had brought benefits, such as the portability of defined-contribution or hybrid pension plans, and had reduced some risks, but these reforms had also increased the direct exposure of households to investment and market risks and, possibly more challenging, longevity risk.

Directors generally saw a role for governments in developing communication strategies to inform households about their retirement challenges, and in coordinating with the private sector to provide financial education. They noted the importance of increased efforts to improve the collection, timeliness, and comparability of data on the household sector for assessing the flow of financial risk through the financial system, and in particular the risk profile of households.

Discussing a staff study on *corporate finance in emerging markets*, Directors observed that it was unclear whether the decline in domestic bank lending to corporations (outside China and India) was a result of reduced external financing needs or constraints on the sources of funding. Nevertheless, Directors called for continued efforts by emerging markets to improve their institutional frameworks to facilitate corporates' access to equity finance on appropriate terms. They saw a need to narrow gaps in the implementation and enforcement of widely accepted principles of corporate governance, disclosure, and transparency, while recognizing the need to take into account country-specific legal and institutional circumstances as well as the stage of market development. Assessing corporate sector financial fragilities was significant, given the increased importance of corporates relative to sovereigns in international markets and the potential risks if market conditions became less benign.

Oil market developments

In the face of rapidly rising oil prices—which surged more than 30 percent in 2004 and an additional 35 percent between the end of 2004 and mid-March 2005—the Board held a seminar in March 2005 to discuss market developments.[5] Prices were at record levels in nominal terms, although they were significantly below their peaks of the 1970s in real terms. While Directors recognized that the outlook for prices was subject to a large margin of uncertainty, the prevalent view was that some of the recent price increase was likely to be permanent. Directors also broadly agreed that current low levels of spare production capacity, in the context of strong demand growth and potential supply disruptions, increased the risk of greater volatility in prices.

On the issue of investment in new oil production capacity, many Directors felt that the current low levels of spare production capacity and strong demand growth called for increased investment in new productive capacity. Some other Directors, however, pointed to past experiences of overinvestment and very low prices and also noted that other factors besides capacity limitations were contributing to high prices. While Directors considered that a durable increase in prices would stimulate investment, they also cited a number of other factors affecting investment: the high initial costs of investment, the long time horizon for payoffs, uncertainties associated with forecasting long-term prices, and geopolitical risks. Directors agreed that members should strive to remove undue obstacles to investment. They also noted the importance of adequate investment in refining and other downstream activities, where structural rigidities persisted.

Directors broadly agreed that the impact of the recent high oil prices on the global economy had not been too large and that growth prospects continued to be favorable; moreover, oil prices remained well below historical peaks in real terms. They attributed this relatively limited impact in part to the ongoing reduction in oil intensity of consumption and production, especially in advanced economies, as well as to the greater credibility of countries' macroeconomic policy frameworks. Directors were reassured that many oil-importing developing countries were able to respond to price increases without undue hardship through a combination of adjustment, use of reserves, and external financing. However, the impact on some oil-importing developing countries had been significant. Directors thus stressed the need to remain watchful, especially if prices rose further.

Directors recommended that policy responses by oil exporters should take into account their current macroeco-

[5]The Board's discussion is summarized in Public Information Notice No. 05/48, *www.imf.org/external/np/sec/pn/2005/pn0548.htm*.

nomic situation, the size of the oil windfall relative to the economy, the size of oil reserves, the existing liquidity cushion, the external and public debt situation, and the capacity to identify and implement good spending programs. They encouraged oil exporters to react prudently, given the uncertain outlook for oil prices, and attached importance to transparency and accountability in the management of oil revenues (see Chapter 2 for a discussion of the IMF's *Draft Guide on Resource Revenue Transparency*). As to oil importers, their response to higher oil prices would continue to require some combination of increased foreign borrowing, reserve drawdown, and adjustment, including allowing real exchange rate depreciation. Directors agreed that the IMF should continue to stand ready to provide temporary balance of payments financing where it would be a useful complement to countries' own policy adjustments.

Directors noted the desirability, for global prosperity, of stability in oil markets and underscored the importance of closer dialogue between consumers and producers. In that context, they agreed that the timeliness, accuracy, and comprehensiveness of data on oil supply and demand should be improved, including data on inventories. They considered that such improvements could help reduce uncertainty and price volatility as well as improve decision making by producers and consumers. Directors agreed that the Fund should continue to support the efforts of the international bodies responsible for collecting data on the oil market and encouraged Fund representation at meetings of those bodies. Fund support will continue to include technical assistance to members to improve their institutional frameworks, such as statistical legislation and organization. Directors agreed that the Fund should continue to encourage members to accelerate their participation in the Fund's data-related initiatives.

Many Directors also remarked on the important contribution that countries could make to oil market stability through policies to restrain demand for oil products. These actions included policies to improve energy efficiency, promote energy conservation and use of alternative fuels, and facilitate pass-through of international price changes to retail prices. In this context, the prices of petroleum products, including taxes and excises, should reflect not only their market costs but also the social costs that can result from their use. Directors considered that, where necessary, these measures should be accompanied by appropriate social safety nets.

Country surveillance

To conduct surveillance in accordance with Article IV, the IMF regularly sends staff teams to member countries. Formal "Article IV" consultations are usually conducted once a year (less often in some countries), with informal staff visits

Turkey

Under Turkey's previous IMF-supported program, the government implemented ambitious macroeconomic and structural policies, laying the basis for continued economic gains in FY2005. Turkey's new three-year program should help consolidate these achievements.

Economic growth reached an impressive 10 percent in 2004. To rein in public debt and the current account deficit, the government overperformed on its budgetary target and secured a primary surplus of 7 percent of GNP in 2004. This reduced Turkey's public debt burden to 63 percent of GNP, almost 30 percentage points lower than after the 2000–01 crises. The central bank's skillful conduct of monetary policy drove the inflation rate down to the single digits, the lowest in a generation. Marking this success, the Central Bank of Turkey announced it would move to formal inflation targeting in 2006. The authorities also introduced a redenominated currency in January 2005—the new Turkish lira—dropping six zeros from the old currency. As part of the new Fund-supported program, the government has also embarked on important reforms of, among other things, tax administration, social security, and banking legislation. These structural reforms will strengthen Turkey's institutional framework and support medium-term growth prospects.

Reflecting these gains and large capital inflows, financial market performance has been impressive. Benchmark bond interest rates have fallen well below 20 percent, from 25 percent at end-April 2004; external bond spreads have narrowed substantially; the stock market is at record levels; and the lira remains strong.

Turkey-IMF activities in FY2005

May 2004	Visit of First Deputy Managing Director Anne O. Krueger
July 2004	Completion of eighth review of Turkey's performance under Stand-By Arrangement and of Article IV consultation by the Fund's Executive Board
April 2005	Visit of Managing Director Rodrigo de Rato to address second Istanbul Investment Advisory Council

often taking place between these consultations. The team collects economic and financial data and discusses with government and central bank officials economic developments since the previous consultation, as well as the country's exchange rate and monetary, fiscal, financial sector, and structural policies. The staff team may also meet with such nonofficial groups as legislators, trade unions, academics, and financial market participants to solicit their views on the economic situation. Toward the end of the visit, the team prepares a summary of its findings and policy advice, which it leaves with the national authorities, who have the option of publishing it.

On return to IMF headquarters, the staff team prepares a report describing the economic situation and the talks with the authorities, and evaluating the country's policies. The report is discussed by the Executive Board and a summary of the discussion produced. Through these consultations, the IMF seeks to identify policy strengths and weaknesses, indicate potential vulnerabilities, and advise countries on appropriate corrective actions if needed. If the member country agrees, the full Article IV consultation report, accompanied by a Public Information Notice (PIN), which provides background and a summary of the Board discussion, is published. The member country may elect to release only the PIN. In FY2005, the Board conducted 130 Article IV consultations with member countries (Table 1.1). (All PINs are posted on the IMF's website, as are Article IV reports approved for release.)

Supplementing these systematic and regular Board reviews of individual member countries are Executive Board assessments of economic developments and policies of member countries borrowing from the IMF, as well as frequent and informal sessions to discuss developments in individual countries. The IMF's country surveillance is also informed by voluntary assessments under the Financial Sector Assessment Program (see Chapter 2).

At its July 2004 biennial review of surveillance, the Board agreed that Article IV consultations with systemically or regionally important member countries would provide fuller treatment of the cross-border impact of their economic conditions and policies. More generally, Directors agreed that consultations would be more explicit in linking economic performance to global economic and financial conditions and would enhance the analysis of country-specific vulnerabilities to global economic and financial risks. (The biennial review is covered in detail in Chapter 2.)

Regional surveillance

The IMF has been stepping up its regional surveillance by strengthening discussions of regional currency unions and by paying more attention to the regional dimensions of economic developments and policy issues. These discussions are expected to allow, for example, comparative analysis of developments and policies across a region and to shed further light on regional transmission of shocks.

Sub-Saharan Africa

As part of this effort, Fund staff have begun to provide the Board with periodic regional overviews. The first, discussed by the Board at an informal seminar in April 2005, covered sub-Saharan Africa.[6] *Regional Economic Outlook: Sub-Saharan Africa* reported that the most critical challenge the region faces is sustaining and accelerating economic growth. It noted that even recently improved growth rates—which reached an eight-year high of 5 percent in 2004—fall short of the level required to achieve the Millennium Development Goal of halving poverty by 2015 (see Chapter 4).

Eastern Caribbean Currency Union (ECCU)

Faced with a series of setbacks—including natural disasters, the continued erosion of preferential trade agreements in bananas and sugar, declining activity in offshore centers, weaknesses in the global economy, and the lingering effects of September 11—the ECCU countries have followed expansionary fiscal policies to generate growth. These policies, however, have saddled many countries with rapidly rising debt and weak fiscal positions.

The Executive Board, at its May 5, 2004, discussion of the ECCU,[7] urged the regional authorities to strengthen fiscal positions and reduce debt rapidly while undertaking reforms focused on improving the business environment and competitiveness so as to reinvigorate growth.

To reduce the sources of vulnerability in the region, Directors emphasized reducing reliance on traditional agriculture, strengthening underlying fiscal positions, and enhancing the effectiveness of financial supervision. It is also important to strengthen the region's institutional capacity to mitigate the effects of natural disasters. They encouraged the authorities to ensure the consistency of national fiscal policies with the region's currency board arrangement and welcomed efforts under way to develop home-grown stabilization programs.

Euro area

The Executive Board discussed economic policies in the euro area in July 2004. Directors acknowledged the bright-

[6]For the full report, see *www.imf.org/external/pubs/ft/AFR/REO/2005/eng/01/SSAREO.htm*.

[7]For a summary of the discussion, see Public Information Notice No. 04/101, *www.imf.org/external/np/sec/pn/2004/pn04101.htm*.

Table 1.1 Article IV consultations completed during FY2005

Country	Board date	PIN issued	Staff Report published
Afghanistan, Islamic Republic of	January 19, 2005	January 27, 2005	February 4, 2005
Albania	February 28, 2005	March 10, 2005	March 10, 2005
Algeria	January 12, 2005	January 28, 2005	February 15, 2005
Angola	March 4, 2005		
Antigua and Barbuda	November 15, 2004	November 22, 2004	November 24, 2004
Armenia	December 1, 2004	December 10, 2004	December 17, 2004
Australia	October 27, 2004	November 8, 2004	November 8, 2004
Austria	August 2, 2004	August 4, 2004	August 5, 2004
Azerbaijan	December 22, 2004	January 21, 2005	January 21, 2005
Bahrain	June 14, 2004	August 24, 2004	
Barbados	May 3, 2004	May 14, 2004	May 26, 2004
Belarus	May 7, 2004	May 19, 2004	May 19, 2004
Belgium	February 18, 2005	March 3, 2005	March 3, 2005
Benin	October 6, 2004	November 12, 2004	November 24, 2004
Brazil	March 21, 2005	March 25, 2005	
Brunei Darussalam	May 21, 2004	September 23, 2004	
Bulgaria	June 14, 2004	June 18, 2004	June 28, 2004
Cambodia	September 13, 2004	September 27, 2004	October 22, 2004
Cameroon	April 22, 2005	April 29, 2005	
Canada	February 16, 2005	March 29, 2005	March 29, 2005
Chile	August 4, 2004	August 5, 2004	September 13, 2004
China	July 28, 2004	August 25, 2004	November 5, 2004
Colombia	April 29, 2005	May 9, 2005	May 9, 2005
Congo, Republic of	June 10, 2004	July 22, 2004	August 2, 2004
Costa Rica	July 2, 2004	August 19, 2004	September 20, 2004
Croatia	August 4, 2004	August 12, 2004	August 12, 2004
Cyprus	February 18, 2005	March 22, 2005	March 22, 2005
Czech Republic	August 6, 2004	August 17, 2004	August 17, 2004
Denmark	August 2, 2004	August 6, 2004	August 6, 2004
Ecuador	July 26, 2004	August 12, 2004	
Egypt	May 24, 2004	July 12, 2004	
El Salvador	January 31, 2005	February 14, 2005	
Equatorial Guinea	April 25, 2005	May 6, 2005	May 6, 2005
Eritrea	September 3, 2004	February 9, 2005	
Estonia	November 8, 2004	November 11, 2004	November 11, 2004
Ethiopia	September 13, 2004	January 31, 2005	January 31, 2005
Fiji	August 23, 2004	September 14, 2004	
Finland	January 28, 2005	February 7, 2005	February 7, 2005
France	October 20, 2004	November 3, 2004	November 3, 2004
Gabon	March 28, 2005	April 26, 2005	May 3, 2005
Germany	October 25, 2004	November 2, 2004	November 2, 2004
Greece	February 2, 2005	February 9, 2005	February 9, 2005
Guinea	August 27, 2004	October 3, 2004	December 7, 2004
Guinea-Bissau	November 19, 2004	December 10, 2004	March 11, 2005
Guyana	January 24, 2005	March 11, 2005	
Honduras	March 28, 2005	April 13, 2005	
Hong Kong SAR	February 2, 2005	February 21, 2005	February 21, 2005
Hungary	May 10, 2004	May 24, 2004	May 24, 2004
India	January 24, 2005	February 3, 2005	March 10, 2005
Indonesia	May 3, 2004	May 9, 2004	July 2, 2004
Iran, Islamic Republic of	September 10, 2004	September 27, 2004	September 27, 2004
Ireland	October 29, 2004	November 4, 2004	November 4, 2004
Israel	March 21, 2005	March 29, 2005	April 18, 2005
Italy	February 7, 2005	February 9, 2005	February 10, 2005
Jamaica	August 2, 2004	August 16, 2004	August 16, 2004
Japan	July 28, 2004	August 11, 2004	August 11, 2004
Kazakhstan	July 21, 2004	September 20, 2004	October 28, 2004
Kenya	December 20, 2004		
Korea	January 21, 2005	February 4, 2005	February 11, 2005
Kuwait	April 25, 2005	May 13, 2005	
Kyrgyz Republic	November 19, 2004	January 14, 2005	February 10, 2005
Lao People's Democratic Republic	November 29, 2004	January 12, 2005	January 12, 2005
Latvia	August 4, 2004	August 6, 2004	August 16, 2004
Lebanon	May 7, 2004	July 7, 2004	
Liberia	April 20, 2005		

Table 1.1 *(concluded)*

Country	Board date	PIN issued	Staff Report published
Libya	January 28, 2005	March 8, 2005	March 8, 2005
Lithuania	March 23, 2005	March 31, 2005	March 31, 2005
Malawi	October 29, 2004	November 24, 2004	December 6, 2004
Malaysia	February 7, 2005	March 14, 2005	
Maldives	May 24, 2004	July 23, 2004	
Mauritius	July 21, 2004	August 25, 2004	
Mexico	October 18, 2004	December 23, 2004	December 23, 2004
Micronesia, Federated States of	February 25, 2005	March 22, 2005	March 22, 2005
Moldova	February 7, 2005	February 17, 2005	February 17, 2005
Morocco	May 5, 2004	May 12, 2004	June 9, 2004
Myanmar	March 25, 2005		
Namibia	February 14, 2005	March 9, 2005	March 11, 2005
Netherlands	September 8, 2004	September 17, 2004	September 22, 2004
Niger	June 28, 2004	July 19, 2004	August 24, 2004
Nigeria	July 16, 2004	August 3, 2004	August 6, 2004
Oman	October 8, 2004		
Pakistan	December 1, 2004	December 20, 2004	December 20, 2004
Panama	March 23, 2005	April 12, 2005	
Papua New Guinea	June 2, 2004	November 10, 2004	November 10, 2004
Paraguay	July 30, 2004	September 16, 2004	February 18, 2005
Philippines	March 7, 2005	March 20, 2005	March 21, 2005
Poland	July 12, 2004	July 26, 2004	July 26, 2004
Qatar	March 14, 2005		
Romania	July 7, 2004	July 27, 2004	July 27, 2004
Russian Federation	September 1, 2004	September 30, 2004	September 30, 2004
Rwanda	October 6, 2004	November 16, 2004	December 3, 2004
St. Kitts and Nevis	November 15, 2004		
St. Lucia	May 5, 2004	November 15, 2004	December 8, 2004
St. Vincent and the Grenadines	May 5, 2004	May 19, 2005	
San Marino	July 28, 2004	August 4, 2004	August 13, 2004
Saudi Arabia	December 22, 2004	January 12, 2005	
Senegal	March 7, 2005		
Seychelles	January 21, 2005		
Sierra Leone	November 12, 2004	January 19, 2005	January 24, 2005
Singapore	February 7, 2005	April 28, 2005	April 28, 2005
Slovak Republic	February 11, 2005	February 17, 2005	March 2, 2005
Slovenia	May 7, 2004	May 24, 2004	May 24, 2004
Solomon Islands	July 16, 2004	August 12, 2004	August 12, 2004
South Africa	September 3, 2004	December 2, 2004	December 2, 2004
Spain	February 9, 2005	February 17, 2005	February 17, 2005
Sudan	April 29, 2005		
Suriname	March 25, 2005	April 20, 2005	April 25, 2005
Swaziland	February 18, 2005		
Sweden	August 4, 2004	August 9, 2004	August 9, 2004
Switzerland	June 2, 2004	June 18, 2004	June 18, 2004
Tajikistan	March 18, 2005	March 25, 2005	April 15, 2005
Tanzania	August 6, 2004	September 7, 2004	September 7, 2004
Thailand	September 1, 2004	December 1, 2004	
Timor-Leste	July 16, 2004	October 12, 2004	October 12, 2004
Tonga	June 23, 2004	July 29, 2004	
Trinidad and Tobago	October 22, 2004	December 8, 2004	January 5, 2005
Tunisia	October 27, 2004	November 8, 2004	November 12, 2004
Turkey	July 30, 2004	August 10, 2004	
Turkmenistan	June 4, 2004		
Uganda	February 23, 2005		
Ukraine	October 25, 2004	January 24, 2005	January 24, 2005
United Arab Emirates	May 28, 2004	June 29, 2004	June 29, 2004
United Kingdom	March 2, 2005	March 8, 2005	March 8, 2005
United States	July 23, 2004	July 30, 2004	July 30, 2004
Uzbekistan	June 7, 2004		
Vanuatu	February 25, 2005	March 11, 2005	March 31, 2005
Venezuela, República Bolivariana de	September 13, 2004		
Vietnam	November 22, 2004	January 5, 2005	May 4, 2005
Yemen, Republic of	March 14, 2005	March 24, 2005	March 23, 2005
Zimbabwe	July 7, 2004	September 17, 2004	September 17, 2004

ening of the short-term outlook but observed that long-standing structural challenges had yet to be tackled. Directors cautioned that the transmission of the growth momentum to domestic demand, particularly in some of the larger economies, remained sluggish.

Directors agreed that monetary policy had been appropriate, particularly in view of the persistence of inflation during the cyclical downturn. Looking forward, Directors believed that monetary policy should remain supportive of the recovery in domestic demand as long as the medium-term outlook for price stability was favorable. While risks of second-round effects from higher oil prices, as well as from hikes in indirect taxes and administered prices, had to be watched closely, the slack in labor markets and continued wage moderation underpinned an encouraging outlook for inflation. At the same time, Directors emphasized that renewed appreciation pressures on the euro stemming from global current account imbalances remained a medium-term downside risk to growth.

A genuine consensus on upholding a strong and disciplining fiscal framework had to be restored, Directors emphasized, in particular against the backdrop of the fiscal challenges associated with rapid population aging. Most Directors felt that a failure to build a new consensus on reforming the Stability and Growth Pact (SGP) could have potentially grave consequences for the European Economic and Monetary Union (EMU) and its member countries, many of which rely on the SGP as an external commitment device to maintain fiscal discipline. In this vein, and with the recovery gaining traction, Directors called on member states to accelerate the pace of fiscal consolidation.

Turning to growth prospects, Board members saw the euro area's key structural challenge as raising longer-term growth, in the first instance by strengthening incentives to work. Reversing the long-term decline in labor utilization through reforms of tax-benefit systems and by lengthening working lives would need to be a key plank in the strategy to shore up social protection systems in most member countries. As to the areas for reform, Directors welcomed the measurable progress in deregulating and integrating product and financial markets but urged more efforts to liberalize the service sectors.

The lack of reform momentum was a source of concern for Directors, particularly with respect to labor and pension reforms. The key challenge at the area-wide level was imparting momentum to structural reforms at the national level through more decisive leadership at the European Union level.

Directors welcomed the European Union's new efforts to relaunch the stalled Doha Round of trade negotiations. The European Union's recent offers to phase out all farm export subsidies and further limit negotiations on the four Singapore issues (trade and investment, competition policy, transparency in government procurement, and trade facilitation)—so-called because it was at the 1996 Singapore Ministerial Conference that WTO members decided to start work on them—provided a fresh, much-needed impetus for reaching agreement on a negotiating framework, and Directors felt that it would be desirable to complement these efforts with a more ambitious multilateral offer on market access.

West African Economic and Monetary Union (WAEMU)

At the time of the Board's October 2004 discussion, the WAEMU region's economic prospects for 2004 were clouded by the crisis in Côte d'Ivoire, pressures on external competitiveness, higher oil prices, and a locust invasion. While the region's competitiveness had suffered no significant loss, Directors urged the authorities to pursue appropriate macroeconomic policies and structural reforms aimed at enhancing the efficiency of the export sector so as to strengthen external competitiveness and improve prospects for sustainable growth and poverty reduction.

The momentum toward macroeconomic convergence within the WAEMU had slowed and the political commitment to further trade liberalization had softened. Directors stressed that concerted and credible action by all countries to deliver on their regional commitments in all areas was necessary to achieve economic and financial convergence and allow the region to reap the benefits of further trade liberalization.

The WAEMU monetary arrangement had helped keep inflation low and maintain confidence in the currency, Directors observed. They welcomed the move to eliminate central bank financing of the national budgets, which would strengthen financial discipline. To safeguard against the risk of arrears accumulation or excessive external borrowing following this move, WAEMU limits on debt and arrears accumulation had to be strictly observed.

Despite the limited integration of WAEMU financial markets, Directors recommended that the authorities move progressively toward formulating and implementing monetary policy based on regional, rather than country-specific, targets, once constraints imposed by the lack of financial integration were alleviated. To strengthen credit institutions, Directors stressed the need to improve supervisory frameworks through regulatory reform and better enforcement. Finally, Directors welcomed the enhanced collaboration between the WAEMU Commission and the Executive Secretariat of the Economic Community of West African States (ECOWAS) aimed at establishing a single regional market within ECOWAS.

Strengthening surveillance and crisis prevention

CHAPTER | 2

The IMF continues to strengthen the quality and effectiveness of its surveillance operations. Its efforts in this area, which have been intense since the emerging market crises of the mid- and late 1990s, are aimed at ensuring that the Fund is as effective as possible in helping member countries improve the performance and resilience of their economies, minimizing adverse international spillovers from problems that arise, and identifying and addressing potential vulnerabilities in the international financial system.

During FY2005, the IMF conducted another extensive biennial review of its surveillance and stepped up its consideration of financial sector issues, including through a review of the Financial Sector Assessment Program that it conducts jointly with the World Bank. It also considered members' debt-related vulnerabilities and how these might be related to financial crises, as well as issues relating to central banks' liquidity management. It discussed some members' demand for new policy monitoring and signaling arrangements that do not involve IMF financing, and continued to help members improve their statistical data and comply with international standards and codes.

Biennial Review of Surveillance

In its July 2004 discussion of the IMF's Biennial Review of Surveillance,[1] the Executive Board confirmed the need for focused surveillance built on high-quality analysis. The review centered on how to make surveillance more effective for all members, and, in so doing, reinforce the Fund's crisis prevention efforts. It was based on an assessment by Fund staff that sought to take into account views solicited not only from country authorities but also from financial market participants, think tanks and other nongovernmental entities, and the media.

Directors agreed that IMF surveillance should evolve continuously, adapting to changes in the world economy and the needs of member countries. They welcomed the progress in strengthening surveillance since the 2002 biennial review but underscored that challenges remained. Mindful of the International Monetary and Financial Committee's call for proposals to enhance the focus, quality, persuasiveness, impact, and overall effectiveness of surveillance, Directors considered a number of issues.

Focus and quality of analysis

Notwithstanding the expanded reach of surveillance, country (Article IV) consultations must remain focused on key issues, Directors reaffirmed. Coverage should be adapted to country circumstances and the selection of topics should be based on macroeconomic relevance. At the apex of the IMF's hierarchy of concerns were external sustainability; vulnerability to balance of payments or currency crises; sustainable growth and the policies to achieve it; and, for systemically important countries, conditions and policies that affect the global or regional economic outlook.

The IMF had generally succeeded in covering a broader range of topics without losing focus, Directors agreed. Still, individual consultations would benefit from more discriminating coverage of issues outside the IMF's traditional areas of expertise, greater use of information from appropriate outside sources, and more selective coverage of trade matters (Box 2.1), with a focus on those that most influence stability and growth prospects. The Board encouraged staff to exchange views with members in defining priority topics but stressed that staff retain ultimate responsibility for selecting them.

Directors emphasized that IMF surveillance was an ideal vehicle for the analysis of global and regional spillovers. They saw substantial scope for improving the treatment of these issues through greater integration of country, regional, and global surveillance. They also called for fuller treatment of the global impact of the largest member countries' economic conditions and policies and for more pointed treatment, in all consultations, of risks to the short- and medium-term outlook.

Informal Board discussions of issues affecting different regions were valuable complements to the global and country surveillance exercises, Directors agreed. Such discussions

[1]The Board's discussion is summarized in Public Information Notice No. 04/95, *www.imf.org/external/np/sec/pn/2004/pn0495.htm;* the review can be found at *www.imf.org/external/np/pdr/surv/2004/082404.htm*.

Box 2.1 The IMF's role in trade

Trade policy has traditionally been an important part of IMF surveillance and, in a number of cases, IMF-supported programs. Every few years, the IMF reviews aspects of its work on trade. The review undertaken during FY2005 was broader than previous reviews.

At their February 2005 discussion of the IMF's role in trade,[1] Directors endorsed the Fund's trade policy agenda and policy positions. They reaffirmed the importance of successfully concluding the Doha Round of multilateral trade negotiations to promote efficiency and growth, reduce poverty, and support the achievement of the Millennium Development Goals. Developed countries had a critical role to play in addressing remaining impediments to trade, Directors agreed, by removing restrictions to exports from developing countries, reducing tariff escalation, and cutting agricultural and other subsidies. Developing countries, for their part, had to commit to further trade liberalization.

Directors broadly endorsed the Fund's work on trade and favored only a fine tuning. They considered it useful to extend the staff's analysis of the spillover effects of the trade policies of key industrial countries to cover the trade policies of larger middle-income countries, which increasingly affect the export prospects of other countries. Directors also encouraged the staff to increase coverage of trade in services, noting its growing importance.

The Board cited the proliferation of regional trade integration arrangements and the associated pooling of trade policy and administrative decisions. While recognizing that multilateral trade liberalization on a most-favored-nation basis was the preferred way to secure open markets globally, Directors emphasized that regional trade agreements, if appropriately structured, could provide immediate economic benefits and be complementary to and compatible with multilateral liberalization.

The IMF, in collaboration with other international institutions (particularly the World Bank and the World Trade Organization) and donors, should continue to give trade-related policy advice to low-income countries with the aim of integrating trade reforms more systematically into their Poverty Reduction Strategy Papers. Such advice should draw on the work prepared in the context of the Integrated Framework (IF), an interagency initiative to coordinate trade-related technical assistance with development partners and help mainstream trade into national strategies. The IMF should also consider how best to work in a collaborative way with other partners, through the IF, to explore further ways of easing low-income countries' adjustment to more liberal trade regimes.

With regard to the IMF's work in providing financial support for member countries' adjustment and reform programs, Directors welcomed the recent reduction in trade conditionality, which was due to, among other things, the general streamlining of the Fund's structural conditionality and the adoption of more open trade policies by many countries. Directors endorsed the IMF's recent emphasis on trade-related macroeconomic vulnerabilities, which remained a pressing issue for the poorest countries with Fund-supported programs, and welcomed the introduction of the Trade Integration Mechanism (TIM) as a means of dealing with this issue (see Chapter 3).

Directors agreed that the IMF's assessment of trade policy issues remained indispensable in the context of Article IV surveillance and other functions. They acknowledged that the related work of other institutions could provide valuable insights in such assessments from a different perspective but said that it could not replace the Fund's own work.

[1] "IMF Executive Board Reviews Fund's Work on International Trade," Public Information Notice No. 05/49, *www.imf.org/external/np/sec/pn/2005/pn0549.htm*.

provided useful opportunities to undertake comparative analysis of major developments and policies within each region and could shed further light on the regional transmission of shocks.

Clear and candid treatment of *exchange rate issues* remained a challenge. While recognizing the sensitivity of exchange rate issues, Directors stressed that a thorough discussion of them continued to be critical for surveillance. To enhance such discussions, Directors endorsed

- clear identification of the de facto exchange rate regime in staff reports;
- more systematic use of a broad range of indicators and other analytical tools to assess external competitiveness; and
- a thorough and balanced presentation of the policy dialogue between staff and member country authorities on exchange rate issues, particularly when the views of staff and the authorities diverged.

No exchange rate regime was appropriate for all countries or all circumstances, Directors reiterated.

Separately, in a seminar in December 2004, Directors discussed what a country should do to make a successful transition from a fixed to a flexible exchange rate regime (Box 2.2).

While Directors welcomed recent improvements in the coverage of *financial sector issues* in surveillance, they observed that coverage was not yet on a par with that of other main issues. (Further details on how the Fund is enhancing financial sector surveillance are discussed below.) They pressed the staff to make use of all available options to bring the necessary expertise to bear on analysis of financial sector issues.

Directors reiterated that vulnerability to balance of payments or currency crises, and external sustainability, were key concerns. The IMF's strategy to improve vulnerability assessments and balance sheet analysis was having a positive

Box 2.2 From fixed to floating exchange rates

In recent years, a number of IMF member countries have moved from fixed to flexible exchange rate regimes. Most of these shifts have occurred under disorderly conditions. The Executive Board asked Fund staff to provide more advice to countries making such transitions, given their complexity from both an institutional and an operational perspective.

At a seminar in December 2004,[1] Directors agreed that four ingredients were generally desirable to support a successful, orderly transition to a float:

- a deep and liquid foreign exchange market;
- a coherent intervention policy;
- an appropriate alternative nominal anchor; and
- adequate systems for reviewing and managing public and private sector exchange rate risk.

Directors acknowledged that these four ingredients constituted an ideal framework and that some countries had successfully floated their exchange rates without meeting every condition fully.

In reviewing the key aspects of *developing a deep and liquid foreign exchange market,* Directors highlighted the need to reduce the central bank's market-making role, increase information flows in the market, and improve the market microstructure. They also underscored the need to foster two-way risk in the foreign exchange market to help develop risk-management expertise and minimize destabilizing trading strategies.

Turning to *intervention strategies,* Directors recognized the difficulties in identifying the conditions for, and determining the appropriate timing of, intervention. They noted that identifying and correcting exchange rate misalignments were difficult in practice and that exchange rate movements might provide important market signals. They cautioned that intervention should not be used as a substitute for implementing prudent macroeconomic policies and structural reforms.

Directors agreed that *inflation targeting* could be a useful and transparent nominal anchor to a more flexible exchange rate regime. Many countries, however, lacked the institutional prerequisites to implement inflation targeting quickly and successfully. Furthermore, Directors stressed that other nominal anchors could also be used to promote credible anti-inflationary monetary policies that, combined with sound fiscal policies, could provide a solid environment for flexible exchange rate regimes.

Directors recognized that floating transfers some risks back to the private sector and could bring some vulnerabilities to the fore. They thus encouraged countries to strengthen, at an early stage, *systems to manage foreign exchange risk* in the private sector. They also encouraged the use of such systems for the public sector.

Board members agreed that the pace at which relevant institutions could be built was a main determinant of how early preparations for an exchange rate float could help bolster a country's ability to make the move in an orderly manner.

Most Directors agreed that experience highlighted the risks of opening capital accounts before floating the exchange rate, especially the risk of sudden outflows. In light of experience, they supported moving toward increasing flexibility ahead of, or at the same pace as, liberalizing the capital account, depending on country circumstances.

[1]"IMF Executive Board Discusses Fixed to Float: Operational Aspects of Moving Toward Exchange Rate Flexibility," Public Information Notice No. 04/141, *www.imf.org/external/np/sec/pn/2004/pn04141.htm*.

impact, and Directors urged the staff to continue refining analytical techniques, while recognizing the data constraints. They called for better integration of the various components of vulnerability assessments to provide a clearer view in staff reports.

Areas outside the IMF's traditional expertise—such as the investment climate, institutional reforms, and social issues—had received substantial attention in Fund surveillance. Directors considered that, in addition to greater selectivity and wider use of appropriate outside sources of information, coverage of the investment climate and institutional reforms would benefit from greater attention to past and current implementation of policy recommendations. Most Board members felt that, in member countries where shocks could have a sizable impact on social conditions, Article IV consultations and other contacts could offer an opportunity to solicit interested member countries' views on protecting social safety nets or other priority expenditures in times of economic stress.

Turning to the IMF's efforts to foster good governance in its member countries, Directors viewed the implementation of the 1997 Guidance Note on Governance[2] as broadly satisfactory. At the same time, coverage of governance issues in Article IV consultations should be refined, Directors agreed, including through the greater use of existing governance indicators. Fund staff should also draw more systematically on Reports on the Observance of Standards and Codes (ROSCs) (see "Standards and codes, and data provision to the Fund," below) and other available material and pay closer attention to policy recommendations and their implementation.

Article IV consultation reports for low-income countries typically contain a broad treatment of growth objectives because, as these countries make progress on macroeconomic stability, the main challenges many of them face are sustaining high growth rates and reducing poverty. In many cases, coverage has been extended to an analysis of the sources and impediments to growth. Most Directors considered that, where relevant, consultations could be used to

[2]See *www.imf.org/external/np/sec/nb/1997/nb9715.htm#I2.*

analyze alternative macroeconomic scenarios under different aid flow assumptions, thereby shedding light on sustainable macroeconomic scenarios. Directors urged the staff to pay greater attention to external shocks that could derail growth in low-income countries and actions that might help improve these countries' resilience. They underscored the importance of close monitoring by the international community of progress toward the achievement of the Millennium Development Goals (see Chapter 4) and suggested that, for this purpose, IMF surveillance in low-income countries should draw as much as possible on World Bank information.

The quality of surveillance in countries with IMF-supported programs had improved since 2002, Directors agreed. They noted that progress on considering the short- and medium-term economic outlook had been more limited, but were hopeful that more systematic use of alternative scenarios would foster advances in this area.

Policy dialogue with country authorities

A close and frank policy dialogue between the IMF and its member countries is essential for effective surveillance. Directors therefore stressed the importance of a close rapport with member country authorities based on trust; they agreed that frequent contacts outside Article IV consultations could help. They also encouraged staff to make greater use of cross-country studies.

In reviewing the modalities of surveillance in currency unions, Directors noted that the formal procedures for surveillance of the euro area had worked well and that the modalities for the other currency unions—the West African Economic and Monetary Union, the Central African Economic and Monetary Community, and the Eastern Caribbean Currency Union—have also moved toward greater formalization. They favored establishing an appropriate framework for policy discussions with regional institutions in these three currency unions, which would recognize that the discussions should be part of Article IV consultations with concerned members. Such steps would strengthen surveillance over monetary and exchange rate policies, trade policies, and financial sector regulation and supervision.

Communication and signaling

Effective communication of the IMF's policy messages is essential for enhancing the overall effectiveness of surveillance, Directors agreed. It helps inform economic discussions in member countries and encourages sound decisions by market participants. At the same time, communication, including publication, while crucial for transparency, should not come at the expense of the Fund's role as a confidential advisor to members by reducing the candor of the dialogue with them and in reporting to the Board. To strengthen communication of the IMF's policy messages, Directors encouraged staff to develop outreach programs (see Chapter 8) and enhance contacts with local think tanks and also to disseminate more actively within the Fund best practices and innovations in the modalities of consultations.

Directors also discussed how the IMF could best respond to requests from some members for frequent policy monitoring and for delivering a signal on the strength of a member's policies (see below under "Policy monitoring, precautionary arrangements, and signaling").

Assessing the effectiveness of surveillance

Directors underscored the importance of regularly assessing the effectiveness of surveillance, while conceding that it was a daunting task. This was partly because, with the broadening purview of surveillance and its transformation into a more public process, the chain of reactions to IMF policy advice had grown more complex. Directors thus appreciated that the staff's papers for the biennial review were based not only on an in-house assessment but also on outreach to external audiences. In addition, to make further progress, they also encouraged greater discussion of the effectiveness of individual Article IV consultations, including, as needed, the relevance or appropriateness of past IMF policy recommendations and the authorities' responses, as well as clearer delineation and planning of the focus of individual consultations.

Use of staff resources

Some Directors thought that the total cost of staff resources devoted to surveillance was already substantial and saw little scope for implementing the review's recommendations fully. A number of others maintained that stronger surveillance could be achieved through more strategic management of resources and better prioritization. Many Directors called for further consideration of resource savings and offsets, such as greater selectivity in the coverage of individual surveillance exercises.

Given resource limitations, Directors saw a need to define priorities among strategic objectives and specific recommendations, while recognizing that the effectiveness of IMF surveillance depended on its evenhanded implementation. They supported assigning immediate priority to sharpening the focus of Article IV consultations and ensuring deeper treatment of exchange rate issues; enhancing financial sector surveillance; and deepening the coverage of regional and global spillovers in country surveillance (Box 2.3). These would serve as the monitorable objectives for the next biennial review. In addition, progress on improving debt sustainability and reducing balance sheet vulnerabilities and further work on surveillance in low-income countries would also be monitored in the next review.

Financial sector surveillance

A well-regulated and well-supervised financial system is essential for any country to maintain macroeconomic and financial stability and avoid financial crises. In its continuing efforts to help member countries in this important area, the IMF during the financial year

- completed 24 assessments under the joint Fund-Bank Financial Sector Assessment Program, of which 6 were updates. Another 36, including 8 updates, were either under way or scheduled for the next fiscal year or later;
- held Board seminars and discussions on issues such as gaps in financial sector regulation and implementation of monetary policy at different stages of market development;
- launched a pilot project in 12 countries to test ways to improve coverage of financial issues in Article IV consultations;
- devoted additional resources to monitoring financial systems, especially using financial soundness indicators (Box 2.4);
- completed the first phase of the assessment of offshore financial sectors; and
- increased participation by financial sector experts in Article IV missions or in separate missions, and enhanced training in financial sector issues for staff working on country surveillance.

Financial Sector Assessment Program

The Financial Sector Assessment Program (FSAP) was introduced in May 1999 by the IMF and the World Bank to strengthen the monitoring of financial systems. It is designed to help countries prevent or increase their resilience to crises and cross-border contagion and to foster sustainable growth by promoting financial system soundness and financial sector diversity. Assessments of financial systems undertaken under the FSAP

- identify the strengths, risks, and vulnerabilities in the financial system and the two-way linkages between financial sector performance and the macroeconomy;
- ascertain the financial sector's development needs; and
- help country authorities design appropriate policy responses.

The comprehensive nature of financial sector assessments requires a wide range of analytical tools and techniques. These include financial stability analysis, stress testing and scenario analysis, and assessments of countries' observance of relevant international financial sector standards, codes, and good practices. In implementing the FSAP, the IMF and the World Bank draw on feedback received from the Executive Boards of both institutions, from countries that have participated in the program, and from various international groups. They also draw on the knowledge of experts from a range of cooperating central banks, supervisory agencies, standard-setting bodies, and other international institu-

Box 2.3 Better integrating country, regional, and global surveillance

To enhance its analysis of global and regional spillovers, the IMF is working to better integrate country-level, regional, and global surveillance. Its principal means for doing so are through the Executive Board's reviews of the Fund's main global surveillance documents, the *World Economic Outlook* reports and the *Global Financial Stability Reports* (see Chapter 1).

The Fund will also sharpen its focus on global and regional issues in country surveillance. Article IV consultations with systemically or regionally important Fund members will need to provide fuller treatment of the cross-border effects of their economic conditions and policies. To date, such analysis has focused principally on the systemic effects of trade policies. More generally, consultations will be more explicit in linking economic performance to global economic and financial conditions, and will enhance the IMF's analysis of country-specific vulnerabilities to global economic and financial risks.

Regional surveillance and global surveillance complement country surveillance by highlighting spillover effects and regional issues, and need to be better integrated with country surveillance. The Fund has initiated a number of reviews of regional financial sector issues where there are important commonalities and spillovers across countries. For example, the operation of regional financial conglomerates demands the close cooperation of relevant supervisors and an intensified exchange of information. The first such review, covering six countries in Central America, was undertaken in FY2005.

At the same time, the increasing interdependence of economies reinforces the central role that global surveillance must play in the IMF's fulfillment of its responsibilities for overseeing the functioning of the international monetary system, safeguarding global financial stability, and promoting cooperative action to address global imbalances. The IMF's research agenda will give particular attention to evolving priorities for surveillance and program design—including international spillovers—and to how member countries can cope with volatility in global economic conditions.

Box 2.4 Financial soundness indicators

The financial crises of the mid- to late 1990s in a number of emerging markets underscored the need for new tools to detect vulnerabilities in financial systems. In response, the IMF developed a broad set of indicators and analytical techniques, including indicators designed to evaluate the health of a country's entire financial system, in contrast to bank prudential indicators, which apply only to individual institutions.

Once the set of indicators was agreed upon, the question arose as to how the IMF could help national authorities develop the ability to compile them, ensure that they were comparable across countries, and disseminate them to increase market transparency and strengthen market discipline. The first step was the preparation of a *Compilation Guide on Financial Soundness Indicators,*[1] which reflects the consensus of experts as well as feedback from the public.

After the *Guide* was finalized in July 2004, the IMF Executive Board recommended that staff undertake a coordinated compilation exercise. Statistical coordinators and compilers from about 60 countries participating in the pilot project on a voluntary basis met in Washington in November 2004 to discuss and finalize the specific terms of reference for the exercise. Countries participating in the exercise have made a commitment to compile and submit to the IMF end–2005 data for at least a core set of 12 indicators covering the banking sector. (The *Guide* contains the list of core and encouraged indicators.) The countries are encouraged to follow the *Guide's* recommendations to the extent possible to foster comparability of data across countries, but are permitted to use existing methodologies. To assist data users, countries have also committed to prepare metadata (information about the data), including on deviations of their existing methodologies from the recommendations in the *Guide*.

[1]Available at *www.imf.org/external/np/sta/fsi/eng/2004/guide/index.htm.*

tions, and outside experts augment the expertise in the IMF and the World Bank.

At a March 2005 IMF Board discussion of the Financial Sector Assessment Program,[3] Directors noted that it remained a cornerstone of financial sector work by the IMF and the World Bank in member countries. About 120 countries, two-thirds of the membership, have already participated or requested participation in the FSAP. Directors noted that further proposals may arise from the upcoming reviews of the program by the Independent Evaluation Office (IEO) and the World Bank's Operations Evaluation Department (OED). These studies, together with the Fund's own strategic review, will provide an opportunity to make a more in-depth and critical assessment of the progress so far and the program's overall effectiveness.

Assessments continued to be comprehensive and to highlight a broad range of financial sector vulnerabilities, while heightening member countries' awareness of international financial standards. Expertise developed in the assessment process has also improved the quality of IMF and Bank advice. In addition, especially in assessments of lower-income countries with underdeveloped financial systems, more effort had been devoted to explaining why specific markets were missing and broad access to financial services was limited. Feedback from country authorities underscored the usefulness of the program in diagnosing stability and development needs in financial systems and in charting appropriate policy responses. Directors cited country authorities' suggestions of areas for further improvement as key to strengthening the FSAP.

Joint and voluntary nature. Most Directors agreed that the FSAP's two key features—its joint World Bank–IMF character and its voluntary nature—should remain unchanged. The FSAP exercise was a good example of effective Fund-Bank collaboration. Its joint nature efficiently pools resources from the two institutions, contributes to a broad perspective on financial issues in low- and middle-income countries, and leads to greater consistency in policy advice. In addition, the FSAP's voluntary participation results in greater country ownership. Directors stressed the importance of maintaining the case-by-case design of FSAP assessments to make the exercise useful to countries, within limits that preserve the program's integrity.

Streamlining. Directors noted that recent FSAP streamlining and improved prioritization had resulted in assessments that are better tailored to country circumstances. This, along with the smaller average size of financial systems undergoing initial assessments in the previous two years, had contributed to lower average costs per FSAP, freeing up IMF resources for other financial surveillance work, such as FSAP updates and participation in Article IV missions, and allowing the World Bank to put more emphasis on issues related to financial sector development. As a result, the balance of resources used in the program had become more equally distributed between the two institutions.

FSAP updates. Directors noted that the number of FSAP updates was rising and would eventually account for the bulk of the program. Since 2001, 12 updates have been completed, and more are planned. They agreed that updates would require, at a minimum, an assessment of financial sector developments and progress in implementing earlier

[3]The discussion is summarized in Public Information Notice No. 05/47, *www.imf.org/external/np/sec/pn/2005/pn0547.htm*. Staff papers on the FSAP are posted at *www.imf.org/external/np/fsap/2005/022205.htm* and *www.imf.org/external/np/fsap/2005/022205a.htm*.

FSAP recommendations. Updates should contain a financial stability analysis, reassessments of key development and structural issues raised in the initial assessment, and factual updates of key standards and codes. At the same time, updates could include additional elements if justified by new developments or particular risks. Flexibility would maximize the program's usefulness to country authorities and its contribution to surveillance.

Given the pace of financial sector development and the need to keep the staff's institutional knowledge current enough for effective financial sector work, an average frequency of FSAP updates of about five years seemed reasonable. In any particular country, however, the frequency would depend on financial sector developments; the country's willingness to participate, systemic importance, and track record in implementing recommendations from previous assessments; and resource availability.

Country coverage and follow-up. The Board agreed that the FSAP had achieved broad country coverage, especially of systemically important countries, but that coverage differed widely among regions. Many Directors were concerned that several systemically important countries had yet to request an initial assessment, and they encouraged these countries to do so.

While Directors supported the steps taken by Fund staff to strengthen follow-up monitoring of financial systems, more needed to be done to ensure that issues identified during the FSAP were followed up through IMF surveillance. Directors therefore encouraged more systematic participation in Article IV consultations by financial sector specialists and more technical support from headquarters. They also urged staff to continue making technical assistance follow-up more systematic.

Additional work. Directors favored continued research on developmental and stability issues to better underpin the IMF's policy advice in the financial sector. They saw great potential in regional financial exercises for regions with substantial cross-border links. Directors agreed that countries could gain from deepening such linkages while addressing related vulnerabilities.

Gaps in financial sector regulation

In 2000, the IMF Executive Board endorsed a set of international standards in the area of financial sector regulation to help guide policies and reforms in Fund member countries. The assessment of the observance of these standards by Fund members is carried out mainly in the context of the FSAP. The Financial Stability Forum and the standard-setting bodies have asked the Fund to provide periodic feedback on the assessment process, emerging issues for regulators, and the adequacy of international guidance.

Chile

Chile's economy grew at an annual rate of 6.1 percent in calendar 2004, a level not seen since the mid-1990s, thanks to a sharp improvement in Chile's terms of trade and the strong performance of both mineral and nontraditional exports. Private investment picked up significantly, including in the mining sector, and the economic growth outlook for the remainder of 2005 remains favorable.

In 2004/2005, the Chilean authorities continued to pursue prudent macroeconomic policies. Consistent with the country's structural balance rule, which aims at a cyclically adjusted surplus of 1 percent of GDP, the central government registered a surplus of 2¼ percent of GDP in 2004. The central bank has continued to manage monetary policy prudently in the context of its inflation targeting framework and, in April 2005, headline inflation was about 3 percent, the mid-point of the central bank inflation target range.

In August 2004, the IMF and the World Bank jointly completed a Financial System Stability Assessment (FSSA) for Chile that included Reports on the Observance of Standards and Codes (ROSCs) on monetary and financial policy transparency, banking supervision, and securities regulation. The FSSA, which found that Chile's financial system was robust, outlined suggestions for further improvements, including strengthening competition in the provision of financial services, modernizing the securities market infrastructure, and enhancing financial oversight.

Chile-IMF activities in FY2005

August 2004	Completion of the 2004 Article IV consultation discussions and publication of the FSSA and accompanying ROSCs
September 2004	Visit of Managing Director Rodrigo de Rato
October 2004	Publication of Detailed Assessment of Observance of the IMF Code of Good Practices on Transparency in Monetary and Financial Policies under the Financial Sector Assessment Program
December 2004	Staff visit
March 2005	Publication of ROSC—Financial Action Task Force Recommendations for Anti-Money-Laundering and Combating the Financing of Terrorism

In October 2004, the Board considered a staff paper, *Financial Sector Regulation: Issues and Gaps*.[4] The paper reviews issues in financial regulation across the banking, insurance, and securities sectors, and highlights some of the practical issues in the implementation of good regulation across these three sectors. It examines the implementation of financial sector regulation in 36 Fund member countries where regulatory systems in all three sectors were assessed under the FSAP during 2000–03. A cross-sectoral approach to the review of regulatory systems was chosen to enable the Fund to identify common regulatory themes.

Directors had a wide-ranging discussion covering, among other things, the role of good-quality regulatory preconditions, some issues regarding the standards themselves, the challenges that financial conglomeration and the internationalization of finance pose for financial sector regulators, and structural factors such as dollarization and state ownership of financial institutions. They considered high-quality financial regulation to be a key element of financial stability and important for Fund surveillance, and agreed that the existence of certain preconditions—including sound macroeconomic policies, adequate legal and accounting frameworks and standards, and the availability of human and financial resources—is crucial for effective financial regulation.

Monetary policy implementation at different stages of market development

Central banks in emerging market and developing economies have been moving toward greater reliance on money market operations for the implementation of monetary policy. The Fund has encouraged the process and provided technical assistance for the transition. So far, the experience of these economies with market-based monetary policy operations has been mixed. Limited competition in financial markets has complicated the use of money market operations, particularly in some smaller countries. While some larger countries have successfully begun market operations, others still cannot fully rely on money market operations for liquidity management, despite lengthy periods of adjustment.

At a seminar in November 2004,[5] the Board discussed the Fund staff's efforts to identify guidelines for developing strong frameworks for monetary policy operations.

[4]Available at *www.imf.org/external/np/mfd/2004/eng/102504.htm*; see also "Financial Sector Regulation: Issues and Gaps—Background Paper," *www.imf.org/external/np/mfd/2004/eng/081704.htm;* and the summary of the Board discussion in Public Information Notice No. 04/131, *www.imf.org/external/np/sec/pn/2004/pn04131.htm*.

[5]The Board discussion is summarized in Public Information Notice No. 05/15, *www.imf.org/external/np/sec/pn/2005/pn0515.htm*. The paper is posted at *www.imf.org/external/np/mfd/2004/eng/102604.htm*.

Directors saw as useful the development of a menu of options for implementing monetary policy that takes into account potential impediments to market development, including the extent of dollarization, the size of the country, the government's financing needs, structural excess liquidity, central banks' implementation capacity, and the strength of the banking system. They encouraged follow-up work to further refine the IMF's policy advice to countries developing their money markets.

Offshore financial centers

During FY2005, the first phase of the assessment of offshore financial centers (OFCs) was completed. These centers account for a sizable portion of global financial flows and thus are important for global financial stability. In recognition of this, in June 2000, the Financial Stability Forum encouraged OFCs to take steps to meet international standards and codes and asked the IMF to undertake initial assessments of them. The IMF's Executive Board, at the November 2003 review of the Offshore Financial Center Assessment Program, commended the significant progress made by the program since it was initiated in 2000 and agreed with its proposed evolution.

Some offshore centers do better than many countries in complying with international standards and codes of good practice. Nevertheless, deficiencies remain, notably in centers' efforts to combat money laundering and the financing of terrorism, cross-border cooperation, and information exchange between jurisdictions and domestic agencies. In its assessments of offshore centers, the IMF evaluates compliance with international standards in banking, insurance, and securities, and with the policies, laws, and methods needed to prevent money laundering and the financing of terrorism.

The evaluation of the first phase of the IMF program—completed in February 2005,[6] in which 41 out of 44 jurisdictions were assessed and their reports published—found that progress had been made in meeting the four priorities set by the Executive Board:

- regular monitoring of developments in financial centers;
- improved transparency through an information network developed by Fund staff in consultation with OFCs;
- expanded Fund technical assistance; and
- greater collaboration with standard-setting bodies and onshore and offshore supervisors.

[6]"Offshore Financial Centers: The Assessment Program—A Progress Report," *www.imf.org/external/np/pp/eng/2005/022505.htm*.

At an informal seminar in March 2005, the Executive Board also considered a staff paper on possible modalities for integrating informal remittance providers into the formal sector through a regulatory framework to avert the risk that informal systems could be misused for money laundering or the financing of terrorism.

Balance sheet approach, debt, and liquidity

One important contribution to the analysis of an economy's vulnerability to financial crises and to understanding how capital account crises occur is the "balance sheet approach"—that is, the examination of the stocks of assets and liabilities in an economy's main sectors for mismatches in maturities, currencies, and capital structures.[7] During FY2005, such balance sheet analysis was increasingly integrated into the Fund's operations, with a particular focus on the role of public debt. Analyses of balance sheet vulnerabilities are increasingly being incorporated into Article IV consultations and other surveillance exercises.[8]

Box 2.5 Structuring sovereign debt to prevent crises

How should government debt be structured to reduce the likelihood of crises? A paper by Fund staff[1] considers recently developed analytical approaches to improving the structure of sovereign debt using existing debt instruments and cites the pros and cons, and the practical challenges, of a number of innovations.

Three key messages emerge from the analysis:

- The credibility of fiscal and monetary policies has a strong influence on the willingness of investors to hold long-term local currency bonds. Credibility depends on both the quality of a country's institutions and the country's reputation for sound policymaking. Building such a reputation can take many years, but the combination of macroeconomic stabilization and institutional and structural reforms can accelerate the process.
- Finding ways to protect private creditors from the dilution of sovereign debt could reduce the cost of borrowing and increase low-debt countries' market access as well as help prevent overborrowing and risky debt structures. Debt dilution occurs when new debt reduces the claim that existing creditors can hope to recover in the event of a default. Dilution has long been recognized as a problem in the context of corporate debt, where it is addressed through debt covenants and explicit seniority. The Fund staff paper argues for further investigation of analogous innovations in the sovereign context.
- Instruments with equity-like features, which provide for lower payments in the event of adverse shocks and weak economic performance, can help sovereigns improve debt sustainability and international risk-sharing. In particular, GDP-indexed bonds would provide substantial insurance benefits to both advanced and emerging market economies, although they present substantial implementation challenges.

[1]The paper, in revised form, was published in January 2005 as IMF Occasional Paper No. 237, *Sovereign Debt Structure for Crisis Prevention,* Eduardo Borensztein and others (Washington: International Monetary Fund), *www.imf.org/external/pubs/nft/op/237/op237.pdf*.

In their Biennial Review of Surveillance in July 2004, Directors reiterated that vulnerability to balance of payments or currency crises and external sustainability are matters at the apex of the Fund's hierarchy of concerns. They observed that the current strategy to improve vulnerability assessments and balance sheet analysis is having a positive impact and, while recognizing data constraints, urged staff to continue refining the analytical techniques. A few Directors considered that debt sustainability assessments would be enhanced if they were conducted independently of regular country work. Some other Directors considered that high-quality vulnerability assessments are dependent upon close analysis of country-specific conditions, which require area departments' expertise. All Directors saw a need for better integrating various components of vulnerability assessments to provide a clearer view in staff reports on the extent of vulnerabilities. A number of Directors pointed out that balance sheet analysis is relevant to assessments of vulnerabilities in advanced as well as in emerging market economies.

Directors also held seminars to examine related issues, including innovations aimed at reducing the vulnerabilities that emanate from today's sovereign debt structures (Box 2.5) and liquidity management, and encouraged borrowing countries to have a regular dialogue with their private creditors (Box 2.6).

Debt-related vulnerabilities

In October 2004, the Board held a seminar to assess the Fund staff's efforts to improve its vulnerability analysis through the balance sheet approach. Discussion focused on the staff paper "Debt-Related Vulnerabilities and Financial Crises—An Application of the Balance Sheet Approach to

[7]See, for example, the note "Integrating the Balance Sheet Approach into Fund Operations," February 23, 2004, *www.imf.org/external/np/pdr/bal/2004/eng/022304.htm*.

[8]Examples include "Bulgaria: Selected Issues and Statistical Appendix," IMF Country Report No. 04/177, June 2004, *www.imf.org/external/pubs/ft/scr/2004/cr04177.pdf*; "Australia: 2004 Article IV Consultation—Staff Report," IMF Country Report No. 04/353, November 2004, *www.imf.org/external/pubs/ft/scr/2004/cr04353.pdf*; "Republic of Estonia: Selected Issues," IMF Country Report No. 04/357, November 2004, *www.imf.org/external/pubs/ft/scr/2004/cr04357.pdf*; and "Ukraine: Selected Issues," IMF Country Report No. 05/20, January 2005, *www.imf.org/external/pubs/ft/scr/2005/cr0520.pdf*.

Box 2.6 Investor relations programs

Having recognized that improved communication with investors and creditors is critical to the prevention and resolution of financial crises, a number of countries and multinational corporations have introduced investor relations programs. The IMF's Executive Board has emphasized the value to countries that borrow from international capital markets of establishing procedures for a regular dialogue with their private creditors and has called on Fund staff to follow up on this matter in Article IV consultation discussions with emerging market countries.

A study by IMF staff[1] notes that countries and investors agree that an investor relations program should include several elements, which may differ from country to country:

- dissemination through a website or e-mail of data and information on recent economic performance and policy initiatives;
- establishment of channels (either formal or informal) to answer investors' questions, and to obtain feedback on their concerns;
- contacts of senior policymakers with investors through meetings, teleconferences, and road shows to discuss issues of mutual interest; and
- coordination among government entities in providing information to investors about a country's economic situation and fostering a dialogue between investors and government.

Many countries have made significant strides in all of these areas since 2001.

[1] "Investor Relations Programs—Recent Developments and Issues," October 2004, *www.imf.org/external/np/icm/2004/102604.htm.*

Box 2.7 Measuring and analyzing balance sheet risk with contingent claims

The contingent claims approach (CCA) is a finance-based economic model used to analyze the vulnerability of the balance sheets of the corporate, financial, and public sectors.

This approach uses balance sheet and financial market data to construct a marked-to-market balance sheet along with a set of credit risk indicators. It is different from other vulnerability analyses in that it incorporates volatility to derive current estimates of risk exposures. In so doing, the approach provides a measure of balance sheet risk that is comprehensive and forward looking. The CCA is widely used in the corporate sector to estimate risk and is increasingly being used in the financial sector as well. It is a tool that can help policymakers design and implement strategies to reduce balance sheet risk and rank policy options.

In an informal Board seminar on the contingent claims approach, Executive Directors encouraged Fund staff to continue to develop the model as a means of identifying key vulnerabilities. Fund staff are in the process of building a framework to estimate the credit risk of the corporate, financial, and public sectors.

Emerging Market Countries," which takes a broad look at the evolution of various balance sheet indicators in emerging markets over the past decade, and examines in more detail several recent crises and near-crises.[9] (See "Debt relief and sustainability" in Chapter 4.)

Directors noted that an examination of currency and maturity mismatches in sectoral balance sheets had provided a useful complement to the Fund's traditional flow-based analysis. The staff's cross-country analysis and ex post case studies illustrated how the debt structure and balance sheet mismatches could contribute to financial crises. The Fund has also begun work on developing a comprehensive approach to risk analysis based on balance sheets (Box 2.7). Directors generally agreed with the deliberate pace at which the staff had been integrating insights from the balance sheet approach into Fund operations, especially with respect to country surveillance. The need to avoid a mechanistic approach could not be overemphasized, and there was as yet no intention to make the balance sheet approach a standardized element of IMF surveillance. Going forward, the Fund will work with member countries to improve the statistical basis for more meaningful assessments of balance sheet vulnerabilities, with due regard to balancing the costs and the benefits of such an endeavor to member countries.

Although balance sheet analysis should preferably be applied to all countries, because of resource constraints, priority would necessarily be given to countries whose balance sheet weaknesses—particularly currency mismatches—appeared largest and where Fund efforts would most help reduce vulnerabilities. These include emerging market countries and countries of systemic importance. The staff would continue to work with industrial countries to refine balance sheet analysis and to integrate the assessments into Article IV consultations where relevant. Specifically, the staff would continue to apply balance sheet concepts in its study of the potential risks from equity and housing price bubbles in mature countries. Directors observed that developing a balance sheet approach was a work in progress, with much more work needed at both the analytical and the operational levels.

Liquidity management

In May 2004, the Executive Board held a seminar to discuss the interactions between international reserves, public debt management, and private liability management in limiting a

[9] "IMF Executive Board Discusses Balance Sheet Approach to Analysis of Debt-Related Vulnerabilities in Emerging Markets," Public Information Notice No. 05/36, *www.imf.org/external/np/sec/pn/2005/pn0536.htm*.

country's liquidity risks. Liquidity management by member countries is important for preventing financial crises, and the IMF's focus on liquidity management complements its other work on debt sustainability analysis and financial sector surveillance.

Directors noted that foreign exchange reserves, along with a country's exchange rate, played a key role in helping countries cope with external shocks by providing them with a temporary buffer to limit immediate disruptions and giving them time to put in place appropriate policy responses. Reserves can also add to market confidence when combined with sound policies, thereby strengthening economic and financial stability. Directors emphasized, however, that international reserves could neither substitute for sound macroeconomic policies and prudent debt management nor make up for fundamental external imbalances.

Reserve indicators are only a guide and a starting point in analyzing the adequacy of reserves, Directors agreed, and they cautioned against a one-size-fits-all approach. Such indicators had to be carefully interpreted, based on a complete analysis of, and careful judgments about, a country's macroeconomic circumstances.

Recent capital account crises have shown that both the structure and the level of public debt can create major vulnerabilities in a country's balance sheets. More broadly, sound liability management by both the public and the private sectors can play a major role in containing exposure to interest rate, currency, and rollover risks embedded in the structure of national balance sheets. Directors thus saw merit in enhancing the IMF's policy advice on public debt management, building on the IMF's and the World Bank's "Guidelines for Public Debt Management."[10] They emphasized the role of short-term, foreign-currency-linked debt in generating vulnerability to crises, and thus the importance of monitoring and addressing the combination of currency and maturity risks in debt structures. Directors noted the need to integrate the analysis of public debt with that of macroeconomic developments and policies such as exchange rate issues and the currency composition of debt.

Directors encouraged IMF staff to undertake further analytical and empirical work on liquidity management issues, to keep developing a diagnostic toolkit, and to continue integrating liquidity management analysis in country work.

Policy monitoring, precautionary arrangements, and signaling

During FY2005 further consideration was given to the instruments for signaling to markets and the public the

[10]Available at *www.imf.org/external/pubs/ft/pdm/eng/guide/080403.htm*.

Ghana

In May 2003, the IMF's Executive Board approved a three-year Poverty Reduction and Growth Facility (PRGF) arrangement for Ghana covering 2003–05. During this period, Ghana has made progress in achieving most of the program objectives and its economic performance has been satisfactory.

Real GDP growth outpaced program projections during 2004, for the second consecutive year, and Ghana built up international reserves as a buffer against external shocks much faster than expected. While the inflation rate remained above the central bank's target, it declined by one-half by the end of 2004. At the same time, the ratio of domestic debt to GDP—the government's fiscal anchor—has declined significantly, helped both by better budgetary discipline and by faster GDP growth.

Satisfactory policy implementation also helped Ghana reach the completion point under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative in July 2004. Ghana received debt relief equal to $2.2 billion, in net present value terms, and will be able to save about 1.2 percent of GDP in debt-service payments annually during the next 10 years.

Ghana-IMF activities in FY2005

June 2004	Submission of Ghana's Annual Poverty Reduction Strategy Paper Progress Report
July 2004	Completion of the second review of Ghana's PRGF-supported program
	Ghana becomes the fourteenth country to reach the completion point under the enhanced HIPC Initiative
	Publication of the joint IMF-World Bank assessment of the PRSP progress report
	Publication of the Report on the Observance of Standards and Codes (module on fiscal transparency)

Box 2.8 Signaling under surveillance

The IMF's assessment of members' policies and economic developments provides information or "signals" that may be used by other agents—such as investors and donors—in making decisions. For example, the IMF's assessments of economic trends and policies in publications such as the *World Economic Outlook* and the *Global Financial Stability Report* may inform investment decisions, and its report on a low-income country's policies following an Article IV consultation may influence donors' aid decisions.

Typically, the Fund provides written and oral assessments directly to the donor community in response to specific requests from the latter. On occasion, however, a member country applying to donors and lenders for financial assistance may request that the Fund's assessments be forwarded to them. The assessments are meant to enable the recipients to form a clear view of the strengths and weaknesses of a country's macroeconomic and related structural policies.

To ensure a more regular provision of signals, some member countries have also requested more frequent visits by IMF staff and, in some cases, more frequent reporting to the IMF Board than annual Article IV consultations. Some of these countries want to support an ongoing engagement with the donor community or the World Bank, while others seek the benefits of a more intense dialogue with Fund staff and more frequent independent reports on economic developments. In the cases of Jamaica, Lebanon, and Nigeria, IMF staff prepare two reports a year for the Executive Board. Although the publication of the reports is voluntary, most such reports have recently been published. Despite the lack of formal endorsement of their policies, these countries have found this intensified relationship with the IMF useful.

IMF's assessments of members' policies outside the context of a financial arrangement, and to the current and potential roles of precautionary arrangements both in signaling and in providing protection against the emergence and spread of capital-account-driven crises. Previous Board discussions had not led to a consensus on these issues because of differences of view on whether existing Fund policies are adequate to address members' needs.

Some members continue to look to the IMF for more frequent policy monitoring and delivery of signals on the strength of their economic and financial policies outside the context of a financial arrangement. They seek a mechanism that demonstrates their commitment to sound policies, either for domestic purposes or as a signal to international creditors and donors, but do not need, or prefer not to request, IMF financing. Demand for signaling by the Fund has also come from donors and creditors.

A range of mechanisms can be considered—and indeed have been used or explored in the past—as possible ways of meeting members' demand for signaling. The Board had another exchange of views in September 2004 on the possible design of a proposed signaling instrument, referred to as the Policy Monitoring Arrangement, against the background of a review of the history of signaling by the Fund.[11]

Directors generally agreed that any new signaling mechanism, if adopted, should be devised in such a way as to fit appropriately into the Fund's array of instruments ranging from surveillance to Fund-supported programs, noting that precautionary Stand-By Arrangements and low-access PRGF arrangements have served as useful instruments. Key design issues, should such an instrument be introduced, would include the standard for activation of the mechanism, modalities for reviews, and publication.

Also in September 2004, the Board discussed the possible use of precautionary Stand-By Arrangements to prevent capital account crises,[12] a subject it has considered on a number of occasions in recent years. Precautionary arrangements are an important instrument for signaling policy discipline and providing contingency financing. The use of these instruments is particularly relevant for countries exiting from sustained use of Fund resources. They also have a role to play in supporting members' efforts to reduce their vulnerabilities to capital account crises. A difficult issue pertaining to this crisis prevention role, however, is the possible use of precautionary arrangements with exceptional access.

In particular, many Directors argued that the expiration of the Contingent Credit Line in late 2003 had left a gap in the Fund's toolkit. A new policy that would provide ex ante assurances of appropriate financial support could help strengthen the Fund's role in crisis prevention. By contrast, many other Directors took the view that regular precautionary arrangements within the normal access limits provided sufficient support for member countries with strong policies and that innovations in Fund surveillance and efforts to increase transparency were already bearing fruit.

As with previous Board discussions on these interrelated issues, no consensus was reached.

Existing policies already allow for frequent consultation with members that do not have a financial arrangement with the Fund, affording a basis for staff assessments of the

[11]For further details, see "Signaling by the Fund—A Historical Review," *www.imf.org/external/np/pdr/signal/2004/071604.htm*, and the summary of the Board discussion, Public Information Notice No. 04/114, *www.imf.org/external/np/sec/pn/2004/pn04114.htm*.

[12]See "Crisis Prevention and Precautionary Arrangements—Status Report," *www.imf.org/external/np/pdr/cp/eng/2004/090304.htm*, and the summary of the Board discussion, Public Information Notice No. 04/117, *www.imf.org/external/np/sec/pn/2004/pn04117.htm*.

Box 2.9 ROSCs and data standards initiatives

Reports on the Observance of Standards and Codes (ROSCs). A ROSC is an assessment of a country's observance of one of 12 areas and associated standards useful for the operational work of the Fund and the Bank. The reports—about 75 percent of which have subsequently been published—examine three broad areas: (1) transparent government operations and policymaking (data dissemination, fiscal transparency, monetary and financial policy transparency); (2) financial sector standards (banking supervision, payments systems, securities regulation, insurance supervision, and efforts to combat money laundering and the financing of terrorism (AML/CFT)); and (3) market integrity standards for the corporate sector (corporate governance, accounting, auditing, insolvency, and creditor rights). Participation in the standards and codes initiative continues to grow. As of end-April 2005, 723 ROSC assessments and updates had been completed for 122 countries, or two-thirds of the Fund's membership, and most systemically important countries had volunteered for assessments. More then 300 of the ROSCs were on financial sector standards. Of these, about one-third were related to banking supervision, and the others were fairly evenly distributed across the other standards and codes (except for ROSCs related to AML/CFT, which began to be assessed later).

Special Data Dissemination Standard (SDDS). Created in 1996, the SDDS is a voluntary standard whose subscribers—countries with access to international financial markets or seeking it—commit to meeting internationally accepted norms of data coverage, frequency, and timeliness. Subscribers also agree to issue calendars on data releases and follow good practice with respect to the integrity and quality of the data and access by the public. SDDS subscribers provide information about their data compilation and dissemination practices (metadata) for posting on the IMF's Dissemination Standards Bulletin Board (DSBB).[1] Subscribers are also required to maintain an Internet website, electronically linked to the DSBB, that contains the actual data. SDDS subscribers began disseminating prescribed data on external debt in September 2003. As of April 30, 2005, there were 60 subscribers to the SDDS. Belarus, Egypt, and Russia became subscribers in FY2005.

General Data Dissemination System (GDDS). The GDDS framework was established in 1997 to help Fund member countries improve their statistical systems. Voluntary participation allows countries to set their own pace but provides a detailed framework that promotes the use of internationally accepted methodological principles, the adoption of rigorous compilation practices, and ways in which the professionalism of national statistical agencies can be enhanced. The 79 IMF members participating in the GDDS at end-April 2005 provide metadata describing their data compilation and dissemination practices as well as detailed plans for improvement for posting on the IMF's Dissemination Standards Bulletin Board. Participation in the GDDS has nearly quadrupled since 2001.

In addition, the Fund staff has been developing the Statistical Data and Metadata Exchange (SDMX) standard, in collaboration with other international organizations. The SDMX aims to facilitate efficient electronic exchange and management of statistical information among national and international entities by providing standard practices, coherent protocols, and other infrastructural blueprints for reporting, exchanging, and posting data on websites.

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

[1]The website address is *dsbb.imf.org/Applications/web/dsbbhome/*.

members' policies. These assessments may be released to the public or to creditors or donors but do not constitute endorsements of the policies or statements that the policies meet a particular standard. Different variants of this approach have recently been used for a number of countries (Box 2.8). At the request of the International Monetary and Financial Committee at its April 2005 meeting, a paper that addresses the issue of signaling for countries eligible for assistance under the Poverty Reduction and Growth Facility will be discussed by the Board in FY2006 (see Chapter 4).

Standards and codes, and data provision to the Fund

The IMF and the World Bank assess member countries' policies in 12 areas—data quality, monetary and financial policy transparency, fiscal transparency, banking supervision, securities, insurance, payments systems, anti-money-laundering provisions, corporate governance, accounting, auditing, and insolvency and creditor rights—against international standards and codes that serve as benchmarks of good practice.[13] These assessments are intended not only to help countries identify weaknesses in their policies but also to help market participants make better investment decisions (Box 2.9).

Draft Guide on Resource Revenue Transparency

In December 2004, the IMF disseminated for public comment a *Draft Guide on Resource Revenue Transparency.* The *Guide* is intended to help countries address the challenges associated with the fiscal management of revenues from

[13]The Board has not yet endorsed a standard for insolvency and creditor rights, one of the twelve areas.

extractive industries such as oil, natural gas, and mining. It underscores that institutional strengthening and improved transparency can provide significant benefits to both governments and taxpayers. A higher level of fiscal transparency, in turn, promotes more informed public debate and helps countries achieve sounder fiscal policies.

The *Guide* applies the IMF's Fiscal Transparency Code[14] and supplements the *Manual on Fiscal Transparency*,[15] which was published in 2001 as part of the IMF's work on standards and codes. Fiscal transparency reports, or fiscal Reports on the Observance of Standards and Codes (ROSCs), have been published for about 70 member countries on the IMF's website. These reports assess country practices against those described in the Fiscal Transparency Code. The *Draft Guide on Resource Revenue Transparency* can be used for fiscal transparency assessments by the IMF in natural-resource-rich countries and will also be useful in the IMF's policy dialogue with these countries. The IMF will take into account the public comments received when it finalizes the *Guide*.

Data standards

The IMF's Data Standards Initiatives are designed to enhance the public availability of reliable, timely, and comprehensive statistics on member countries, thereby enabling market participants to make well-informed investment decisions, improving the functioning of financial markets, and reducing the likelihood of crisis-precipitating shocks.

Revision of guide to GDDS

In October 2004, the IMF issued a revised *Guide to the General Data Dissemination System (GDDS)* to promote the availability of statistical data related to the Millennium Development Goals (see Chapter 4). The *Guide*, developed in collaboration with regional and international organizations, including the World Bank, gives explicit recognition to the MDG indicators and the development of appropriate statistical monitoring systems.

Online external debt database

In November 2004, the World Bank and the IMF launched an online database that brings together the external debt statistics of 41 countries that subscribe to the IMF's Special Data Dissemination Standard (SDDS). By end-April 2005, the number of subscribers reporting data had risen to 49. The database provides policymakers and market participants with more timely data in a format that enables cross-country comparison as well as better support for balance sheet analysis and surveillance initiatives. The Quarterly External Debt Database, maintained by the World Bank,[16] represents a concrete step by the two institutions to facilitate and encourage worldwide dissemination of external debt data by as many countries as possible.

The data are supplied by countries in internationally agreed formats. Participation in the database is voluntary, and, while initially it will cover only countries that subscribe to the SDDS, the goal is to extend participation to all countries whose external debt data can be disseminated according to the SDDS requirements.

Data and metadata for portfolio and direct investment

The results of the Coordinated Portfolio Investment Survey (CPIS) for end-December 2003 were released on the Fund's external website in March 2005. The survey, conducted annually since 2001, provides data reported by 70 jurisdictions, including most of the large investing economies. Data are reported on each jurisdiction's cross-border portfolio investment, broken down by equity and long- and short-term debt instruments and by jurisdiction of the issuers of the securities. Holdings of securities that are part of foreign exchange reserve assets as well as holdings of selected international organizations are also reported, broken down the same way.

The data are intended to fill gaps in studies of regional concentration, financial integration, spillover effects between jurisdictions (contagion), and globalization, and to provide partner country data to fill gaps in international investment position statistics for individual jurisdictions. Work is continuing to improve the coverage of offshore financial centers and major oil-exporting countries. Metadata describing the compilation practices of participating jurisdictions are also posted on the Fund's external website.

Metadata describing how countries measure foreign direct investment were posted in March 2005. Information for 56 countries is now available on the Fund's website, based on the results of the 2003 joint IMF/OECD Survey of Implementation of Methodological Standards for Direct Investment (SIMSDI).

For both the CPIS and the SIMSDI, the metadata describe data availability, sources, compilation practices, and methodology used, and indicate whether the practices of each jurisdiction are in accordance with international statistical guidelines. A feasibility study is under way to determine whether a Coordinated Direct Investment Survey could be undertaken along the lines of the CPIS.

[14] Available at *www.imf.org/external/np/fad/trans/code.htm*.
[15] Available at *www.imf.org/external/np/fad/trans/manual/index.htm*.
[16] Available at *www.worldbank.org/data/working/QEDS/sdds_main.html*.

Enhanced data reporting to the IMF

As part of its overall effort to improve the quality of data the IMF receives from its members for purposes of surveillance, the Board in recent years has acted to expand the categories of information that member countries are required to report (under Article VIII, Section 5, of the IMF's Articles of Agreement) and to establish new procedures and remedial actions to address cases in which members have breached their obligations.

In January 2004, the Board issued a decision expanding the list of minimum data that IMF member countries are required to provide on a continuous basis. The expanded requirement, which took effect on January 1, 2005, brought the Fund's legal framework for data provision more closely in line with contemporary data needs. Reporting of data specifically listed in Article VIII, Section 5, continues to be mandatory and failure to provide the data constitutes a breach of a member's obligation, unless the member lacks the capacity to do so. The Board's decision outlined detailed procedures for how the Fund would handle the nonreporting, or inaccurate reporting, of data required under Article VIII, Section 5.

The Board decision also encouraged members to adopt internationally accepted compilation methodologies. If members do not do so, they must provide data specifications consistent with commonly understood meanings of a particular indicator. The Fund's staff are expected to be familiar with the specific concepts and definitions used for these indicators as well as with the compilation practices and approaches to data revisions. A member is not at risk of being found in breach of its obligations if it provides or revises data in line with the understandings.