CHAPTER - 3

IMF’S ROLE IN STRENGTHENING INTERNATIONAL MONETARY SYSTEM (2001-2007)

3.1 INTRODUCTION

This third Chapter of the Thesis, to begin with, takes a review of the global economic system at the beginning year (2001 AD) of the new millennium and then proceeds to review the IMF’s role in strengthening the international monetary system through the period from 2001 to 2007 AD. The material being presented here has been selectively adopted from the IMF’s annual reports for the respective years.

3.2 FY 2001

3.2.1 World Economic Outlook in 2001

The global economy in 2000 grew at its fastest pace in over the preceding decade and a half, bolstered by the continuing strong economic performance of the advanced countries and a substantial pickup in growth in other regions of the world, particularly in the Western Hemisphere, Middle East and the countries in transition (Commonwealth of Independent States (CIS) and Russia). The pace of global economic growth moderated in late-2000 and early-2001, however, led by a slowdown in the advanced economies, especially, the United States of America, and a moderate growth in a number of emerging market countries (the term as used in this Thesis, are mainly the developing countries that have advanced far enough in capital market development to attract foreign portfolio investments and/or borrow significantly in international capital markets).

‘Headline’ inflation (including energy and food) edged up in the advanced economies, reflecting higher energy prices and strong economic activity, but fell in the developing countries and countries in transition. Fiscal imbalances were reduced in the major regions of the world but external imbalances remained a source of concern in some countries. Financial flows to emerging market economies continued to recover in 2000, although the cost of financing increased as the international market conditions tightened. Buoyant world demand supported strong growth in the volume of trade, both in advanced economies and especially in developing and transition economies.

Other key developments during 2000 and early-2001 included the sharp fall in the major equity markets, particularly in the United States and a retreat of oil prices from their late-2000 high. Global liquidity conditions improved in early-2001, partly as a response to cuts in US interest rates that began in January. Oil prices increased from
the second quarter of 2000 through to November, but then eased, partly because of the global slowdown. The outlook for oil prices and production, however, remained highly uncertain.

Output growth strengthened in the developing countries in 2000, fuelled by buoyant exports as well as recoveries in domestic demand. Economic growth picked up strongly in Latin America, the Middle East and, to a lesser extent, in Africa and in developing Asia. Continued strong growth in China and India supported the economic improvement in Asia, as a whole.

Following a period of economic growth at or above potential, activity in the advanced economies weakened late in 2000, led by a sharp slowdown in the United States, stalled recovery in Japan and moderate growth in Europe. This slowdown was a result, in part, of the tightening of monetary policy during the year, and also of higher oil prices and the decline in equity markets the worldover.

3.2.2 Global Economic Environment in 2001

In commodity markets, oil prices continued to increase during most of 2000, paced by strong energy demand and supply constraints, before easing in early-2001. To contain oil prices within its $22-$28 reference range, OPEC announced plans to cut oil production. Spot prices stayed volatile, reflecting uncertainties about the extent and duration of the global economic slowdown, and also about oil production prospects and the political situation in some parts of the Middle East. Non-fuel commodity prices remained in a slump, rising little from their depressed level of 1999. The largest changes were in prices of metals and timber. Metals prices, after firming slightly in the third quarter of 2000, fell back. Food prices increased late in 2000, but also declined subsequently. In addition to a fall in coffee prices, the beef market was hurt by health concerns, particularly in Europe, and cereals stocks remained high relative to consumption. During early 2001, weakening global demand put further downward pressure on commodity prices.

World trade volumes rose sharply in 2000, particularly early in the year. Imports into the advanced economies grew at double-digit annual rates as demand growth picked up in North America and Europe. Imports into developing countries also grew strongly, especially in developing Asia, the Middle East and the Western Hemisphere. Rapid consumption and investment growth in the largest countries of these regions fueled the increase in demand for imports.

Capital flows to emerging market economies surged in 2000, although remaining below the peak levels of 1997. The flows were mostly in the form of syndicated lending and equity investment. Syndicated lending in 2000 rose well above the volumes of the previous two years, buoyed by lending to sovereign or quasi-sovereign entities. Sizeable volumes of lending were channeled into the telecommunication and energy sectors, the latter reflecting continued high prices of oil and natural gas.

While dollar and euro-denominated interest rates rose for short-term maturities
in 2000, partly because of a tightening of monetary policy in North America and Europe, long-term rates fell or remained constant.

In currency markets, an apparent misalignment persisted among major currencies, particularly the euro and the US dollar, associated with ongoing large external imbalances among the largest economies. The US dollar strengthened against the euro in early 2001 and both the US dollar and the euro firmed against the yen. While the dollar’s strength may have reflected investors’ perceptions of a relatively strong growth outlook for the United States over the longer term, the appreciation of the dollar appeared at odds with the need to reduce external imbalances to more sustainable levels. The strength of the US dollar was also reflected in a fall in the dollar/sterling exchange rate in 2000, declines in the Australia and New Zealand dollars to record-low levels, and downward pressures on some emerging market currencies.

3.2.3 IMF’s Role in Strengthening International Monetary System in FY 2001

During FY 2001, the IMF made progress on a range of initiatives launched over the past several year to strengthen the architecture of the international monetary system and also to strengthen the IMF as a centre of excellence for the stability of the international monetary system. These efforts were reinforced at its 2000 Annual General Meeting when the members endorsed the Managing Director’s vision of focusing the IMF’s work on promoting international financial stability as a global public good - especially through stronger efforts to prevent financial crises, but also by helping resolve crises more effectively when they occur. Subsequently, the IMF intensified its efforts to foster the implementation of reforms by members, including strengthening their financial sectors. Among the major steps taken towards strengthening the IMF’s operations were:

• further increasing the transparency of the IMF’s operations and policy deliberations and of its members’ economic policymaking and data;

• moving beyond the pilot phase of the Financial Sector Assessment Programme (FSAP) - the joint IMF-World Bank programme designed to help strengthen member countries’ financial sectors - with the goal of covering about 24 countries each year;

• taking steps to improve the IMF’s analytical framework for assessing countries’ external vulnerability to financial crisis, developing a framework for evaluating the adequacy of reserves, and with the World Bank, developing guidelines for both public debt and foreign exchange reserves management;

• establishing a new International Capital Markets Department to improve the IMF’s understanding of international financial markets and financial flows;

• establishing a Capital Markets Consultative Group as a channel for regular, informal and constructive dialogue with private sector representatives;

• moving forward with assessments of offshore financial centers and, at the request
of the International Monetary and Financial Committee and in collaboration with
the World Bank, enhancing the IMF’s contribution to international efforts to
combat money laundering.

Also critical to strengthening the international monetary system and improving
crisis prevention has been the work on internationally recognized standards and codes
of good practice in policymaking, in areas that directly benefit macroeconomic policies
and the functioning of financial markets. Further, a framework for the involvement of
the private sector in crisis prevention and management had already been agreed in the
previous year. The IMF subsequently gained experience in the practical issues involved
in applying the framework in financial crises. Work also advanced on two issues that
have a bearing on the development of the framework - restructuring international
sovereign bonds and corporate sector workouts.

Financial Sector Assessment Programme (FSAP)

The role that financial sector weaknesses have played in the eruption and spread
of financial crises in recent years, and the important links between the financial sector
and a country’s overall economic health, led the IMF to intensify its focus on financial
sector surveillance.

The FSAP was initially launched as a pilot programme in May 1999. It is intended
to strengthen the monitoring and assessment of financial systems in the context of IMF
country surveillance and the World Bank’s financial sector development work. The value
of the FSAP lies in the significant improvement in financial sector oversight it will
engender. In addition, several benefits flow from its joint IMF-World Bank sponsorship,
as well as from the expert support it receives from more than 50 cooperating institutions.
This ensures consistency of policy advice by the IMF and the World Bank, economizes
on scarce expert resources, and enhances the programmes’ legitimacy.

Reserve Adequacy and Management

The IMF stepped up its efforts to assist members in the assessment of reserves
adequacy, an essential aspect of preventing liquidity-related crises. Because the provision
of accurate, comprehensive, and timely data on international reserves is essential for the
analysis of external vulnerability, the IMF proposed members’ use of the data template
on international and foreign currency liquidity, which provides a benchmark to assess
the adequacy of provision of data to the IMF on official foreign currency reserves and
their liquidity.

Debt Management Guidelines

The IMF and the World Bank worked together to develop a set of guidelines to
assist countries in their efforts to improve their public debt management practices. The
guidelines were designed to help ensure that these are in line with sound practices and
well understood and accepted by policymakers, debt managers and market participants.
The guidelines would be a useful instrument to assist countries in their efforts to improve
their public debt management practices and reduce financial vulnerability and at times,
can serve as useful benchmarks for both country authorities and the IMF in the context
Early Warning Systems and Vulnerability Indicators

The IMF continued its work to improve its methods for assessing the likelihood of foreign exchange crises. Early Warning Systems (EWS) - formal models that estimate the probability of crises from a set of variables - are important tools to monitor risks that arise from conditions in member countries and international markets. The IMF staff have increasingly used results of EWS work and analyses of relevant indicators to inform and strengthen surveillance discussions. The work of EWS has also provided analytical support for the use of key indicators of vulnerability now reported in country reports. The limitations of these models and of vulnerability indicators as crisis predictors has necessitated continued caution in their use for country surveillance.

Efforts to strengthen and systematize further the IMF’s approach to analyzing external vulnerability continue, including through empirical research, internal working groups, and external outreach, such as collaboration with the Financial Stability Forum. Work on vulnerability is also conducted in the context of the work on standards and the FSAP.

Combating Money Laundering

At the request of the International Monetary and Financial Committee, in April 2001, the IMF’s executive board discussed money laundering and how the IMF could enhance its contributions to global anti-money laundering efforts. It was agreed that money laundering was a problem of global concern, affecting major and smaller financial markets alike, and that international cooperation had to be stepped up to address it. It was further agreed that the IMF had an important role to play in protecting the integrity of the international financial system, including through efforts to combat money laundering. The IMF’s involvement in this area would be strictly confined to its core areas of competence and would not extend into law enforcement activities. The IMF was to take the following steps to enhance international efforts to counter money laundering:

- intensify its focus on anti-money laundering elements in all relevant supervisory principles;
- work more closely with major international anti-money laundering groups;
- increase the provision of technical assistance;
- include anti-money laundering concerns in its surveillance and other operational activities when relevant to macroeconomic issues; and
- undertake additional studies and publicize the importance of countries acting to protect themselves against money laundering.

The IMF’s efforts were to continue to be on principles of financial supervision with intensified focus on their anti-money laundering elements to help ensure that financial institutions have in place the management and risk control systems needed to deter money laundering. As part of this process, a methodology for enhancing the assessment of
financial standards relevant to countering money laundering was to be developed and could be used to prepare a new section in reports for the FSAP.

3.3 FY 2002

3.3.1 World Economic Outlook in 2002

In 2001, the world economy experienced a synchronized, widespread slowdown after the unusually strong expansion of the previous year, with growth slowing in every major region except Africa. The slowdown reflected a series of intertwined developments in 2001, including the downward adjustment in equity prices (particularly in the information technology sector), a rise in energy prices, and the tightening of monetary policy in industrial countries in response to evidence of rising demand pressures. The already weakening international economy was further affected by the September 11 terrorist attacks in the United States, which had a substantial, although largely temporary, influence on macroeconomic conditions.

In the first few months of 2002, however, there were increasing signs that the slowdown was bottoming out in most regions and that growth was turning up in some, most notably North America and a number of east Asian countries. This reflected, at least in part, the significant easing of macroeconomic policies in the advanced countries in 2001, especially in the United States and in a number of emerging countries in Asia. Partly mirroring the weakening of growth in 2001, inflation remained extremely low almost everywhere. Indeed, ongoing deflation in Japan continued to worsen already difficult economic conditions.

3.3.2 Global Economic Environment in 2002

A series of fluctuations in the price of oil, reflecting both demand and supply factors, dominated developments in commodity markets. Oil prices remained in the OPEC’s reference band of US$22-28 a barrel range through much of 2001, as falling demand due to slowing growth was essentially offset by OPEC’s production cuts. The terrorist attacks in September led to an extremely brief spike in prices on fears of supply disruptions, after which prices rapidly dropped below the lower band of the OPEC’s reference range as slowing activity led to a fall in actual and anticipated demand, bottoming out at around US$19 per barrel. This weakness was largely reversed in early 2002 as demand revived while OPEC and some non-OPEC members responded to price weakness with further production cuts. During April, prices remained highly volatile around US$25 a barrel when a series of largely non-economic factors raised concerns about supply disruption, including increased tensions in the Middle East and political developments in Venezuela.

Non-oil commodity prices were generally depressed through 2001 and early-2002, as slowing activity reinforced longer-term price weakness caused largely by supply factors, as well as industrial country subsidies. Early-2002 saw some increases in prices, particularly in the more cyclically sensitive metals, but overall non-oil commodity prices remained below their levels at the start of 2001. Prices of semiconductors, the market for which is rapidly gaining the same characteristics as those for ‘traditional’ commodities,
felled rapidly through 2001 as demand for information technology goods slumped before showing some revival in early-2002 on evidence of a recovery in growth.

World trade volumes fell in 2001, reflecting the weakness in economic activity, particularly in manufacturing and, more specifically, information technology, sectors that are relatively trade-intensive. Owing to the generalized and synchronized nature of the economic slowdown, all regions were affected, with the decline in exports being most marked in emerging Asia (excluding China and India), because of the importance of information technology production in the region. In contrast to other measures of activity, such as industrial production, there was little evidence of a pickup in trade volumes in early-2002.

Financial flows to emerging markets declined in 2001, with portfolio flows being especially affected by outflows, the deflation of the information technology bubble, and the economic slowdown in the United States, which resulted in a generalized move of investors to higher quality assets. Despite a drop in global foreign direct investment (FDI) and a fall in cross-border mergers and acquisitions activity, net FDI flows to emerging market countries are estimated to have increased to US$175 billion. Emerging markets continued to play down their external debt to international banks over the year.

In fixed income markets, the slopes of the yield curves in the United States and euro zone became quite steep, reflecting the anticipation of economic recovery. In contrast, the steeper yen yield curve pointed to renewed concerns about the health of the banking sector in Japan. Optimism about a US recovery was also apparent in the corporate bond market, as credit spreads narrowed over the last two months of the year. The strength in the long-term credit markets contrasted with the turbulence in short-term markets, and borrowers continued to replace short-term debt with longer-term issues as commercial paper markets became increasingly expensive.

Other factors limiting contagion included the generally more appropriate economic policies adopted by many emerging market countries, including the use of more flexible exchange rate regimes. However, events at the beginning of FY 2003 showed that emerging markets were vulnerable as investors turned more risk averse and concerns over policy continuity and the debt structure of certain key emerging market borrowers mounted. These developments affected Latin American countries in particular as the effects of contagion were felt through banking sector channels and difficult access to new borrowings.

In global and emerging stock markets, a rally in January 2001 prompted by the surprise cut in US interest rates quickly filled in February and March on continuing evidence of US economic slowing and poor corporate earnings reports. Another rally in April and May 2001 also gave way to a sell-off in June. In the months before the September 11 terrorist attacks, unfavourable economic indicators caused severe weaknesses in global stock markets. After falling sharply in the two weeks following the attacks, stock prices regained pre-attack levels by mid-October. In fact, the rally that started in late September 2001 and continued well beyond the year was the longest sustained rally since April 2000. By mid-November, most major stock markets were returning to double-digit growth.
rates following increased investor confidence on expectations of an imminent economic recovery. The increased confidence partly reflected the rapid monetary policy response in industrial countries. However, in the first quarter of 2002, equity prices were broadly unchanged in the US and Europe, despite an improved global outlook owing to concerns over the quality of reported earnings in the wake of the unexpected collapse of Enron and other large corporations. Emerging equity markets strongly out-performed mature equity markets during the first quarter of 2002, with emerging Asia performing the best, on the back of impressive gains by technology companies.

In foreign exchange markets, the US dollar remained remarkably strong in 2001, notwithstanding the economic downturn of the fourth quarter. This strength continued in the first quarter of 2002 because markets expected that the US economy would be the first to rebound from the global slowdown. However, in April 2002, with sentiment toward the dollar becoming mixed, and against the background of increased uncertainty in the outlook for corporate earnings, the dollar softened. The euro remained weak relative to the dollar throughout 2001 and first quarter of 2002, but began to strengthen in April, whereas the Japanese yen remained strong, limiting the dollar’s gains.

In the industrial countries, growth was weak in 2001. The slowdown was especially marked in the US and Canada, in part because growth had been more robust over 2000. Europe also saw a significant deceleration in the activity. Within Europe, activity was particularly weak in Germany and Italy, and relatively more robust in France and the United Kingdom, with the performance of domestic demand accounting for many of these variations across countries. Activity in Australia and New Zealand remained relatively strong, largely reflecting buoyant domestic demand. In contrast, Japan suffered its third and most severe recession of the last decade. While external factors promoted the slowdown, weakness in domestic demand was also a contributing factor. By early 2002, however, there were signs that the economy was bottoming out.

3.3.3 IMF’s Role in Strengthening International Monetary System in FY 2002

Discussions on how to reform the international monetary system took centre stage in 1998 in the aftermath of the crises in the Asian countries. Since then, much had been done to improve the IMF’s capacity for crisis prevention and the architecture of the international monetary system generally. Specifically, initiatives had been launched to improve the IMF’s analysis of countries’ vulnerability; to increase the transparency of economic policymaking by member countries as well as of the IMF’s own policies and operations; to promote timely and accurate report to the IMF and publication of economic data within a framework of internationally accepted standards; to strengthen financial sectors, including through prudential supervision; and to encourage the adoption of consistent monetary and exchange rate regimes less prone to crisis. As a result, policies were strengthened in many countries. The resilience of the global economy and the international monetary system in the face of the economic slowdown of 2001 and the events of September 11 suggested that these efforts were beginning to bear fruit.

Nevertheless, it would have been unrealistic to support that all member countries
will always be able to avoid crises. Thus, the IMF had also been working to strengthen its capacity to assist members to resolve crises. During FY 2002, IMF’s Board discussed two main aspects of this work. First, it examined how to help members cope with difficulties, when they arise, of maintaining their access to capital markets in a fashion that also maintains the stability of the international monetary system. Second, in relation to extreme cases when a member needs to restructure its financial obligations, the IMF investigated frameworks for sovereign debt restructuring that would lead members to be more inclined to approach their creditors at an early stage, before delay destroys the value of the credit and increases the scale of economic disruption. At the same time, it was also recognized that the care should be taken in the design of a new framework to avoid inducing countries to look to default as an easy way of avoiding needed adjustments.

Another key area of work to strengthen the international monetary system - the international effort against money laundering - took on heightened importance in the wake of the events of September 11, 2001. Those events prompted a reexamination at national and international levels of mechanisms to promote and enforce laws combating not just money laundering but also the financing of terrorism. In this connection, the IMF discussed how it should intensify its contribution to these international efforts, and work advanced on several fronts.

The following paragraphs take a review of the IMF’s progress made in the areas of crisis prevention (external vulnerability, strengthening financial sectors), crisis resolution (including sovereign debt restructuring), and combating money laundering and financing of terrorism upto April, 2002.

Crisis Prevention - Assessing External Vulnerability

The crises of the late-1990s were in many ways different from earlier crises and prompted a reevaluation of traditional methods of assessing a members’ vulnerability to changes in external circumstances. This reevaluation has reflected the increased role of private financing in emerging markets, the increased interconnectedness of markets across the globe, and the links between external financing difficulties and distress in the financial and corporate sectors - links formed partly by pressures on a country’s exchange rate. With the prevention of crises and the promotion of financial stability among its top priorities, the IMF has strengthened its analysis of the vulnerability of member countries to changes in external circumstances and, in particular, to capital market conditions.

In October, 2001, the IMF’s executive board took stock of the progress in monitoring members’ external vulnerability on a more continuous basis, especially for emerging market economies, whose access to international capital markets is often not certain. The increased efforts to combine qualitative analysis reflecting individual country circumstances with vulnerability indicators and other quantitative tools and the improved integration of bilateral and multilateral surveillance activities was welcomed, as crises can emanate from either advanced or emerging market economies. It was noted that the use of information on markets and market developments in vulnerability assessments was being further strengthened by the work of the new International Capital Markets Department (ICMD). It was also observed that the IMF was drawing systematically on
a number of separate inputs:

• **The latest revisions to the World Economic Outlook**: These are the starting points for any assessment of vulnerabilities because a key objective is to capture influences from the global economy on emerging market countries, including through the explicit consideration of adverse scenarios;

• **Early Warning System Models**: These models estimate the likelihood of a balance of payments crisis based on a combination of vulnerability indicators. While work continued on improving their performance, these models still miss many crises and predict others that do not occur, and are likely to remain imperfect, somewhat mechanical, signalling tools; as such these need to be qualified by detailed country analysis and used cautiously;

• **Financing Requirements**: Where there is a risk that a country’s access to global financial markets may become difficult or be interrupted, detailed estimates of its external financing needs and prospective sources and uses of funds are important. The potential for liquidity problems is also reflected in the work on reserve adequacy, which takes into account indicators such as the ratio of reserves to short-term external debt, and stress testing of the balance of payments. This work on reserve adequacy and the work on assessing the determinants of spreads and ratings are useful to inform preventive policies.

• **Market Information and Contagion Risks**: Besides the direct information content of foreign exchange spreads on borrowing costs for individual countries, the analysis of spreads serves to focus attention on changes in market perceptions and as such, sharpens the discussion of contagion. The new ICMD is responsible for systematically drawing on market information as well as refining tools to understand markets and market behaviour;

• **Financial Sector Vulnerability Assessments**: The IMF’s specialized knowledge about the financial sectors of its members is a key input into the IMF’s evaluation of vulnerabilities. Evaluations under the Financial Sector Assessment Programme (FSAP) help to assess the robustness of the financial sector through stress tests and alternative scenarios. For all countries, the staff remains actively involved in financial sector monitoring and advice.

• **Area Department Expertise**: The specialist knowledge of the IMF’s area departments on their countries provides a broader perspective and judgment on the tools used for vulnerability assessments.

Strengthened vulnerability assessments allow for timely policy adjustments to forestall external crises. It is seen that the IMF had an important role to play in involving national authorities in the discussion on vulnerabilities and in convincing them of the urgency of such measures. Work to reduce external vulnerabilities of member countries continued to involve the development of policy guidelines. ‘Guidelines for Public Debt Management’ were published at the end of FY 2001. ‘Guidelines for Foreign Exchange Reserves Management’ were also developed in close collaboration with reserve
management entities from a broad group of member countries and international institutions and published in September 2001.

The agenda for further work on vulnerability assessment is broad and evolving, and the IMF’s board of directors had discussed a number of potential improvements to the various inputs into the assessments. The priorities ahead include work on national balance sheet approaches to crisis prevention and resolution and on financial sector indicators. In addition, continuing efforts need to be made to better understand market dynamics, to identify developments in individual countries that may have implications for other members, and to take careful account of the aggregated effects on the global economy of similar policies synchronized across a number of countries.

**Strengthening Financial Sectors**

Along with the Asian crises, the banking sector problems faced by a large number of IMF members highlighted the critical importance of concerted action to strengthen financial systems. During FY 2002, as part of its intensified financial sector surveillance activities launched in recent years, the IMF continued to carry out a number of financial ‘health checkups’ under the joint IMF-World Bank FSAP programme, and examined the use of summary financial soundness indicators (FSIs). The work ahead on FSI-related issues includes activities in four areas: support of compilation effort by national authorities, analytical and empirical work on measuring and analyzing FSIs, strengthened monitoring of FSIs, in cooperation with country authorities, and encouraging national authorities to release the indicators to the public on a regular basis.

**Capital Account Liberalization**

The IMF has strengthened its work on capital account issues, including by undertaking more analysis, giving more prominence to capital account issues in Article-IV consultations, and expanding the discussions with the private sector. The benefits of capital account opening include a more efficient international allocation of savings and improved productivity (for example, through technology transfer in foreign direct investment flows), enlarged opportunities for portfolio diversification, risk sharing, deeper financial markets, and a greater international division of labour. On the other hand, volatile international capital flows have played a role in a number of recent crises, pointing to the importance of appropriate sequencing of capital account liberalization.

The general principles that could be helpful to countries in sequencing and coordinating capital account liberalization may be enumerated as under:

- the importance of macroeconomic stability and of giving priority to financial sector reforms that support such stability;
- coordinating different financial sector policies to ensure mutually reinforcing reforms;
- taking into account the initial condition of financial and non-financial entities and the effectiveness of existing capital controls;
- implementing early, key measures that may have a long lead time;
• considering the sustainability of the reform process; and
• ensuring the transparency of liberalization process.

The principles point to the desirability, in most cases, of liberalizing long term flows (in particular, foreign direct investment) ahead of short-term flows with suggestions of specific policy measures that should be put in place before different types of flows are liberalized. In many cases, a gradual approach to liberalization may be required, but would not in itself guarantee orderly liberalization.

Crisis Resolution

While the IMF’s efforts at crisis prevention should reduce the number of crises over time, it would be unrealistic to expect that all member countries would always be able to avoid crises. The IMF considered that improved understanding of the reasons behind the loss of market access could also provide useful indications on how countries might reaccess markets. Three determinants of market access stood out, namely, changes in global financial conditions, market contagion and domestic economic policies. Past experience suggested that countries that lose market access as a result of adverse developments in global financial markets, or minor spillover from crises elsewhere, generally regain market access quickly as the effects of such developments pass. It was also stressed that domestic economic policies were often a major cause of loss of market access. While noting the importance of favourable conditions in international capital markets for restoring access, it was agreed that the single most important determinant of a country’s prospects was adopting credible corrective policies, especially corrective macroeconomic and structural policies that improved a country’s external accounts and debt sustainability. Finally, the need to seek greater input from market participants themselves was also stressed, together with a better understanding of the rationale underlying their lending decisions as the IMF continued to refine its work in this area.

Sovereign Debt Restructuring

In the infrequent cases when countries run up unsustainable debt burdens, they need to seek a restructuring of their obligations. A shortcoming in the international financial system is the absence of a framework for the predictable and orderly restructuring of sovereign debts. There is no comprehensive mechanism for majority decision-making by private creditors, a problem that is compounded when the debt includes numerous different debt instruments issued in different jurisdictions. The upshot of this collective action problem is that the debt restructuring is often delayed, prolonged, and disorderly, depleting asset values of creditors and imposing severe hardship on the debtor country. This is not only damaging to the debtor and its creditors, it is also disruptive to international capital markets and to the trading partners of the debtor country.

Inevitably, it would take time to sort through the complex issues associated with the design of a restructuring mechanism, and then, if so agreed and if there was broad-based support for the steps that it would require, to put a statutory approach in place. Contractual improvements could help before then, and such improvements should be pursued vigorously on their own merits. The IMF would continue to explore ways in
which contractual approaches to debt restructuring can be made more effective.

Future work in this area could include steps that could be taken to create stronger incentives for the use of appropriate majority restructuring and majority enforcement provisions in international debt contracts. It would also include an assessment of the feasibility and market acceptability of collective action clauses that aggregate claims across instruments for voting purposes.

Finally, it was agreed that efforts to improve the existing framework for debt restructuring should not displace other aspects of the work programme on the resolution of financial crises. Improving the assessment of debt sustainability was crucial. It was also confirmed that an early review of access limits would be a key element in IMF efforts to improve the effectiveness of the private sector involvement framework.

In April 2002, the IMF endorsed the work programme to strengthen the existing framework for crisis resolution, and in particular, to provide members and markets with greater clarity and predictability about the decisions the IMF will take in a crisis. The IMF also welcomed the consideration of innovative proposals to improve the restructuring of sovereign debt to help close the gap in the current framework. The IMF would continue to examine the legal, institutional, and procedural aspects of two approaches, which could be complementary and self-reinforcing: a statutory approach, which would enable a sovereign debtor and a supermajority of its creditors to reach an agreement binding all creditors; and an approach, based on contract, which would incorporate comprehensive restructuring clauses in debt instruments.

**Combating Money Laundering and Financing of Terrorism**

Money laundering and financing of terrorism are issues that concern countries at every stage of development. These are global problems that not only affect security, but also potentially harm economic prosperity and the international financial system.

**Money Laundering**

At the end of FY 2001, the IMF and the World Bank had considered how the two institutions might enhance their contributions to global efforts to fight money laundering. It was recognized that more vigorous national and international efforts to counter money laundering were needed. The IMF’s Board had generally agreed that it should take a number of steps to enhance international efforts to counter money laundering, including:

- developing a methodology that should enhance the assessment of financial standards relevant for countering money laundering that could be used in reports under the FSAP;
- working more closely with major international anti-money laundering groups;
- increasing the provision of technical assistance in this area;
- including anti-money laundering concerns in its surveillance and other operational activities when macroeconomically relevant; and
- undertaking additional studies and publicizing the importance of countries acting
to protect themselves against money laundering.

Terrorism Financing

In considering how the IMF could extend its activities to limit the use of financial systems for terrorism financing, and to make its anti-money laundering work more effective, it was stressed that the IMF’s involvement in these areas should be consistent with its mandate and core areas of expertise. Recognizing that no single agency can resolve the problems independently, it was emphasized that the IMF should adopt a disciplined and collaborative approach that respected the expertise, scope and mandate of other institutions, and that the roles of the various institutions involved should be clarified. It was reaffirmed that the IMF’s primary efforts should be in assessing compliance with financial supervisory principles and providing corresponding technical assistance, and that it would be inappropriate for the IMF to become involved in the law enforcement issues.

It was further agreed that a key element in combating money laundering and terrorism financing was more effective information-sharing and cooperation among national authorities and international agencies. The country governments were called upon to create mechanism to enable collection and sharing, including cross-border sharing of financial information with appropriate supervisory and law enforcement authorities. It was stressed that the primary responsibility for enforcement of anti-money laundering and anti-terrorism financing measures would continue to rest with national authorities.

3.4 FY 2003

3.4.1 World Economic Outlook in 2003

Economic and financial markets developments had been mixed since the spring. Negative developments had occurred on several fronts, including the sharp decline in global equity markets since the end of March 2002; the deterioration in financing conditions facing most emerging market borrowers, and weaknesses in a number of current and forward-looking indicators for the US, Europe and several other regions. These developments were especially disappointing in light of the strengthening of several global economic indicators, including trade and industrial production, seen since the end of 2001, as well as first-quarter growth that exceeded expectations in several regions.

The world economy and financial market activity had shown considerable resilience in the face of multiple shocks. It was observed that several factors should support a steady strengthening in global growth, including the continuing stimulus from earlier macroeconomic easing in many regions, the winding down of inventory corrections, and the recent signs of greater stability returning to global financial markets. The risks to the short-term outlook were predominantly on the downside. In particular, the equity price falls could have a more market impact on domestic demand than expected, especially in the US, which had led the global recovery. Movements in major exchange rates would be appropriate from a medium-term perspective, although in the short-term, some negative impact on the recovery in Japan and the euro area, which had been led by external demand, should not be ruled out.
3.4.2 Global Economic Environment in 2003

The global economy had been resilient and in many industrial countries, the fundamentals remained sound. It was agreed that a global recovery should gradually reassert itself, achieving global GDP growth of just over 3 per cent in 2003. In addition, with corporations in both the US and Europe having relatively high cash balances, investment could respond relatively quickly. Nonetheless, it was acknowledged that considerable uncertainties and risks gave cause for concern for the economic outlook, given the fragility of the global recovery and the likelihood that the resilience of the world economy to shocks might have weakened. Developments in the oil markets, in particular, would need to be monitored closely.

The economic impact of a conflict in Iraq was very difficult to quantify. It was considered that the balance of the other risks to the outlook was principally on the downside, and that sluggish growth could persist even in the absence of a war. Three elements underpinned this caution. First, the global recovery remained heavily dependent on the US and there was no obvious candidate to take up the slack if growth in the US faltered. A disorderly adjustment in response to global imbalances, involving a sharp depreciation of the US dollar, remained a risk. Secondly, the possibility of further declines in mature equity markets could not be ruled out, as earnings expectations remained relatively optimistic, and an adjustment in housing prices in some industrial countries was also possible. Third, despite progress, a number of emerging market countries remained vulnerable to a deterioration in the global environment. Notwithstanding, these downside risks, a sustained global deflation was regarded as unlikely, although price declines in individual countries could not be ruled out.

With inflationary pressures in general quite moderate, the monetary policies in major industrial countries would need to remain accommodative. With regard to fiscal policies, the situation differed by country. In the short run, the scope for fiscal tightening was constrained by the cyclical situation. Automatic fiscal stabilizers should generally be allowed to operate, although fiscal consolidation remained a clear medium-term priority in many industrial countries with high levels of public debt and mounting pressures from aging populations. It was urged to accelerate structural reforms to boost confidence and domestic demand growth, particularly in Europe and Japan, in order to reduce global dependence on the US and to foster an orderly reduction in global imbalances.

Country-wise policymakers would need to remain vigilant to changing circumstances and be flexible and ready to adapt to them as events unfold. Close international cooperation and dialogue and concerted efforts would be required to confront global uncertainties and boost global confidence.

Inflationary pressures across the globe remained subdued and wage increases were generally moderate. With the run-up to the war in Iraq and associated uncertainties, energy prices rose markedly toward the end of 2002 and the beginning of 2003, but fell back at the end of the war. In exchange markets, the US dollar depreciated during the financial year on a trade-weighted basis, while the euro appreciated.
3.4.3 IMF’s Role in Strengthening International Monetary System in FY 2003

Improving Sustainability Analysis

Assessments of the sustainability of a country’s external and public debt are a key element in the IMF’s work with many countries. Judgements about debt sustainability, whether the debt can be serviced without an unrealistically large correction to the balance of income and expenditure, underpin the IMF’s decisions in programme contexts, in particular by helping to determine when financing is appropriate and, if so, the appropriate amount of financing to provide. These judgements become critical, and in many cases, particularly finely balanced, in cases of emerging market countries that are highly integrated into global capital markets and may have large financing needs.

In June 2002, the IMF’s board discussed and endorsed a new framework for judging debt sustainability. The new framework provides a reality check on the baseline projections on the basis of which sustainability is assessed, by clarifying the underlying assumptions regarding key variables, including growth, real interest rates, exchange rates, and primary fiscal or external imbalances, and by highlighting their implications. It introduces a set of standardized parameters for stress-testing the programme baseline, to identify the extent to which sustainability hinges on the assumption of a macroeconomic outcome more favourable than experienced in the past and to help ensure the robustness of the programme in the face of plausible shocks.

It was noted that the assessments of sustainability are necessarily based on judgement, given that they depend upon a complex assessment of the interrelationships among several factors - macroeconomic developments, political and social constraints on adjustment, and the availability and cost of private and official financing. The new framework helps strengthen the analytical basis for making these judgements. It does not provide a mechanistic approach, which would be inappropriate given the wide variation in the debt-bearing and adjustment capacities of different economies over time. Rather, it is framework for informing these judgements and expressing them in a transparent manner. As greater experience is gained, efforts will continue on further refining the framework.

A Better Framework for Crisis Resolution

While crisis prevention has been the main focus of the IMF’s reform agenda, the Fund has also been working to improve the management and resolution of the financial crises that do occur, where it also has a central role. Indeed, a stronger and clearer framework for crisis resolution should make an important contribution to crisis prevention in addition to lessening the number and severity of crises. Evolving reforms of the framework for crisis resolution have been designed to reinforce incentives for countries and their creditors to reach voluntary, market-oriented solutions to their financing problems. To this end, the IMF has sought to combine a clearer policy on access to Fund’s resources and a greater selectivity in its lending with an examination of possible approaches to strengthening the mechanisms for the restructuring of sovereign debt.
Dealing with Unsustainable Sovereign Debt

The IMF has also been engaged in an active debate on how best to deal with the relatively rare cases in which sovereign debts have become unsustainable. The challenges to a successful restructuring are several. Sound macroeconomic and structural policies are clearly critical. Transparency and predictability in restructuring process are also important, to permit better-informed due diligence and decision-making, and ease the task of achieving adequate intercreditor equity. Another challenge is effective collective action by creditors. In particular, there is a danger that individual creditors will decline to participate in a voluntary restructuring in the hope of recovering payment on the original contractual terms, even though creditors, as a group, would be best served agreeing to a restructuring.

The IMF has been working with its members and other representatives of the international financial community on possible approaches to improving the framework for the resolution of sovereign restructuring cases, and in particular on:

• The inclusion of collective action clauses (CACs) in sovereign bond contracts,
• The establishment of a statutory framework through a sovereign debt restructuring mechanism (SDRM).

These approaches could be complemented through the development of a voluntary code of conduct, that is, a set of standards for transparency and best practices, that could help guide the conduct of the debtors and their creditors across a broad spectrum of circumstances, ranging from relative tranquility to acute stress. The IMF welcomed the private and public sector initiatives in this area and supports their development. It is clear, in this context, that a code could be effective only to the extent that it is able to attract broad support among the debtors and their creditors.

Combating Money Laundering and Financing of Terrorism

In July 2002, the IMF’s board discussed proposals to advance the IMF’s contribution to international efforts to combat money laundering and the financing of terrorism (AML/CFT). The IMF had begun a new chapter in its work on this subject by taking two key steps:

• conditionally adding the Financial Action Task Force (FATF) 40 Recommendations and the 8 Special Recommendations (FATF + 40 +8) to the list of areas and associated standards and codes useful to the operational work of the IMF; and
• endorsing a 12-month pilot programme of AML/CFT assessments and accompanying ROSCs that would involve participation of the IMF and the World Bank, the FATF, and FATF-style Regional Bodies (FSRBs).

Governing Principles

In moving forward, the IMF’s Directors emphasized that four key principles should guide the IMF’s role in AML/CFT assessments and accompanying reports:

• the IMF staff’s involvement in assessing non-prudentially regulated financial sector
activities should be confined those that are macroeconomically relevant and pose a significant risk of money laundering or terrorism financing;

- all assessment procedures should be transparent and consistent with the mandate and core expertise of the different institutions involved, and compatible with the uniform, voluntary and cooperative nature of the ROSC exercise;
- the assessments should be followed up with technical assistance, if required by a member, to build its institutional capacity and develop its financial sectors; and
- the assessments would be conducted in accordance with the comprehensive and integrated methodology being developed jointly by the IMF, the World Bank and the FATF.

**Pilot Programme**

A 12-month pilot programme of AML/CFT assessments was initiated in October 2002, with participation of the IMF, World Bank, FATF and many of FSRBs. The Fund and the Bank are undertaking the assessments of the FATF 40+8 in the context of the FSAP. The assessments are identifying weaknesses in AML/CFT regimes, and technical assistance has been significantly stepped up in response. Areas of weakness include legislative drafting and review, especially in combating the financing of terrorism and the effectiveness of supervisory arrangements.

**3.5 FY 2005**

**3.5.1 World Economic Outlook in 2004**

In August 2003, economic data in some countries and forward-looking indicators, particularly in financial markets, pointed to a strengthening of global growth in the second half of 2003 and 2004 and there were prospects of a gradual, albeit moderate, recovery.

Given this environment, the IMF’s board called for macroeconomic policies to remain appropriately supportive and for reinvigorated structural reform efforts to strengthen confidence and reduce vulnerabilities over the medium term. In particular, monetary policies in industrial countries should remain supportive for the time being, and, with inflationary pressures very moderate, it was considered that most regions had scope for further monetary easing if the recovery faltered or inflation significantly undershot policy objectives. The orderly depreciation of the dollar was generally welcomed. Going forward, it was mostly agreed that the cooperative approach, which would be needed to underpin the global adjustment process, would be helped by currency adjustments that were more broadly spread, with several emerging Asian economies being relatively well placed to handle greater upward exchange rate flexibility.

The IMF’s board agreed that the fiscal policy would have much less room for manoeuvre. While automatic stabilizers should generally be allowed to operate, it was stressed that greater priority would need to be given to credible, high-quality fiscal consolidation to address both the recent deterioration in the fiscal outlook of the largest economies and the impending pressures of population ageing. The industrial and emerging economies were also called on to make sustained further progress in vigorously
implementing ongoing structural reforms.

The IMF’s board underscored the particular importance of a successful outcome of the World Trade Organization (WTO) Cancun Ministerial meeting in September 2003 in curbing protectionist pressures and achieving further trade liberalization, which would help strengthen confidence in the economic recovery. Progress with agricultural reforms, especially in the largest industrial economies, would be critical for boosting the growth prospects of developing economies and making progress with poverty reduction.

Against the backdrop of improved global outlook, it was agreed that the focus of policy efforts should be on medium-term measures that would underpin the sustainability of the recovery while rebuilding room for maneuver to respond to possible future shocks. Managing the transition to higher interest rate environment in most countries where growth was strengthening was a key challenge facing monetary policy in the period ahead. While the situation was likely to vary significantly among countries, depending on the evolving pace and nature of the recovery, it was expected that as the recovery continued, interest rates in most countries would need to rise toward more neutral levels. In this context, it was considered especially important that central banks communicate their policy intentions clearly to the financial markets to reduce the risk of abrupt changes in expectations, and that rate increases, when they actual occur, be well anchored on fundamentals.

To support an orderly resolution of the global imbalances in the context of sustained growth in the world economy, the IMF’s board called on members to adopt a credible and cooperative strategy that would facilitate the medium-term rebalancing of demand across countries and regions. The main pillars of this strategy should be credible medium-term fiscal consolidation effort in the US; an acceleration of structural reforms in the euro area; further banking and corporate reforms in Japan; and a gradual shift toward more exchange rate flexibility, combined with additional structural reforms to support domestic demand, in most of the emerging Asia. Reiterating the critical importance of open markets for supporting broad-based global economic growth and poverty reduction in low-income countries, the IMF called for a timely resumption and successful conclusion of multilateral trade negotiations under the Doha Round.

3.5.2 Global Economic Environment in 2004

The global economic recovery gained traction during 2003 with growth nearly reaching its long-term trend rate. With accommodative policy stances in the industrial countries and renewed confidence beginning in the second quarter of 2003, economic growth strengthened and broadened. Growth in world trade volume also picked up, buttressed by increases in intra-regional trade in Asia, involving especially China and Japan. Net private capital flows to emerging markets and developing countries increased as portfolio investment rebounded, and foreign direct investment (FDI) also picked up. Emerging market bond spreads narrowed and many emerging market sovereigns took advantage of the low interest rates to issue debt.

Although the recovery became increasingly broad-based, its pace and nature varied significantly. During the financial year, growth was most rapid in the emerging market
countries of Asia, particularly China, and the US, and least well established in the euro area. The recoveries in the US and Japan gained steam, spurred by the growth of private consumption and a rebound in business investment in the US and the growth of net exports, business investment, and consumption in Japan. More than in the corresponding stage of most previous cycles, employment growth in the US was subdued during much of the financial year, turning up only toward the end.

The euro area showed some signs of recovery beginning in the second half of 2003, but growth remained well below its potential and domestic demand growth was lackluster. Cyclically induced job losses were less pronounced in the euro area, but the gradual recovery was insufficient for unemployment to fall from its nearly 9% rate.

In FY 2004, the recovery broadened to include improved GDP growth in all emerging market regions. In many cases, the recoveries were export-led, but gradually, the strengthening of domestic demand began to contribute to growth.

Emerging Asia continued to experience the fastest growth. The region accounted for about half of world output growth in 2003, demonstrating its importance as an engine of global expansion. China continued to grow strongly, exhibiting incipient signs of overheating toward the end of the financial year. India’s growth accelerated, reflecting both cyclical and structural factors.

With the firming recovery, producer and non-fuel commodities prices rose. Oil prices surpassed levels seen before the Iraq war, owing to increased demand as well as to uncertainties about supply stemming from geopolitical risks. Consumer price inflation remained relatively subdued, in part reflecting substantial excess capacity and moderate wage increases. The dollar depreciated during the financial year on a trade-weighted basis. Toward the end of the financial year, however, the dollar steadied, and the euro fell back from its peak. Emerging Asian currencies also depreciated on a trade-weighted basis, accompanied by a further significant buildup in official reserves in countries with relatively inflexible exchange rate regime.

In the major financial markets, nominal bond yields reached a four-decade low in the US in mid-2003. Encouraged by abundant global liquidity, broadening economic growth, and the improving credit quality of both mature and emerging market borrowers, investors increasingly favoured risky assets. As a result, credit spreads on mature and emerging bond markets narrowed, and the cost of default protection fell. Toward the end of the financial year, as expectations of an upturn in policy rates in the US gathered, market participants began to unwind carry trades and to reduce risk exposures.

Global equity markets rallied strongly on expectations of continued strong global growth and associated improvements in corporate earnings as well as low interest rates. By the end of the financial year, spreads on emerging market bonds had started to rise again as bond yields in the US rose in anticipation of an increase in policy rates. Primary issuance of equities in emerging markets was also strong during the financial year, although
investor appetite dimmed as the year came to a close.

3.5.3 IMF’s Role in Strengthening International Monetary System in FY 2004

During the year, the IMF focused on improving its analytical tools for the early identification of vulnerabilities, including in the financial sector, sharpening its focus on balance sheet weaknesses in the context of large and volatile international capital flows, and looking at accounting issues related to public investment.

Debt Sustainability Assessments

In June 2002, as a part of the IMF’s efforts at crisis prevention and resolution, the Executive Board had endorsed a new framework for assessing the countries’ public and external debts. Such assessments underpin the IMF’s policy advice in both programme and surveillance contexts. The new framework was intended to bring a greater degree of consistency and discipline to sustainability analyses, including by laying bare the basis on which projections are made and subjecting projections systematically to sensitivity tests. In July 2003, the Directors reviewed the application of the framework and considered possible methodological refinements.

It was noted that realistic and credible assessments of debt sustainability were a necessary basis for effective IMF surveillance and informed decisions on the use of Fund’s resources. Debt sustainability depends on a confluence of factors, including macroeconomic developments, political and social constraints on adjustment, and the availability and cost of private and official financing. Debt dynamics should, therefore, be viewed against a variety of indicators, including the level, structure and characteristics of debt; the plausibility of whether the primary surplus required to stabilize the debt dynamics can be infinitely sustained; and the possible rollover risk arising from financing needs.

During the past year (FY 2003), debt sustainability assessments based on the standard framework were progressively introduced and became routine in connection with requests for use of Fund’s resources under the General Resources Account and Article-IV consultations with countries with significant market access. It was agreed that sustainability assessments had, on the whole, contributed to more realistic projections of debt dynamics.

Agreeing that debt sustainability assessments should become an integral part of the analyses underlying staff reports, the Directors noted that further improvements might be needed. It underscored the importance of continued efforts to ensure technical understanding of the framework by markets and country authorities and of engaging the latter fully in discussing debt sustainability assessments.

Balance Sheet Approach

The financial crises of mid- to late-1990s pointed to the need to complement more systematically the IMF’s traditional flow-based analysis with an examination of countries’ stock variables as shown in their balance sheets.

Balance sheet mismatches - of currencies, maturities, and capital stock - can help
gauge a country’s exposure to interest rate, exchange rate, and rollover risk. The IMF uses the balance sheet approach to examine how the structure of public debt, and balance sheet mismatches more generally, can contribute to financial crises, and how these factors should affect judgments of reserve adequacy.

The role of the balance sheet approach was considered by the Executive Board at the informal seminars in July 2004. While it was felt that this approach provided a useful analytical framework for the study of vulnerabilities, its data requirements and resource costs are high. Most viewed it as complementary to the traditional flow-based analysis. The Board generally supported integrating the balance sheet approach into IMF’s operations in a phased, cautious manner, but not making full-fledged balance sheet analysis a standard requirement for surveillance. Thus, for the time being, given data and resource constraints, the IMF’s work on the balance sheet analysis will be focused on emerging market countries based on a risk-oriented approach.

Systemic Issues

During FY 2004, the IMF continued to search for ways to make its work more incisive in its traditional core areas. In November 2003, the Executive Board held discussion on Exchange Rate Arrangements, suggesting that the ‘bipolar’ view of exchange rates, according to which rates should be either firmly fixed or freely floating, need to be nuanced in recognition of the fact that the benefits of exchange rate flexibility increases with economic and institutional development. Hence, it was emphasized that macro-economic and structural policies should be consistent with the chosen exchange rate regime. In March 2004, the Board considered the implications for surveillance of the Independent Evaluation Office’s report on fiscal adjustment in IMF-supported programmes. The action plan seeks to ensure that in countries where structural and institutional fiscal reforms are a priority, this area receives appropriate attention in surveillance.

The IMF, together with the World Bank, also helped to support further international cooperation on trade, including through stepped-up surveillance of trade policies, especially in countries whose trade policies are of fundamental importance for the world trading system, with a focus on increasing market access.

Financial Soundness Indicators (FSIs)

Efforts to strengthen the analytical underpinnings of financial system stability assessments are supported by the IMF’s ongoing work to develop FSIs, which are used to assess the soundness of financial institutions and identify vulnerabilities in the corporate and household sectors that may pose risks to the stability of the financial system. Some of the FSIs that have been developed are described below:

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<th>Core Set</th>
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<td><strong>Deposit-taking Institutions</strong></td>
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<td>Capital adequacy</td>
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<td>Asset quality</td>
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In June 2003, the IMF’s Executive Board endorsed further work to encourage the compilation and dissemination of FSIs and to develop their role in financial stability analysis. FSIs were considered to be a key tool that enhances the overall effectiveness of IMF’s surveillance, increases the transparency and stability of the international financial system and strengthens market discipline.

It was also noted that the FSIs differed from country to country because of differences in accounting and bank supervision practices and varying levels of financial sector development, but the convergence towards internationally-accepted accounting standards should result in greater data comparability.

**Crisis Resolution**

Crisis prevention efforts notwithstanding, debt-servicing difficulties, which may develop into financial crises, will still be experienced by some countries, and during FY 2004, the IMF continued to work toward improving crisis resolution mechanism. The IMF’s efforts on crisis resolution focused on promoting the inclusion of collective action...
clauses (CACs) in international sovereign bonds to be issued in jurisdictions where CACs were not yet the market standard, contributing to initiatives aimed at formulating a voluntary code of conduct for sovereign debtors and their creditors, and considering issues that are of general relevance to the orderly resolution of financial crises.

Anti-Money Laundering (AML)/Combating the Financing of Terrorism (CFT)

In its March 2004 review of the 12-month pilot programme of AML/CFT assessments jointly undertaken by the IMF and the World Bank, the IMF’s Board endorsed the 40+8 Recommendations of the Financial Action Task Force (FATF) as the new, expanded standard for AML/CFT assessments. The Board decided to expand the IMF’s AML/CFT assessment and technical assistance work to cover the full scope of the expanded recommendations.

The IMF welcomed the participation of the FATF and FATF-style regional bodies in the pilot programme, underlined the importance of coordinating the work of the IMF and the World Bank to avoid duplication and were encouraged by the assessment reports received. The IMF looked forward to receiving: (i) a full review of the assessments and their consistency with the principles of the ROSCs, as well as the effectiveness of coordination efforts, in about 18 months’ time, and (ii) a comprehensive review of the overall effectiveness of the IMF/World Bank Programme in about 3 years’ time.

It was noted that the pilot programme had achieved its initial goals. It had led to a considerable deepening of international attention to AML/CFT issues and to the provision of substantial technical assistance in this area. It was encouraging to note that most jurisdictions had responded positively to the assessments and there generally were high level compliances with the FATF recommendations in higher- and middle-income countries. While observing that there were more general weaknesses regarding compliance with the 8 special recommendations on terrorism financing in 2001 than with the original 40 FATF recommendations, the IMF’s board welcomed the heightened awareness among jurisdictions of the need for some legislative and institutional frameworks in this area and emphasized that a key element of raising global compliance with the FATF standard is the delivery of technical assistance.

3.6 FY 2005

3.6.1 World Economic Outlook in 2005

In March 2005, the IMF’s Directors Board noted that the global expansion remained broadly on track, underpinned by generally supportive macroeconomic polices 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 US, 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, it was felt that inflation risks required careful monitoring, with due regard to rising unit
labour costs in many industrial countries as labour markets tighten, and to monetary policy implementation in a number of emerging markets with strong external inflows.

Looking ahead, it was 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 US and China;
- a significant tightening of financial market conditions, which could hurt US domestic demand, prompt financial market deleveraging and asset price corrections more broadly, and lead to a deterioration in emerging market financing conditions;
- a further sharp increase in oil prices.

As to global current account imbalances, the IMF’s Directors were concerned about their further widening over the past year, and cautioned that this might increase the risk of abrupt movements in exchange rates. It was 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 US; steps toward greater exchange rate flexibility, supported by continued financial sector reforms in emerging Asia; and continued structural reforms to boost growth and domestic demand in Japan and Europe. It was reiterated that the collective responsibility of the membership to ensure that the strategy was implemented in a timely and effective manner. Accordingly, a number of key medium-term issues that needed to be addressed were identified:

- Fiscal positions in many countries remained very difficult, particularly against the backdrop of global population ageing, and posed a threat to medium-term macro-economic stability;
- Structural reforms had to be advanced to remove rigidities and enable domestic economies to take full advantage of the opportunities provided by globalization;
- 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 service;
- Despite the improved growth performance of recent years, meeting the Millennium Development Goals (MDGs) posed an enormous challenge for most developing countries. It was noted that 2005 was a critical year for the MDGs and the IMF called on these countries to press ahead with policy and governance reforms to strengthen their investment environments and private sector-led growth, and that the advanced economies should support these efforts with substantially higher
Oil Market Developments

The oil prices were rising rapidly, surging more than 30 percent in 2004 and an additional 35 percent between the end of 2004 and mid-March 2005. Prices were at record levels in nominal terms, although they were significantly below their peaks of the 1970s in real terms. While it was recognized that the outlook for prices was subject to a large margin of uncertainty, the prevalent view was that some of the recent price increases were likely to be permanent. It was also broadly agreed that the 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, it was felt that the current low levels of spare production capacity and strong demand growth called for increased investment in new productive capacity. However, there were past experiences of over-investment and very low prices and also that other factors besides capacity limitations were contributing to high prices. While it was considered that a durable increase in prices would stimulate investment, there also were a number of 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. It was agreed that the members should strive to remove undue obstacles to investment.

It was also observed 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 favourable; moreover, oil prices remained well below historical peaks in real terms. This relatively limited impact was attributed in part to the ongoing reduction in intensity of consumption, especially in advanced economies, as well as to the greater credibility of countries’ macro-economic policy frameworks. 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. Thus, there was need to remain watchful, especially if prices rose further.

The IMF noted the desirability, for global prosperity, of stability in oil markets and underscored the importance of closer dialogue between consumers and producers. It was also observed that the oil importing countries could make an important contribution to the oil market stability by restraining their demand for oil products, by improving energy efficiency, promoting energy conservation and using alternate fuels. 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; hence, where necessary, these measures should be accompanied by appropriate social safety nets.

3.6.2 Global Economic Environment in 2005

Global economic growth in 2004, at 5.1 percent, was the strongest in three decades. Particularly heartening was the strong performance of many of the poorest countries, 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 divergence across regions, with the US 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 the widening current account imbalances and US 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.

In FY 2005, 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 emerging Asia, excluding China, moderated somewhat during FY 2005, 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. India’s growth slowed modestly during FY 2005 with the impact of uneven monsoon and higher oil prices offset by buoyant industrial activity and strong investment.

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 due to higher demand. Consumer price inflation rose modestly in a number of countries, but long-term inflationary expectations remained anchored. 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 US, raised interest rates. Fiscal policies were varied. Although the fiscal stance in the US 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.

3.6.3 IMF’s Role in Strengthening International Monetary System in FY 2005

IMF’s Role in Trade

Trade policy has traditionally been an important part of the IMF’s surveillance and, in a number of cases, of IMF-supported programmes. Every few years, the IMF reviews aspects of its work on trade. The review undertaken during FY 2005 was broader than previous reviews.
In February 2005, the IMF’s Directors Board endorsed the 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 the remaining impediments to trade 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.

It was considered useful to extend the analysis of the spillover effects of the trade policies of key industrial countries to cover the trade policies of large middle-income countries, which increasingly affect the export prospects of other countries.

A reference was made to the proliferation of regional trade integration arrangements and the associated pooling and administrative decisions. While recognizing that multilateral trade liberalization on a most-favoured-nation basis was the preferred way to secure open markets globally, it was also 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) 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 inter-agency 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 the 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 programmes, the IMF welcomed the recent reduction in trade conditionality, which was due to, among other things, the general streamlining of the IMF’s structural consolidation and the adoption of more open trade policies by many countries. Also endorsed was the IMF’s recent emphasis on trade-related macroeconomic vulnerabilities, which remained a pressing issue for the poorest countries with IMF-supported programmes, together with the introduction of the Trade Integration Mechanism (TIM) as a means of dealing with this issue.

**Balance Sheet Approach : Debt and Liquidity**

**Debt Management**

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.
During FY 2005, such balance sheet analysis was increasingly integrated into the IMF’s operations, with a particular focus on the role of public debt.

In their biennial review of surveillance in July 2004, the IMF’s directors reiterated that vulnerability to balance of payments or currency crises and external sustainability are matters at the apex of the IMF’s hierarchy of concerns. It was observed that the current strategy to improve vulnerability assessments and balance sheet analysis was having a positive impact and, while recognizing data constraints, urged the staff to continue refining the analytical techniques. It was considered that (i) debt sustainability assessments would be enhanced if they were conducted independently of regular country work, (ii) high-quality vulnerability assessments were dependant upon close analysis of country-specific conditions, which require area department’s expertise. A need was seen for better integrating various components of vulnerability assessments to provide a clearer view in staff reports on the extent of vulnerabilities. It was felt that balance sheet analysis is relevant to assessments of vulnerabilities in advanced as well as emerging market economies.

It was noted that an examination of currency and maturity mismatches in sectoral balance sheet had provided a useful complement to the IMF’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.

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 current mismatches, appeared largest and when IMF’s efforts would most help reduce vulnerabilities. These include emerging market countries and countries of systemic importance.

**Liquidity Management**

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.

It was 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. It was 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, and have 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 national balance sheets. Also emphasized was 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 risk in debt structures. 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 was also noted.

**Crisis Resolution**

Despite the best efforts of both member countries and the IMF, not all financial crises stemming from debt-servicing difficulties can be prevented. The IMF has, therefore, continued its work on improving techniques to resolve such crises, particularly those stemming from debt-servicing difficulties. The IMF’s crisis resolution efforts continue to promote the use of collective action clauses in international sovereign bond contracts; encourage a broadening of the consensus on the draft *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets* promoted by the Institute for International Finance; and consider other ways to resolve financial crises in an orderly fashion.

**Looking forward**

The IMF’s lending function continues to make an essential contribution to the re-establishment of external viability and economic stability and, therefore, to sustainable growth in member countries. The IMF’s traditional role of providing financing to help smoothen the adjustment of temporary current account imbalances remains vital for many countries, while for others, the IMF’s main task is to help prevent or mitigate capital account crises and contagion. Strong ownership and institutional backing remain key for the success of IMF-supported programmes, while the IMF, for its part, needs to be selective in supporting only the programmes that put members firmly on the road to external viability.

In March 2005, the IMF looked forward to further reflection on how the needs of members could be met through Fund arrangements, and whether new instruments or revisions to existing facilities were needed. It was also felt that further progress needed to be made toward reaching clearer understanding on the appropriate circumstances and scale of IMF lending. The importance of specifying eventual exit strategies from IMF financial support was stressed. Views on instruments that could meet the needs of members who wished to signal their adherence to sound policies or that could provide a degree of insurance against potential crises were emphasized.

Regarding the appropriate role of the IMF in helping to resolve financial crises, there was recognition of the role of market-based mechanisms as well as interest in a clearer and more consistent role for the IMF in sovereign debt restructuring and assess-
ment of the adequacy of the instruments available for this purpose.

3.7 FY 2006

3.7.1 World Economic Outlook in 2006

Global economic growth reached 4.8 percent in 2005, its third successive year above 4 percent, inspite of high oil prices, natural disasters, and continuing geopolitical uncertainties. This expansion has been notable for its pace, duration, and increasing breadth - every region experienced rapid growth in the FY 2006. Emerging market economies grew particularly rapidly, supported by benign financial conditions, improved policy frameworks and, in many cases, high commodity prices. Developing countries also expanded solidly. The volume of global trade continued to expand rapidly. At the same time, current account imbalances in a number of key economies continued to widen. The current account deficit of the US reached a record 7 percent of GDP in the final quarter of 2005, while oil exporters, Japan, a number of small industrial countries, China and some other parts of emerging Asia continued to run substantial surpluses.

Oil prices remained high and volatile during the period, reaching highest in August 2005 and again in April 2006 because of geopolitical concerns related to Iran and threats to oil production in Nigeria. Non-fuel commodity prices, especially for metals, also rose strongly. The impact of rising commodity prices, as well as of closing output gaps, on global inflation remained surprisingly modest, however. Consumer price inflation picked up somewhat but core inflation remained constrained, and inflationary expectations were well under control.

Monetary policies tightened in most industrial countries, starting to dry up some of the abundant global liquidity. The speed and timing of the tightening differed, however, reflecting the countries’ different cyclical positions. In the US, the Federal Reserve’s tightening cycle continued, with the federal funds rate rising 175 basis points over the period. The European Central Bank began to raise interest rates at the end of 2005, and the Bank of Japan ended its long-standing policy of quantitative easing in March 2006, with markets anticipating policy rate hikes later in 2006. Fiscal policies were varied, but little progress was made in industrial countries outside Canada and Japan, toward strengthening medium-term fiscal balances (and Japan’s fiscal deficit remained very high).

Conditions in mature and emerging financial markets remained favourable, supported by sustained and broadening global growth and subdued inflation. High liquidity, in turn, continued to foster a search for yield, notwithstanding the tightening by key central banks and signs that monetary policy would continue to firm. Long-term interest rates rose more modestly, leading to a marked flattening of yield curves, mainly in the US. Long-term yields were also supported by high institutional investor demand for long-term fixed-income assets. Against this backdrop, financial market volatility, government bond yields in mature markets, and global credit spreads remained low by historical standards. Global equity markets rallied as strong corporate profitability further strengthened balance sheets globally.

Emerging market economies continued to enjoy an exceptionally favourable
economic and financing environment during the period. Solid global growth boosted export demand and commodity prices. Interest rates and credit spreads remained low, with spreads compressing even as yields in mature markets rose. With abundant liquidity continuing to spur a search for yield, investor appetite for new issues from emerging market borrowers was exceptionally strong. At the same time, the investor base for emerging market assets continued to expand, reflecting past out-performance and the improved credit quality of emerging market borrowers. The market was also supported by emerging economies’ continuing active debt management aimed at reducing the vulnerability of their debt structure.

3.7.2 Global Economic Environment in 2006

Although growth remained strong in 2005, risks to global growth continued to be slanted to the downside because of rising oil prices, continuing global payments imbalances, and other issues. The problem of global imbalances continued to raise concerns about the sustainability of the global growth. The difficulties in making progress in the Doha Round of multinational trade negotiations raised concerns that the benefits for the world economy of a successful and ambitious outcome of the negotiations would prove elusive. And there was an increasing concern about the potential consequences for the global economy of a widespread outbreak of avian flu. These issues were the focus of attention both in the IMF’s discussions with its individual member countries and in the IMF’s multilateral surveillance work, as it assessed the possible global implications. The fact that these risks did not undermine global growth during the year did not alleviate concerns about them.

The global payments imbalances continued to widen during FY 2006 and concerns about ways to resolve them became more intense. Several factors account for the very large imbalances that were a feature of the global economy: low consumption and rising external current account surpluses in much of Asia, the large and growing US current account deficit, sluggish growth in Europe, and rapidly increasing surpluses in the main-oil-exporting countries.

For some years, the IMF had argued that these imbalances were a global problem and that a multilateral response - a coordinated package of policies across the regions involved - would bring much larger gains than would be possible from unilateral actions. During FY 2006, this view gained increasingly broad support, accompanied by growing consensus on the shape of the multilateral response that was needed. This would include increasing consumption and exchange rate flexibility in a number of countries with current account surpluses in emerging Asia, raising national savings in the US, with measures to reduce the fiscal deficit and spur private savings, implementing structural reforms to increase flexibility and growth in the euro area and several other countries, undertaking fiscal consolidation and further structural reforms in Japan, and promoting efficient absorption of higher oil revenues in oil-exporting countries with strong macroeconomic policies.

As the imbalances grew, so did the importance of developing a multilateral approach. Unilateral action by any one country or by one group of countries could have
negative consequences for the rest of the world. Promoting a multilateral response, therefore, assumed a high priority for the IMF.

Prospects for a successful and ambitious outcome to the Doha Round also raised concerns, which intensified after the disappointing outcome of the World Trade Organization (WTO) Ministerial Meeting in Hong Kong in December 2005. The IMF continued to support WTO in its efforts to reach a satisfactory outcome of the negotiations including through provision of strong support for the Aid for Trade initiative. A successful outcome of the Doha Round would greatly strengthen the multilateral trading system and so strengthen the prospects for global growth. Conversely, failure to reach an agreement, or an unambitious outcome, would act as a brake on global growth and could also fuel protectionist pressures that would further undermine growth prospects.

A period of rapid global growth is perhaps naturally accompanied by concerns about the factors that might undermine it. But a prolonged, rapid and widespread global expansion, such as the one that continued in FY 2006, also offers policymakers a rare opportunity to make current growth rates sustainable and to put in place the measures necessary to raise potential growth rates in the future. Fiscal policies that cut budget deficits and make possible counter-cyclical, supportive policy during downturns, measures to reduce public debt burdens, structural reforms that free up labour and product markets and trade liberalization, all these are policies that go to strengthen growth prospects and benefit industrial and developing countries alike.

Such policy actions can be implemented more readily during a period of expansion, when support is easier to marshal and policy measures can be planned more carefully and coherently. Deferring such actions until the economy is slowing and pressure for adjustment is more urgent can result in hastily implemented reforms that might not command widespread support or achieve their full potential. Moreover, taking preemptive policy action can make economies more resilient and so less vulnerable to global downturns in the first place. The greater the number of national economies that have implemented reforms raising their growth potential and reducing their vulnerabilities, the more moderate and short-lived any downturn at the global level, as well as at the country level, is likely to be.

3.7.3 IMF’s Role in Strengthening International Monetary System in FY 2006

This, then, was the global economic environment in which the IMF operated during FY 2006; a period of remarkably resilient global expansion, but one in which the downside risks to future growth increasingly engaged the attention of policymakers. As such, it provided the IMF with an opportunity to sharpen the focus of its work and reorient its role in the modern global economy.

The IMF’s principal duties are set out clearly in its Articles of Agreement - to promote macroeconomic and financial stability at the global and national levels, to promote international monetary cooperation in the interests of all its members, to foster a liberal system of trade and payments, to prevent international crises as far as possible; and to help resolve balance of payments problems when they occur, including through
the provision of temporary financial assistance.

During FY 2006, the IMF continued to urge its member countries to adopt policies that would foster macroeconomic stability, raise growth and promote higher living standards, and help reduce poverty. Given the global environment, the IMF also made the case for preemptive action, to take full advantage of the window of opportunity presented by the expansion.

The IMF continued its efforts to help low-income countries achieve more rapid growth and poverty reduction, introducing a new facility to help low-income countries deal with exogenous shocks, and also a new Policy Support Instrument designed to help low-income countries that do not want or need financial support to enjoy the benefits of IMF endorsement of their policy programmes.

In July 2005, the leaders of the G-8 countries proposed a Multilateral Debt Reduction Initiative, writing off the debts owned to international financial institutions by some of the poorest, most heavily indebted countries; and the IMF responded quickly, putting in place in January 2006, mechanisms to cancel the debts owed to it by 19 countries. The IMF also sought to play its role in helping low-income countries meet the Millennium Development Goals, particularly through its advice on macroeconomic policies, including policies appropriate in the context of the current scaling-up of aid.

The IMF’s policy advice is based on the analysis by its staff, its accumulated knowledge and the lessons of the experience of its membership, all considered by the Executive Board. During FY 2006, the focus in some countries was on macroeconomic stability; for others, the emphasis was more on the structural reforms needed to strengthen growth and on longer-term issues such as the implications of demographic change. As always with surveillance work, the aim was to identify weaknesses and to use the IMF’s unique cross-country expertise to identify and highlight effective reforms.

Although the IMF’s mandate has remained essentially unchanged over the years, how it discharges its duties has changed over time, to adapt to changing global economic and financial circumstances. The history of the IMF is, in an important sense, one of adaptation, and the IMF needs regularly to review its work to ensure that it continues to be able to serve its purposes and its member countries as effectively as possible.

The prolonged global economic expansion brought other challenges for the IMF. The absence of financial crises in recent years is, of course, an unambiguously positive development - attributable partly to policy improvements in recent years, at the national and international levels, to which the IMF has contributed. But the benign global economic environment enables member countries and the IMF itself to press ahead with further measures that can mitigate the impact of any future crises and reduce the vulnerability of the international economy, as a whole.

At the same time, the IMF now has fewer borrowers and less lending outstanding than it has had for many years. During FY 2006, both the Brazilian and Argentine governments repaid their loan obligations to the IMF ahead of schedule, reflecting the significant progress made in achieving macroeconomic stability and growth. The decline in IMF lending has important implications for its operating income and points to a need
to review the IMF’s financing structure, in the light of the changed global environment. At the end of FY 2006, it was announced that the IMF would undertake such a review, with the help of a committee of eminent persons, to be completed during FY 2007.

As the world economy continues to evolve, the IMF will have to be ready to adapt further, in ways that cannot yet be foreseen. One of the aims of its newly evolved Medium Term Strategy (MTS) is to put the IMF in a position to identify changing priorities and redeploy resources more effectively in the future. In this way, the IMF can continue to play the central role in maintaining international financial stability and the promotion of global growth that has always been its mission.

**Crisis Prevention**

In September 2005, the IMF sponsored a high-level conference at its Washington, D.C., headquarters that addressed key financial stability issues. Participants in the conference - central bank and supervisory officials from 40 of the IMF’s member countries - examined the risks stemming from rapid credit growth and asset price bubbles in financial and housing markets, possible monetary and prudential policy responses for addressing these risks, the institutional aspects of implementing the financial stability mandate, and issues related to supervisory gaps and preconditions.

Another key issue for financial stability is the dramatic increase in capital mobility. Despite its considerable potential benefits, capital mobility can put countries at risk of a crisis if investors suddenly lose confidence and withdraw their capital. The IMF, therefore, has sought to build up its expertise on the issues surrounding capital account liberalization and to strengthen its policy advice in this area.

**Crisis Resolution**

The IMF continued its work on the orderly resolution of financial crises, analyzing cross-country experiences with sovereign debt restructuring and policy issues raised by specific cases, and promoting the use of collection action clauses (CACs) in international sovereign bonds. The CACs are designed to prevent small minorities of creditors from blocking restructuring deals to which large majorities agree. In its efforts to help improve the sovereign debt restructuring process, the IMF has encouraged the adoption of CACs, maintaining an active dialogue with private market participants and debt managers from a number of emerging market countries, including through such vehicles as the Forum for Public Debt Managers.

### 3.8 FY 2007

#### 3.8.1 World Economic Outlook in 2007

Global economic growth accelerated to 5.4 percent in 2006, up from 4.9 percent in 2005, making the fourth successive year of a strong global expansion. Moreover, the expansion became better balanced, as a slowing in the US economy was offset by firming of growth elsewhere. Emerging market countries grew particularly fast, supported by benign international financial conditions and, in many cases, high commodity prices. Inflation in the advanced economies declined in the second half of 2006 oil prices fell
from their peak in August.

Current account imbalances continued to be large. The external deficit of the US stabilized at 6½ percent of GDP in 2006, with a marked narrowing toward the end of the year. The surpluses of the oil-exporting and East Asian countries continued to rise, while deficits grew in both western and emerging Europe and in rapidly growing emerging market economies such as India.

Activity in emerging Asia continued to expand briskly, led by strong growth in China and India. The pace of fixed asset investment cooled in the second half of 2006 but gathered pace again in early-2007. India’s growth of 9.7 percent in 2006 was supported by strong consumption, and especially, investment.

Oil prices continued to be high and volatile. After reaching a record high of US$ 76 a barrel in August, 2006, the average petroleum spot price declined in subsequent months, reflecting a combination of slowing demand in industrial countries, a recovery of non-OPEC supply, and some easing of geopolitical tensions. However, OPEC’s production cuts after November and a recovery in demand in the first quarter of 2007 caused prices to rebound. Renewed geopolitical tensions in the Middle East pushed prices up even further in April, 2007, to US$ 65 a barrel by the end of April. Prices of non-fuel commodities, led by metals, also rose sharply during the second half of 2006 and the first four months of 2007, as did prices of some agricultural commodities, notably corn, reflecting, in part, the prospect of growing demand for biofuels.

3.8.2 Global Economic Environment in 2007

The monetary policies adopted by IMF member countries reflected different cyclical positions. The US Federal Reserve kept its interest rates on hold from June 2006 on, balancing the risks of a cooling economy against continued concerns about inflation. With inflation in Japan continuing to hover around zero, the Bank of Japan raised its policy rate to 0.5 percent in two quarter-point moves, after abandoning its zero interest rate policy in July 2006. By contrast, the European Central Bank and European national central banks steadily tightened monetary policy. Some emerging market countries, notably China, India and Turkey, also tightened monetary conditions, China and Turkey because of concerns about overly rapid growth, and India because of concerns about inflationary pressures. Regarding fiscal policies, industrial countries made some progress in reducing structural deficits, largely as a result of unusually strong revenue growth. Nonetheless, with their ageing populations, these countries will need to make further substantial adjustments going forward to achieve fiscal sustainability.

In foreign exchange markets, slower growth in the US contributed to weakening of the US dollar. The yen also weakened further, as low interest rates continued to encourage capital outflows. Overall, the currency market conditions remained orderly and their volatility, low.

In emerging markets, yield spreads declined to new historical lows. The market was supported by continued improvements in credit quality (with rating upgrades far exceeding downgrades), more sovereign debt buybacks, and reduced sovereign issuance.
Global investors increased their portfolio allocations in local emerging markets. Net flows to emerging equity markets fluctuated. In particular, sharp outflows were recorded during the corrections of May-June 2006 and February-March 2007, with the largest outflows recorded in those markets that had run up the most.

3.8.3 IMF’s Role in Strengthening International Monetary System in FY 2007

The common thread running through the IMF’s activities in FY 2007 was the continued acceleration of globalization, the greatest challenge facing both the IMF and its members in the early-21st century. With this challenge in mind, the IMF made considerable progress toward key objectives set forth in its Medium Term Strategy (MTS) - strengthening and modernizing surveillance, seeking new ways to support emerging market countries, deepening IMF’s engagement with low-income countries, reforming governance and strengthening internal management to make the IMF a more efficient and effective institution, and placing the IMF’s finances on a sustainable footing.

Programme Support

Many emerging market economies have strengthened their policies, addressed vulnerabilities, and improved debt structures. Some, particularly in Asia, have accumulated large reserves and expanded regional reserve pooling arrangements. The prospects for emerging market economies remain positive, with favourable financial conditions and further robust growth is expected to continue. As a result, most are now able to meet their financing needs for the coming year in the international financial markets, and their demand for IMF lending has declined dramatically. Nonetheless, macroeconomic fundamentals still vary widely among emerging market economies and vulnerabilities remain.

In FY 2007, the IMF considered ways to strengthen its support for emerging market economies. Given their growing reliance on international capital flows, the deepening of financial sector and capital market surveillance would have particular relevance for these economies’ crisis prevention efforts. The IMF also made progress toward developing an instrument that would make financing available to emerging market economies with sound policies in the event of a temporary loss of liquidity. Recognizing that a member’s own policies are central to crisis prevention, the IMF considered a staff paper on the sources and costs of shocks and the policy options that can best insulate members from crisis.

The IMF also explored the ways to deepen its engagement with low-income countries, in collaboration with the World Bank, while focusing on helping them to achieve macroeconomic stability and accelerate growth, the areas in which the IMF is best equipped to assist as these countries strive to reduce poverty and achieve the Millennium Development Goals.

Over the past few years, the IMF has broadened the array of financing and other instruments available to low-income countries. In FY 2007, the IMF focused on finding ways to help countries that have received debt relief through the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI), avoid
building up new unsustainable debt burdens. Given that the low economic development of low-income countries depends crucially on trade, the IMF urged its members to work towards a successful conclusion of the Doha Round of multilateral trade negotiations. The IMF also continued to offer technical assistance in such areas as tax and customs reforms to enable low-income countries to benefit fully from the trade liberalization, and stood ready to provide financial assistance to countries that might be harmed in the short-run by other countries’ trade liberalization.

Efforts towards Anti-money Laundering and Financing of Terrorism

In FY 2007, the IMF also contributed to the international efforts to combat money laundering and financing of terrorism. In collaboration with the Financial Action Task Force (FATF) on money laundering, the World Bank, the United Nations and FATF-style regional bodies (FSRBs). As a collaborative institution with near universal membership, the IMF is a natural forum for sharing information, developing common approaches to issues, and promoting desirable policies and standards. In addition, the IMF’s broad experience in conducting financial sector assessments, providing technical assistance in the financial sector, and exercising surveillance over members’ economic systems is particularly valuable in evaluating country compliance with international AML/FCT standards and in developing programmes to help them address shortcomings.

Financial Soundness Indicators (FSIs)

The IMF has consistently underscored the importance of FSIs in facilitating financial sector surveillance, increasing the transparency and stability of the international monetary system and strengthening market discipline. After developing a core set and an encouraged set of FSIs in consultation with the international community, the IMF launched a 3-year pilot Coordinated Compilation Exercise (CCE) to (i) build the capacity of 62 participating countries to compile FSIs, (ii) promote cross-country comparability of FSIs; (iii) coordinate efforts by national authorities to compile FSIs; and (iv) disseminate the FSI data compiled in the CCE, to increase transparency and strengthen market discipline. Many countries also regularly compile and disseminate FSIs on their own, and these indicators are included in their FSAP documents.