4.1 INTRODUCTION

This fourth Chapter of the Thesis begins with the explanation of the IMF’s concepts of ‘global surveillance’, ‘country surveillance’ and ‘regional surveillance’ and then proceeds with the review of the IMF’s surveillance activities during the study period (FYs 2001 to 2007 AD).

In accordance with Article-IV of its Articles of Agreement, the IMF oversees the international monetary system to ensure its effective operation. The IMF also oversees that each member country complies with its obligations under Article-IV “to collaborate with the IMF and others to assure orderly exchange arrangements and to promote a stable system of exchange rates”. The IMF discharges these responsibilities partly by monitoring economic developments and policies in its 185 member countries. It also monitors economic and financial developments at the global level. The IMF’s overseeing of policies and economic developments at the global, country and regional levels is known as ‘surveillance’.

In today’s globalized economy, where the policies of one country typically affect many other countries, international cooperation is essential. The IMF, with its near-universal membership of 186 countries, facilitates this cooperation. There are two main aspects to the IMF’s work: (a) bilateral surveillance, which comprises appraisal of, and advice on the policies of each member country; and (b) multilateral surveillance or oversight of the world economy.

IMF’s overseeing, or surveillance, activity has evolved continuously to reflect changing global economic realities. In recent years, economic globalization and the increasing international integration of financial markets - and the 1994 Mexican and 1997-98 Asian and Russian financial crises - have underscored the importance of effective surveillance for crisis prevention. The IMF’s surveillance now devotes more attention to factors that make countries vulnerable to financial crises, including financial systems, capital account developments, poor governance, and public and external debt management. The IMF has continued to develop better analytical tools, such as those for assessing reserve adequacy and vulnerability to crises, and has strengthened efforts to incorporate the views of and developments in international financial markets into its surveillance activities. It has also underscored the importance of reporting accurate, timely and comprehensive statistics and has encouraged members to publish country reports with a view to facilitating more informed decisions in the public and private
sectors. As a result of these efforts, surveillance has become more focused and candid.

4.2 **GLOBAL SURVEILLANCE**

The IMF’s Executive Board conducts global surveillance through its reviews of world economic and financial market developments and prospects. Twice a year in each case, these reviews are based on the IMF staff’s *World Economic Outlook* (WEO) report and issues of the *Global Financial Stability Report* (GFSR), which are published, together with a summing up of the Executive Board’s discussion, ahead of the semi-annual International Monetary and Financial Committee (IMFC) meetings. The WEO reports provide analysis of global, regional and national economic prospects and policies, and the GFSR analyzes developments and risks in international capital markets. Between WEO reports and the GFSR issues, the Board also holds more frequent informal discussions of world economic and market developments, and the IMF staff continuously monitor economic and financial developments in the IMF’s 185 member countries as well as globally.

In addition, IMF management and staff take part in economic policy discussions with finance ministers, central bank governors and other officials in a variety of groups, such as the Group of Seven major industrial countries (G-7), the Group of 24 developing countries (G-24) and the Group of 20 (G-20).

4.3 **COUNTRY SURVEILLANCE**

Under Article-IV of the IMF’s Articles of Agreement, each member country makes commitments to endeavour to pursue economic and financial policies that are conducive to orderly economic growth with reasonable price stability, to seek to promote stability by fostering orderly underlying economic and financial conditions, to avoid manipulating exchange rates to prevent balance of payments adjustment or to gain unfair competitive advantage, and to provide the IMF with the information necessary for surveillance. To ensure that members are fulfilling these obligations, the IMF conducts regular ‘Article-IV’ consultations, usually once a year but less often in some countries. (Informal staff visits often take place between formal consultations). Through these consultations, the IMF seeks to identify policy strengths and weaknesses, indicate potential vulnerabilities and advise countries on appropriate corrective actions, if needed. Article-IV consultations also examine the cross-border effects of countries’ economic conditions and policies, particularly for systemically or regionally important member countries.

During an Article-IV consultation, a staff team visits the member country to collect economic and financial data and discuss with government and central bank officials economic developments since the previous consultation, as well as the country’s exchange rate and monetary, fiscal, financial sector, and structural policies. The team may also meet with non-official groups such as legislators, trade unions, academics, and financial market participants to solicit their views on the economic situation. Towards the end of the visit, the team prepares a summary of its findings and policy advice, which it leaves with the national authorities, who have the option of publishing it. On return to the IMF
headquarters, the team prepares a report describing the economic situation and the talks with the authorities and evaluating the country’s policies. The report is discussed by the Executive Board and a summary of the discussion produced. If the member country agrees, a Public Information Notice (PIN), which provides background and a summary of the Board discussion, is published, with or without the full Article-IV consultation report. All PINs are posted on the IMF’s website, as are Article-IV reports approved for release.

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

4.4 REGIONAL SURVEILLANCE

The IMF has recently been putting more emphasis on the regional context of surveillance to draw common policy lessons and capture cross-country spillovers. In addition to the Executive Board discussions of the policies of four currency unions - the Eastern Caribbean Currency Union, the euro area, the Central African Economic and Monetary Community, and the West African Economic and Monetary Union, the IMF area departments also produce Regional Economic Outlook Reports for sub-Saharan Africa, Asia and the Pacific, Europe, the Middle East and Central Asia and Latin America and the Caribbean.

The IMF has classified India as an ‘emerging market economy’ in Asia region and accordingly, the presentation herebelow has extracted IMF’s only such surveillance observations that relate to India, as a developing country.

4.5 IMF’S GLOBAL SURVEILLANCE - FY 2001

During FY 2001, the IMF’s Board of Directors discussed the World Economic Outlook in September 2000 and again in April 2001.

At its September 2000 meeting, the Board welcomed the strength of the world economy. The high global growth rate was attributable in a large part to the remarkable strength of US economy, supported by a robust expansion in Europe and the countries in transition. Also contributing to world growth were a consolidation of the recovery in Asia, improved growth in Africa and rebounds from year-earlier slowdowns in Latin America and the Middle East. While economic activity in Japan was also improving, the incipient recovery remained fragile.

Although the overall outlook in September 2000 was encouraging, the Directors cited continuing risks and uncertainties and saw no room for complacency. In particular, a number of serious economic and financial imbalances persisted in the world economy - the lopsided pattern of output and demand growth among industrial countries and the
associated imbalances in the external current accounts, the misalignments among the major currencies and the generous level of asset market valuations in the US and several other countries. The possibility that these imbalances might unwind in a disorderly fashion remained a risk to the global expansion. The recent increase in oil prices, if sustained, would also hamper global growth and increase inflationary pressures in advanced economies and hurt oil-importing developing countries as well as many poor countries in sub-Saharan Africa.

Against this background, it was observed that the policymakers worldwide faced important, though widely varying, challenges. The advanced economies had to continue efforts to facilitate an orderly rebalancing of growth and demand across the three main currency areas. In some advanced economies, a further tightening of macroeconomic policies might be needed to reduce the risks of overheating, particularly if higher energy prices fed through to underlying inflation; in others, where there were margins of slack, macroeconomic policies had to continue to support recovery. More broadly, it was stressed that progress with structural reforms had to continue in most advanced, and almost all developing, countries so as to strengthen prospects for sustained economic growth.

A concern was also expressed that, despite the strength of the global recovery, poverty remained unacceptably high and many poor countries continued to face serious economic problems, compounded in some cases by natural disasters and adverse movements in non-oil commodity prices. It was agreed that sustained efforts by the poorest countries were essential, notably in promoting macroeconomic and political stability, good governance, and domestic ownership of the reform agenda. Stronger support from the international community was also important, including through debt relief targeted at poverty reduction, which required funding in full the enhanced Initiative for Heavily Indebted Poor Countries (HIPC Initiative); a reversal of the declining trend in some advanced countries’ official development aid, and reform of protectionist trade policies in advanced economies that particularly affected poor countries.

In their April 2001 discussions, the IMF’s Board of Directors agreed that the prospects for global growth had weakened significantly led by a marked slowdown in the US, a stalling of the recovery in Japan, and a slowing of growth in Europe and in a number of emerging market countries. Some slowdown from the rapid rates of global growth of late-1999 and early-2000 had been both desirable and expected, especially in those countries most advanced in the cycle, but the deceleration was proving to be steeper than previously thought. At the same time, while ‘headline’ inflation in most advanced economies had begun to stabilize, with moderate wage increases and declining oil prices, the underlying inflation remained generally subdued, except perhaps in a number of faster-growing European and emerging market economies.

Given the rapid policy response by several central banks in both advanced and emerging market economies, it was thought that prospects were reasonable that the global slowdown would be relatively short-lived, although the pace of recovery might be slowed by continuing declines in global equity markets. Declining short- and long-term interest rates were expected to support economic activity in the second half of
2001, and with inflation risks receding, policymakers in most advanced economies, excepting Japan, had a substantial room for further easing. Moreover, given the remarkable strengthening in fiscal positions in recent years, most advanced economies also had room for fiscal easing as a second-line of defence, which the US in particular was expected to use. In addition, while a number of emerging market countries continued to face serious difficulties, external and financial vulnerabilities had generally been reduced since 1997-98 crises, as a result of wide-ranging structural reforms. Moreover, the shift away from soft exchange rate pegs to flexible exchange rate systems had improved countries’ ability to cope with external shocks.

However, it was mostly agreed that the outlook remained subject to a considerable uncertainty and that a deeper and more prolonged downturn was possible. Hence, it was emphasized that the extent of the slowdown would be affected by policy decisions by all countries. About the advanced economies, it was agreed that a more proactive approach to macroeconomic policies, particularly on the monetary side, might well be required, and should be pursued consistently with those countries’ respective cyclical positions and without compromising medium-term stabilization goals. Where needed, these policies should be completed by the determined pursuit of structural reforms. In view of the prevailing fragility of external financing conditions, prospects in emerging markets depended critically on maintaining investor confidence. For these countries, the IMF underscored the need to maintain prudent macroeconomic policies and to press ahead with corporate, financial and institutional reforms.

Concern was also expressed that the slowdown in global growth would hurt the low-income countries, both directly and through lower commodity prices. The need for such countries to sustain strong policies was even greater, both in those countries receiving debt relief under the enhanced HIPC Initiative and in others. To help the low-income countries, it was stressed that the advanced economies had a special responsibility to increase aid flows, to support initiatives promoting peace and domestic stability, and to provide further assistance to fight the spread of the HIV/AIDS pandemic. Special emphasis was laid on the importance of further barriers to the exports of the developing countries, and of the poorest countries in particular. In this connection, the IMF welcomed the European Union’s recent initiative to eliminate tariffs on almost all exports of the least-developed countries.

Given the change in the global economic outlook, the IMF felt that it was particularly important to it, in its dialogue with member countries and through multilateral surveillance, to continue to support actively the implementation of policies that promote economic stability and prosperity.

**Emerging Market Economies**

Following a rapid recovery from the regional crisis, growth in the Asian emerging market economies had weakened as a result of higher oil prices, slowing growth in the US and Japan, the downturn in the global electronic cycle, and in some countries, the lagging pace of corporate and financial restructuring. It was noted that the growth was expected to slow down most in the new industrialized economies and in member countries
of the Association of South East Asian Nations (ASEAN), particularly those more advanced in the recovery and where corporate and financial restructuring had lagged. In these countries, it was crucial to restore the momentum of structural reforms. For countries with low inflation and sustainable fiscal positions, the IMF recommended moderate interest rate reductions, coupled in some cases with an easier pace of fiscal consolidation. Growth was expected to be relatively well maintained in China and India. In India, it was agreed that the monetary policy easing should be supported by continued improvements in the environment for private investment and a substantial reduction, over the medium term, in the overall public sector deficit.

Maintaining Improved Fiscal and Monetary Policies

It was noted that the durability of recent fiscal consolidation in the advanced economies was likely to be improved by the associated reductions in public spending (as a share of GDP) and the strengthening of fiscal frameworks over the past decade. It was emphasized that fiscal discipline would be vital in the years ahead, given the substantial increases expected in public spending on pensions and health care as populations aged. To meet pension liabilities and enhance output growth as dependency ratios rose, it was agreed that the policy response should be broad-based, encompassing both pension reform and structural reforms, including labour market improvements. Consideration should be given to directing a part of recent and projected fiscal improvements to increased pre-funding of future pension liabilities. Taking a global perspective on population ageing, it was noted that as dependency ratios decline in many developing countries, increased saving by countries with ageing population could support growth in the developing world and future consumption in advanced economies.

With respect to the decline in inflation in emerging market economies in recent years, it was noted that improved monetary stability in advanced economies and substantial progress in institutional reform in emerging market economies, including more independent central banks and improved knowledge about monetary policy transmission, had played an important role in achieving this outcome. Prudent fiscal policies had also been key in achieving lower inflation and allowing the conduct of a stable monetary policy over the long run. While observing that experience with the more frequent use of inflation targeting to accompany flexible exchange rates had been generally encouraging to day, it was considered that a more definite verdict on inflation targeting would need to await further experience, particularly with the maintenance of price stability during sustained periods that included episodes of financial stress and exchange rate instability.

Role of Foreign Banks in Emerging Markets

One of the major structural changes in the banking systems in many emerging markets in recent years was the sharp increase in the degree of foreign ownership. This change reflected the desire of both large international and regional banks to enter profitable markets and of the local authorities to improve the efficiency and stability of their financial systems, as well as to help reduce the cost of recapitalizing weak domestic banks.
The entry of foreign banks in the emerging markets’ banking systems presented both benefits and challenges to the host country, in terms of efficiency and stability. With regard to efficiency, the entry of foreign banks could improve the efficiency of emerging market banking systems by increasing competition and by introducing a variety of new financial products and better risk management techniques. On the other hand, it was also noted that the foreign banks were less likely to contribute to overall efficiency if they serviced only the most creditworthy corporate and household customers.

With regard to the role of foreign banks as a means of helping stabilize banking systems in emerging markets, a range of views was offered. It was argued that foreign banks could play an important role in stabilizing these systems, owing to their more advanced risk management systems, their better access to international capital markets, and the likelihood that locally the foreign banks would be supervised on a consolidated basis with their parent. On the other hand, it was also argued that the potential contribution of foreign banks would hinge on the circumstances, and might vary. It was suggested that recent experience indicated that foreign banks may simply ‘cut and run’ during crisis period and thus are not a stable source of domestic funding. International banks were seen as managing their exposures to emerging markets on a consolidated basis; a decision by them to cut exposure to an individual country could involve reductions in both cross-border lending and local operations. Moreover, it was argued that the presence of foreign banks opened a new channel of transmitting disturbances in mature market banking systems to emerging markets. Finally, it was agreed that the entry of foreign banks into emerging markets would benefit efficiency and stability most if accompanied by both stronger prudential supervision in emerging markets and enhanced cross-border sharing of information between supervisors in mature and emerging markets. In particular, supervisory authorities would have to upgrade their capacity to acquire information.

4.6 IMF’S GLOBAL SURVEILLANCE - 2002

In FY 2002, the IMF’s Board of Directors discussed the World Economic Outlook on three occasions - two regular discussions in September 2001 and March 2002 and an additional discussion in December 2001 in the aftermath of the terrorist attacks in the US on September 11, 2001.

The two discussions in 2001 focused on signs of a slowdown in world economic growth, sharply albeit temporarily, exacerbated by the events of September 11, 2001. By March 2002, however, there were encouraging indications that the slowdown had bottomed out and that global economic growth was recovering.

In September 2001, the IMF’s Board agreed that prospects for global growth had weakened since May 2001. In particular, the IMF noted the substantial decline in growth in the US over the past year, the serious deterioration in economic prospects for Japan, the weaker conditions and outlook in Europe, and the reduction in the projections for growth for most developing country regions. Slower GDP growth in almost all regions had been accompanied by a sharp decline in trade growth. Financing conditions for emerging markets had also deteriorated, although it was encouraging that the effects of contagion had been more moderate than in preceding episodes.
It was noted that a number of interrelated factors had contributed to the slowdown, including a reassessment of corporate profitability and an associated adjustment in equity prices, and tightening of monetary policy to contain demand pressures in the US and in Europe. More broadly, the faster-than-expected slowdown also reflected the strong cross-country trade and financial linkages that were increasingly evident across countries.

In December 2001 meeting, the IMF’s Board discussed the impact of the September 11 attacks on the world economy and observed that before the attacks, there appeared to be a reasonable prospect for recovery in late-2001. However, more recent data indicated that the situation before the attacks was weaker than had earlier been projected in many areas, including the US, Europe and Japan. It was, therefore, concluded that the tragic events of September 11 had exacerbated an already very difficult situation for the global economy.

In the aftermath of the September 11 attacks, consumer and business confidence had weakened further across the globe. There was a significant initial impact on demand and activity, particularly in the US. In financial markets, there had been a generalized shift away from risk assets in both mature and emerging markets, including a substantial deterioration in financing conditions for emerging market economies. Between the end of September and early-December 2001, however, financial markets strengthened, as equity markets recovered and the earlier flight to quality was reversed. Movements in major exchange rates had been moderate, while commodity prices had fallen back further, especially for oil, as the outlook for global growth had weakened.

The IMF noted that the economic slowdown and worsening financing conditions had adversely affected many emerging market economies. Net capital flows, including foreign direct investment, were constrained. Those countries that required substantial external financing were vulnerable to reassessments of economic prospects and to further shocks in international capital markets.

The IMF’s board members expressed concern that developing countries, particularly the poorest countries, were being hurt by weaker external demand and falling commodity prices, with the oil exporters being particularly affected. Non-fuel commodity exporters would also be affected by further weakness in an already depressed prices, although for some, the benefits from lower oil prices would limit the increase in their requirement for external financing. Thus, while growth was projected to be relatively well sustained, it was viewed that the prospects for individual countries varied widely.

Given the limitations of monetary policy in the then prevailing environment of weak confidence and excess capacity, it was largely agreed that fiscal policy should also play a role, particularly through the operation of the automatic stabilizers.

There had been a marked improvement in global economic prospects by the time of the IMF Board’s March 2002 discussions. The Board welcomed the increasing signs that since December 2001, the slowdown had bottomed out and that a global recovery was under way. This recovery was evident in the US and Canada and, to a lesser extent, in Europe and in some countries in Asia. Financial markets had bounced back strongly after the September 11 shock, commodity prices had begun to pick up, and emerging
market financing conditions had strengthened markedly. Nevertheless, different but serious concerns remained in a number of countries, notably Japan and Argentina.

It was observed that several factors underpinned the recovery. Most important was the substantial easing of macroeconomic policies in advanced economies, particularly the US, and also in a number of emerging economies, especially in Asia. The scope for such policy support owed much to the earlier progress in lowering inflation, strengthening fiscal positions and reducing other sources of vulnerability, which enabled the members to respond promptly and effectively to the difficult situation that the world economy had faced the previous year. It was also noted that the adjustment in inventories appeared to be well along in the US and some other advanced economies and that this would also help boost production in the period ahead. The recovery in the major currency areas had also been supported by lower oil prices, although this was less of a factor following the strong pickup in prices since late-February 2002. The importance of stable oil prices for a durable world economic recovery was also underscored.

It was agreed that the risks to the world economic outlook had become more evenly balanced since December, 2001. Indeed, the recent indicators of confidence, employment and activity in the US had been surprisingly positive, suggesting that the recovery would be stronger than earlier projected. At the same time, a number of potential downside risks in the outlook required continued attention. First, in part because of the synchronized slowdown, relatively little progress had been made in reducing persistent imbalances in the global economy, the overvaluation of the dollar and undervaluation of the euro, and the relatively high household and corporate debts in a number of countries. As such, it was considered that these imbalances could, at least in the short term, widen further.

It was generally concurred that macroeconomic policies in most industrial countries should remain generally supportive of the emerging recovery. However, with the exception of Japan, there appeared little need for additional policy easing and that, in countries where the recovery was more advanced, attention should turn in time toward reversing earlier monetary policy easing. Over the medium term, policy should seek to support sustainable growth, while aiming for an orderly reduction in global imbalances. This would require continued structural reforms to encourage growth in the euro area and in some Asian emerging markets; decisive action in Japan to reinvigorate the economy; and for the US to ensure that medium term fiscal targets were met. Also underscored was the importance of using the recovery to make further progress in reducing vulnerabilities, including through accelerated efforts to address looming problems created by the ageing of the populations of industrial countries; a sustained effort to achieve balanced budgets in the euro area; development of a medium-term fiscal consolidation plan in Japan; reform of the corporate and financial sectors in Asia; and medium-term efforts to strengthen fiscal positions in China, India, and many Latin American countries.

The Board also noted the favourable changes that were occurring in Latin America, central and eastern Europe, Commonwealth of Independent States, Africa and the Middle East.
Emerging Market Economies

The IMF’s Board noted that the prospective recovery in industrial countries should play a central role in supporting activities in emerging markets, along with continued efforts to strengthen economic fundamentals to reduce vulnerability and enhance productive growth. In Asia, which, with the exception of China and India, was particularly hard hit by the global slowdown, there were clear signs of a pickup in activity, aided by nascent strengthening in the electronics sector and easier macroeconomic policies in a number of countries. The emerging recovery would need to be supported by ongoing reforms across the region, especially in financial and corporate sectors. In India, structural fiscal reforms were needed to back the substantial consolidation required, while China should move ahead with reforms to address the competitive challenges arising from WTO membership and, in particular, tackle difficulties in the state-owned enterprises, the banking sector and the pension system.

Many emerging markets had undergone financial sector consolidation, although its extent and pace had varied in different regions. This process was seen as one facet of the continuing globalization of international financial activities and akin to a ‘quiet’ opening of capital accounts. While the migration of financial activities to low-cost financial centres was profoundly altering the financial systems of many emerging markets, it also linked them to international financial markets.

It was pointed out that a number of aspects of the consolidation process differed from the experience of mature markets, including the role of cross-border mergers and acquisitions, which had been rare in mature markets. Furthermore, consolidation in emerging markets had frequently been a vehicle for restructuring the financial system following major financial crises, whereas in mature markets, consolidation had more often been designed to reduce excess capacity. Also, the State authorities had played a major role in fostering consolidation in emerging markets, whereas market forces had been the predominant force for consolidation in mature markets.

The process of financial sector consolidation in emerging markets raised a number of complex policy issues, including how to create sufficient market discipline and official supervision for institutions that were ‘too-big-to-fail’. The experience of mature markets indicated that dealing with these problems would involve strengthening supervisory capacity to monitor the activities of large complex financial institutions, and establishing clear entry and exit rules and prompt corrective action for distressed institutions.

It was noted that the emergence of financial conglomerates providing a wide range of products and services complicated prudential supervision and regulation. These conglomerates raised the issue of how the regulatory agencies overseeing banks, securities, and insurance companies should be structured. It was considered that this would depend on the specific circumstances of each country or region.

On the topic of e-finance, it was noted that while its development was still at an early stage in most emerging markets, there had been a steady growth in the application of the Internet to the production and delivery of financial services. This underscored the need for improved liquidity management at the level of financial institutions and
supervision.

**Global Financial Stability Report - 2002**

In the IMF Board’s discussion on the *Global Financial Stability Report*, the Directors welcomed the recovery in global markets and the reduction in global risk aversion since the fourth quarter of 2001. Overall, financial markets had responded well to the uncertainties that arose during the slowdown and following the events of September 11, and had recovered quickly once it became clear that economic prospects were improving.

More careful discrimination by investors across emerging markets, a variety of technical factors, and the adoption of sound economic policies geared toward more flexible exchange rates, higher official reserves, lower short-term debt, and strong current account positions had contributed to the resilience of emerging markets during the fourth quarter of 2001 and beyond.

*Stability Implications of Global Financial Market Conditions.* While the international financial system had remained resilient in the face of serious disruptions, global financial conditions had worsened during 2001 across a broad range of markets, institutions and sectors. Deteriorating credit quality and corporate earnings were reflected in higher corporate bond spreads and lower stock prices. These price adjustments had adversely affected the balance sheets of corporations and households. The slowdown had also affected financial institutions.

Turning to the outlook for global financial market conditions, it was agreed that the main risks related to the potential for a subdued or delayed global recovery. With asset prices seemingly reflecting expectations of a near-term economic rebound, a subdued or delayed recovery could lead to market corrections. It was noted that under this scenario, Japan and emerging market borrowers could experience particularly adverse effects. The adjustment could also include a temporary and selective withdrawal from risk taking by financial institutions. At the same time, the resilience of the international financial system during financial disruptions in the 1990s was cause for optimism that the adjustments would be manageable.

*Credit Risk Transfer Market.* It was noted that credit risk transfer markets had grown very rapidly, an indication of the useful role they played in spreading risk among economic agents and contributing to portfolio diversification, and in providing alternative sources of liquidity. Concerns about the activities of new and less regulated participants in credit markets could be addressed by improved disclosure and transparency. Many directors also called for strengthened oversight of non-bank and non-financial entities that were active in financial markets. They expressed concerns that regulatory arbitrage might shift risks to institutions least capable of managing them, and that accounting and auditing standards and practices might be deficient in several major countries. It was, therefore, suggested that a top priority in the period ahead should be to update the supervisory and regulatory frameworks to keep pace with the evolving credit-risk transfer markets.
Further Development of Early Warning System Models. It was agreed that the development of models to provide advance warning of a country’s vulnerability to crisis and of the buildup of systemic risk in financial markets was important for effective market surveillance and crisis prevention. Although such early warnings could be useful in helping the IMF to provide timely advice to prevent crises, given their current limited predictive power, early warning system (EWS) models should be used carefully and together with qualitative and other methods of vulnerability assessment. With this caveat in mind, the directors supported efforts to refine the EWS models currently being used in the IMF’s work. Those efforts could also complement work at the national level on EWSs.

4.7 IMF’s Global Surveillance - 2003

During FY 2003, the IMF’s Board of Directors discussed the World Economic Outlook in September 2002 and again in March 2003.

At its September 2000 meeting, the Board noted that economic and financial market developments had been mixed. 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 of the US, Europe and several other regions. These developments were especially disappointing in the light of the strengthening of several global economic indicators, including trade and industrial production, seen since the end of 2001, as well as the 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 and it was observed, going forward, 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. Nonetheless, a concern was expressed about the strength and sustainability of the recovery and it was agreed that the outlook for the remainder of 2002 and 2003 was likely to be weaker than had been anticipated.

In March 2003, the IMF’s Board noted that the pace of the global recovery had slowed down amid rising geopolitical uncertainties related to Iraq, the continued adverse effects of the fallout from the bursting of the equity market bubble and rapidly changing conditions.

The global economy had been resilient and in many industrial countries, the fundamentals had remained sound. It was agreed that a global recovery should gradually reassert itself, achieving a global GDP growth of just over 3 percent 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.
It was recognized that the economic impact of the conflict in Iraq was very difficult
to quantify. It was also considered that the balance of the other risks to the economic
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. Second,
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, it was regarded that sustained global
deflation as unlikely, although price declines in individual countries were not ruled out.

With inflationary pressures in general quite moderate, it was agreed that 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 ageing populations. The Directors urged an acceleration of structural
reforms to boost confidence and domestic demand growth, in order to reduce global
dependence on the US and foster an orderly reduction in global imbalances.

It was underscored that 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. It was considered that a strong
push to advance the multilateral trade negotiations under the Doha Round should be a
key ingredient of such efforts.


In May 2002, the IMF noted that in the context of an improved global economic
outlook, no imminent threat to global financial stability was evident. Stock prices were
broadly unchanged in the US and Europe in the first quarter of 2002, even as concerns
over the recovery and quality of reported earnings weighed heavily on the stock prices
of highly leveraged firms and of firms that had been active in mergers and acquisitions.
At the same time, emerging market bond and equity markets had rallied, reflecting new
inflows from dedicated investors and increased interest from cross-over investors. Bond
market flows to emerging markets had increased during the first quarter of 2002, which,
inspite of decreased overall capital flows, had allowed many governments to satisfy
substantial portions of their 2002 financing needs.

Conditions in global financial markets had deteriorated significantly August 2002,
reflecting eroding investor confidence and heightened risk aversion. A combination of
corporate earnings disappointments, increased investor pessimism and uncertainty about the earnings outlook, and further corporate accounting scandals had triggered repricings and volatility in range of markets. Higher-risk borrowers, including those in emerging markets, faced tighter terms of market access as investors had reduced their appetite for risk. In addition, portfolio rebalancing by international investors appeared to have contributed to downward pressure on the US dollar and US asset prices.

In March 2003, it was observed that the global financial system had remained resilient, despite significant geopolitical uncertainties and a hesitant and uneven global economic recovery. Markets continued to work off the excesses of the equity asset price bubble, and the bursting of the bubble had revealed underlying structural weaknesses, which required carefully crafted policy responses.

In an unsettled international environment, consumers, businesses and investors had remained on the sidelines. It was felt that this uncertainty could persist for some time. In this difficult environment, policies to improve market confidence on a sustained basis would remain of critical importance. The IMF, therefore, underlined its endorsement of continued supportive macroeconomic policies and wide-ranging measures in the structural area to address underlying market vulnerabilities.

Emerging Markets

An unsupportive external environment, together with investor concerns over the risk of policy discontinuity in key emerging market borrowers, had limited the availability and raised the cost of capital for most emerging market borrowers throughout most of 2002. It was encouraging to note that the easing of global financial market conditions in the fourth quarter had led to a reopening of capital markets to many issuers, and that investor concerns about the direction of future policies in some major emerging market economies had abated. However, this recent development should be seen against the backdrop of the longer-term decline in capital flows to emerging market borrowers, which deserved further attention.

Recent market developments provided evidence that more discriminating investors were responding positively to the sustained pursuit of sound policies. Nevertheless, it would remain important to consolidate this encouraging development and further reduce risks of contagion. In particular, the Directors highlighted the importance of further efforts, including by the IMF, to help investors distinguish among borrowers, and of policies aimed at promoting financial stability. They welcomed the improvements in banking sector regulation and capitalization in many emerging markets. Progress had varied by region, however, and it was noted that further measures were needed to bolster domestic banking systems.

Promoting Stability

The GFSR’s primary purpose is to point to weaknesses and vulnerabilities in the global financial system so that policymakers can take steps to prevent crises. During FY 2003, the GFSR suggested a variety of policy actions, and IMF’s Directors highlighted several policy measures that, taken together, should help ward off an excessive cutback
in risk taking, rebuild investor confidence, and strengthen the markets’ self-correcting mechanisms.

In August 2002, the IMF called on financial regulators to be vigilant for signs of further weakness in key institutions and markets. It advised that in advanced countries, policies should continue to support economic activity and an orderly reduction of imbalances over the medium term. In addition, it was emphasized that there should be strong implementation and enforcement of steps to improve corporate governance, accounting, disclosure and transparency, together with close monitoring by national authorities and the IMF, which would be helpful to strengthen markets’ self-correcting forces. In emerging market countries, strong policies to bolster macroeconomic and financial stability would help investors to discriminate more clearly between countries as investment destinations. National authorities should also encourage the development of sound and diversified domestic financial systems.

In November 2002, it was emphasized that macroeconomic policies in the advanced economies should remain responsive to any signs that economic recovery might be faltering. Speedy conclusions of the Doha trade negotiations and implementation of other trade liberalization moves would improve confidence in economic prospects, and provide emerging market countries with an opportunity to increase their export earnings and, ultimately, strengthen their debt-servicing capabilities. Supervisors of non-bank financial institutions, particularly insurance companies, and in a number of cases, pension funds, should be vigilant for signs of significant capital erosion stemming from falling asset prices. Furthermore, the increased reliance of financial institutions upon credit risk transfer instruments to manage their risks warranted enhanced disclosure and regulatory scrutiny.

The continued ability of some emerging markets to tap international capital markets in the then current environment illustrated the importance of strong commitment to the continued implementation of policies aimed at maintaining macroeconomic and financial stability and strengthening institutional frameworks. More generally, it was stressed that firm commitment to the preservation of property rights, the rule of law, transparency, and stability in the legal and regulatory frameworks were key to fostering investor confidence and building a stable investor base.

In March 2003, the IMF saw a continued need for strong confidence-building measures. In the structural area, it highlighted the need for legal and regulatory frameworks to support corporate and financial sector restructuring. It was observed that the ‘feast or famine’ dynamic in emerging market financing and persistent credit tiering underscored the need for the consistent implementation of sound macroeconomic policies. In addition, the IMF also encouraged continued measures to deepen local securities markets, which could help provide a buffer against changing global financial conditions.

4.8 IMF’S GLOBAL SURVEILLANCE - 2004

During FY 2004, the IMF’s Board of Directors discussed the World Economic Outlook in August, 2003 and again in March 2004.
In August 2003 discussions, 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 for a gradual, albeit moderate, recovery. Given this environment, the Directors 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 being 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.

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

The nascent recovery apparent in mid-2003 had begun to spread by the time of the IMF Board’s second meeting in March 2004. It welcomed the strengthening and broadening of the global economic recovery, noting especially rapid upturns in the US and emerging Asia; a sharp pickup in industrial production and global grade; strengthened business and consumer confidence; and positive investment growth in most regions. A broad-based rally in financial markets, including a rise in equity prices, a further drop in bond spreads, and a rebound in private financing flows to emerging markets, supported the recovery. Although growth had picked up and oil and commodity prices had moved up, worldwide inflation remained subdued, a reflection of continued excess capacity, still-weak labour markets, and competitive pricing in both domestic and global markets.

Against the backdrop of the 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 manoeuvre to respond to possible future shocks. Managing the transition to a 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 the expectations, and that rate increases, when they actually 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 called on the 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 a 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 towards 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 also called for a timely resumption and successful conclusion of multilateral trade negotiations under the Doha Round.

It was emphasized that the relatively benign economic outlook provided an advantageous window of opportunity to address vulnerabilities. In particular, efforts to restore sustainable medium-term fiscal positions would be pursued vigorously. In most industrial counties, these would need to involve, in addition to timely fiscal consolidation, credible and high-quality measures to reform pension and health care systems. In addition, for emerging market and other developing countries, the priority should be to address remaining public debt sustainability concerns through tax reforms to reduce revenue volatility, steps to strengthen fiscal institutions, and measures to improve the structure of debt.

Emerging Market and other Developing Countries

Turning to emerging market and other developing countries, the IMF welcomed the recovery, which had been aided by improved fundamentals, strong private capital inflows, and historically low spreads. GDP growth was expected to strengthen in most regions, although the outlook, particularly in countries where public debt remained high, could be affected by a deterioration in external financing conditions, for example, as a result of an abrupt or unexpected increase in interest rates. It was also acknowledged that in addition to abundant liquidity in global financial markets, the decline in emerging market bond spreads also reflected the considerable progress being made by many countries in strengthening their fundamentals and improving the structure of public debt.

The IMF highlighted the exceptionally strong growth in emerging Asia, which was underpinned by accommodative macroeconomic policies, growing domestic demand, competitive exchange rates, and the recovery in the information technology sector. With growth accelerating and some financial imbalances emerging, many counties in the region would need to gradually tighten macroeconomic policies in 2004-05. In a number of countries, accelerated fiscal consolidation may be warranted, along with strengthened prudential oversight of the banking system to ensure that lenders appropriately evaluate and manage risks. Also, the importance of continued further efforts by all countries to increase the flexibility of their economies to foster the mobility of resources among sectors was underscored.

Credit booms in emerging market economies, particularly the risk that such booms may presage sharp economic downturns and financial crises, were also examined by the
IMF. Credit booms are difficult to foresee, and authorities need to remain vigilant, especially in situations where rapid credit growth is accompanied by other signs of macroeconomic imbalance, such as current account deficits, investment booms and increases in the relative prices of non-tradeable. Containment of credit booms usually requires strengthened surveillance of the banking system and close scrutiny of corporate borrowings during periods of rapid growth.

Global Financial Stability Reports - August 2003 and March 2004

During FY 2004, the IMF discussed two GFSRs - one in August 2003 and another in March 2004.

In August 2004, it was noted that the financial markets had remained resilient during the first half of 2003, notwithstanding continued lackluster economic growth, geopolitical uncertainties and high market volatility. However, some concerns remained, associated with risks related to the macroeconomic outlook, rising long-term bond yields, the potential for weak corporate earnings, and the vulnerability of emerging bond markets to a correction. Several policy implications of market developments were noted. The IMF urged authorities in major financial centers to persist in reforms to shore up market foundations, including strengthening corporate governance to restore investor confidence; bolstering the regulation and supervision of insurance companies; and improving the accounting practices and regulation of defined-benefit pension funds.

Although the external financing climate for emerging market countries improved somewhat in 2003, the IMF cautioned that public sector debt in these countries remained high and that there was no room for complacency by borrowers. They urged countries to take advantage of enhanced access to international capital markets to press ahead with the implementation of sound policies and improve the structure of their liabilities, including extending maturities and reducing the dependence on dollar-linked debt. Directors noted that several countries had undertaken successful liability-management operations.

The discussion on the volatility of capital flows to emerging markets was welcomed and it was agreed that foreign direct investment should be encouraged. However, it was pointed out that, while capital flows were inevitably somewhat volatile, sound economic policies and transparency could help countries make flows more stable. There was also much that emerging market countries could do to “self-insure” against the effects of volatility, including managing assets and liabilities; adapting exchange rate arrangements to the degree of capital account openness; strengthening domestic financial. It was noted that developing efficient and stable local sources of finance had become all the more relevant since emerging markets as a group had become net exporters of capital in recent years. The implications of increased holdings of international reserves by some countries were also discussed.

Financial market conditions had strengthened by the time of the Executive Board’s GFSR discussion in March 2004, and the prospects for global financial stability appeared brighter. It was noted that the improved outlook was supported by a firming of the global economic recovery, rising corporate earnings, and a strengthening of corporate
balance sheets. Emerging market borrowers, many of which had taken steps to put their public finances on a sounder footing and improved the structure of their domestic and external debt, were benefiting from higher export demand and commodity prices.

Global Financial Market Surveillance

In response to this improved outlook and the exceptionally low short-term interest rates, the global financial markets had staged a strong, broad-based rally in 2003. While low short-term interest rates were continuing to influence investor behavior and were, in some cases, encouraging increased risk-taking in search for yield, most mature and emerging market indices appeared to be pointing to a period of consolidation, with investors showing renewed caution and increased discrimination.

The improved outlook for financial stability was not without risks, the IMF emphasized, noting that risks would require vigilant monitoring, not least because of their interconnected nature. A first set of risks stemmed from the environment of prolonged low interest rates and abundant liquidity. In this environment, asset valuations may be pushed beyond levels justified by fundamental improvements, eventually necessitating a transition to higher interest rates in mature markets. Such an outcome may have broader ramifications, including increased bond market volatility if investors were to revise their interest rate outlook abruptly, as they did during the 1994 sell-off in global fixed-income markets, or if asset valuations that were predicated on an unusually low level of risk-free rates were corrected abruptly. To guard against these risks, policymakers were encouraged to develop timely and forward-looking communication strategies that encourage investors to base their decisions on fundamentals rather than on the expectation that interest rates will be kept indefinitely at very low levels. In fact, the potential effects of higher interest rates on emerging market economies were being mitigated owing to the progress that many of them had made in reducing vulnerabilities, while stronger world growth would also help offset the impact of higher interest rates.

The potential for market instability arising from large global external imbalances, including the possibility that adverse developments in the currency markets might spill over into other asset markets, was also discussed. The depreciation of the US dollar against other major currencies had so far been orderly. It was mostly considered that, in view of the substantial capital flows that the US economy would continue to need to attract, the risk of a pronounced currency depreciation, possibly resulting in higher US dollar interest rates and a correction in asset valuations. A strong and sustained cooperative effort, aimed at ensuring a smooth adjustment of global imbalances over the medium term, would remain a key policy priority for the international community.

Turning to the improved external financing environment for emerging market borrowers, it was observed that the improved credit quality of many emerging market borrowers and low interest rates in the major financial centers contributed to the impressive compression of spreads on emerging market bonds in 2003. The IMF commended many emerging markets for steps taken in the current favorable market environment to meet a substantial part of their borrowing needs, improve their debt structures, and extend maturities.
Institutional Investors in Emerging Markets

As to the institutional investor base for claims on emerging markets, the IMF saw the development of a stable investor base as a key element in reducing the volatility of capital flows to emerging markets. While ongoing changes had been contributing to a welcome broadening and diversification of the investor base, the decline in dedicated, relative to crossover, investors may also have increased the volatility of capital flows. Another source of potential volatility arose from the impact that even small changes in the portfolio positions of institutional investors could have on emerging markets, given the large size of the assets under the management of these investors. It was agreed that the factors influencing the changing nature of the investor base as well as its policy implications, including debt-management policies and practices in emerging markets, would require continued careful analysis. The IMF emphasized the importance of adequate transparency and disclosure regarding both government policies and corporate developments, with investor relations programmes being a particularly useful instrument.

In addition, it was noted that the development of an efficient market infrastructure in emerging economies would be helpful in attracting institutional investors from both mature and domestic markets. The IMF also commented on the supervisory and regulatory implications of the expanding portfolios of non-bank institutional investors in emerging markets, in particular the rapid growth of pension funds. In view of the growing imbalance between the assets under the management of these funds and the available securities, close coordination would be required between changes in the regulatory framework, the development of local capital markets, and the gradual easing of limits on foreign investment by pension funds to increase their opportunities for portfolio diversification. The IMF viewed the development of local securities markets as key to ensuring proper risk management by the insurance industry. In view of the rapid growth and increasing sophistication of the activities of local institutional investors involved in both local and international markets, it was observed that it would also be important to persevere with strong efforts to enhance the risk-management skills of both investors and regulators.

4.9 IMF’S GLOBAL SURVEILLANCE - FY 2005

During FY 2005, the IMF’s Board of Directors discussed the Global Financial Stability Reports in August 2004 and again in March 2005.

In September 2004 discussions, the Directors welcomed the strengthening of global financial stability and of key financial intermediaries. The combination of broadening global economic growth and low inflation expectations had created a favourable environment for financial markets. Strong economic growth had boosted corporate and banking sector earnings, facilitated further balance sheet strengthening, and improved credit quality. At the same time, subdued inflationary pressure had contributed to stability and relatively low yields in the major bond markets. This had also benefitted emerging markets, boosting their growth prospects and credit quality and facilitating the availability of external financing at relatively low cost.

Nonetheless, a number of important risks to the outlook were cited:
• An unanticipated increase in inflation could transform the market’s assumptions about the likely pace of tightening and result in market turbulence;

• There was potential for market instability arising from the continued large global external imbalances;

• Emerging market countries could be exposed to future external shocks. These countries should use the favourable financing environment to increase their resilience and press ahead with growth-enhancing structural reforms. Measures to reduce public debt to manageable levels and to improve the structure of public debt remained key priorities for many emerging markets.

Emerging Market Countries

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

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

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

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

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

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

To enhance global financial stability and mitigate potential risks, the IMF’s Directors considered a number of steps; in particular, the need for cooperative efforts and credible policy measures to enhance the market’s confidence that global imbalances would be reduced in an orderly manner. At a microeconomic level, supervisors and regulators had to be vigilant to the risk profile of financial intermediaries and their exposure to abrupt market price shocks. Emerging market country authorities should continue to adopt prudent macroeconomic policies that reduce financing needs, while taking advantage of the prevailing benign conditions to fulfill their external financing requirements, improve the structure of their debt, and press ahead with efforts to develop local financial markets. In addition, structural reforms to enhance growth prospects remained a critical avenue for reducing debt-to-GDP ratios to more manageable levels.

4.10 IMF’S GLOBAL SURVEILLANCE - FY 2006

During FY 2006, the IMF’s Board of Directors discussed the Global Financial Stability Reports in August 2005 and again in April 2006.

Global Financial Stability Report - August 2005

It was observed that the configuration of solid growth, low inflation, low bond yields, flat yield curves, and tight credit spreads were contributing to the resilience of
the global financial system. Furthermore, the much-improved balance sheets of the sovereign, corporate and household sectors, together with structural changes such as the growing importance and diversity of institutional investors, were providing an important cushion to financial markets. However, although near-term risk had been reduced, potential vulnerabilities, mainly in the form of larger global imbalances and higher debt levels, had been stored up for the medium term.

Long-term interest rates in mature markets remained low for a number of reasons, including low levels of investment resulting in excess global savings, a reduction in inflation risk premiums because of greater central bank credibility, reserve accumulation by Asian central banks, and an ongoing shift in institutional investor portfolio preferences from equities to bonds. The search for yield remained a dominant theme in financial markets.

Emerging financial markets had become increasingly resilient, but it was cautioned that the positive global economic environment might be masking underlying vulnerabilities in some countries. The IMF’s Board took note of the ongoing broadening of the investor base for emerging markets and the extension of investor interest into local instruments. The Board also welcomed improvements in the balance sheets of key sectors in mature market economies. Indicators of market and credit risk and financial strength underscored the resilience of the banking and insurance sectors in both mature and emerging markets.

**Corporate bond markets in emerging market countries**

Since a number of emerging market countries had achieved macroeconomic stability, the time might be right for the development of corporate bond markets. The IMF’s Board called for continued efforts by emerging markets to facilitate the growth of institutional investors and noted that small and medium-sized corporations should adopt high standards of transparency and corporate governance. It was stressed that, for the effective functioning of securities markets, the authorities should adopt a regulatory framework ensuring investor protection and market integrity and containing systemic risks. Emerging market countries should also reduce the approved time for, and cost of, issuance.

The Directors stressed the importance of a well-developed secondary market in improving price discovery and liquidity while acknowledging that only a few industrial countries were able to achieve this goal. They also noted the complementary role of the development of a government bond market. Regional cooperation could help promote development of bond markets for countries lacking the minimum efficient scale for a deep and liquid bond market.

**Global Financial Stability Report - April 2006**

The IMF’s Executive Board welcomed the continued resilience of the international financial system. It considered that financial conditions would likely remain benign, with continued growth, contained inflation, and stable inflationary expectations. Although the global system faced a number of challenges; in particular, rising interest rates and a turn in the credit cycle for both the corporate and the household sectors, it was mostly
considered that financial markets should be able to deal well with the expected cyclical risks. It was, however, cautioned that medium-term risks to financial stability might have increased somewhat in the face of growing global imbalances, higher household debt, and possible underpricing of risk in certain asset classes. The IMF, therefore, urged national authorities to pursue macroeconomic policies aiming for solid and well-balanced growth while strengthening supervisory and regulatory oversight.

Although the turn in the corporate credit cycle increased the chances that idiosyncratic risks could lead to a widening of credit spreads for specific firms, overall corporate sector balance sheets remained healthy. Moderate changes in the broad corporate spreads should enable self-correcting forces to operate.

Despite the rise in US policy rates, spreads for emerging market external bonds were at record low levels, underpinned by fundamental improvements such as current account surpluses, strong capital inflows, strengthened debt structures and large reserve cushions, in addition to strong macroeconomic policies and performance. Although emerging markets were likely be tested by less favourable external conditions as liquidity conditions tighten, they would probably continue to be resilient.

It was noted that a disorderly unwinding of global imbalances posed a risk for financial stability. So far, structural and cyclical factors have allowed financial markets to intermediate smoothly between surplus and deficit countries. Looking ahead, it was remarked that the prospect of a smooth adjustment in the pattern of accumulation of US dollar assets will be facilitated by the willingness of key countries to take cooperative policy measures aimed at reducing global imbalances over the medium term.

While cyclical changes could well expose weaker segments and pockets of financial markets, it was considered that these were unlikely to pose systemic risks. The market regulators were mostly urged to pursue a ‘no-bail-out’ policy to contain risks of investor complacency. Broadly, regulators should place greater reliance on self-correcting forces of financial markets, while focusing attention on ensuring robust market infrastructure, particularly for credit derivative markets. In particular, it was emphasized that financial regulators should require rigorous risk-management practices. The regulators were also urged to provide guidance on the content of business continuity plans to address possible vulnerabilities related to even risks, such as an avian flu pandemic.

4.11 IMF’s Global Surveillance - FY 2007

During FY 2007, the IMF’s Board of Directors discussed the Global Financial Stability Reports in August 2006 and again in March 2007.

In their August 2006 meeting, the IMF’s Executive Board welcomed the continued strong, broad-based expansion of the global economy during the calendar year 2006, nothing that activity in most regions met or exceeded expectations. It was believed that the global expansion would slow only modestly in 2007 and 2008 and that inflationary pressures would remain contained. It was generally viewed that the market turbulences in February and March 2007 represented a correction after a period of asset price buoyancy that did not require a fundamental revision in the positive global economic
In March 2007, it was agreed that global financial and macroeconomic stability continued to be underpinned by solid economic prospects, although downside risks had increased somewhat in a few areas. A number of market developments warranted increased attention, reflecting a shift in underlying financial risks and conditions since the discussions on the previous GFSR in August 2006.

While none of the identified short-term risks constituted a threat to financial and macroeconomic stability, adverse events in one area could lead to a reappraisal of risks in other areas, with possible broader implications for the economy. The market turbulence of February and March 2007 validated this assessment and served to remind market participants that such revaluations could occur quite rapidly. Macroeconomic risks as well as risks faced by emerging markets had eased marginally since the previous GFSR, but the market and credit risks had risen, albeit from relatively low levels, and large capital inflows to a number of emerging market countries posed challenges to policymakers. The risk of a disorderly unwinding of global imbalances had also eased somewhat but remained a concern.

Hedge funds were playing a constructive role in improving market efficiency and stability, but the IMF’s Board cautioned that their size and complex risk structure could lead to increased transmission or amplification of shocks. While observing that the increased diversity of assets, source countries, and investor types contributed to a globalized financial system that, by allowing capital to flow freely, should enable a more effective diversification of risks, enhance the efficiency of capital markets, and support financial and macroeconomic stability, the Board underscored the importance of gradual and carefully sequenced liberalization of financial markets. They welcomed the GFSR’s contribution to financial sector surveillance in encouraging national legal, regulatory, and supervisory systems to adjust to the more globalized financial environment.

The Board also favoured improved mechanisms for multilateral collaboration, specially for strengthening supervisory coordination, including through better application of well-established international standards and further work on crisis management and resolution arrangements.

Commodity Prices

Because fluctuations in both oil and non-fuel commodity prices have important policy implications, the IMF has been increasing its coverage of these markets in multilateral surveillance. It has consistently advised oil-importing countries, for example, on the importance of market-based pricing, that is, putting an end to subsidies and allowing the pass-through of oil prices to consumers. The IMF’s Board recognized the possibility that inflationary pressures could revive as resource utilization constraints start to bind. It was also observed that sharply rising prices of non-fuel commodities, particularly metals, had underpinned strong growth in many emerging market and developing countries and advised these countries to invest current revenue windfalls to support future growth in non-commodity sectors. The Board also stressed the risk of a reversal of the recent decline in oil prices given continuing geopolitical tensions and limited spare production outlook.
As seen earlier, the IMF is mandated to oversee the international monetary system and monitor the economic and financial policies of its 186 member countries. The purpose is mainly to ensure as smooth working of the system as possible. This responsibility of the IMF is known as ‘surveillance’.

During the process of surveillance, the IMF keeps a tight watch on each member country’s economy and the world economy. The IMF, through surveillance, highlights possible risks to the domestic and the external stability and proffers advice on the needed policy adjustments. The IMF, therefore, helps the international monetary system to serve its essential purpose of facilitating the exchange of goods, services and capital among countries, thereby sustaining a sound economic growth.

Over the years, the IMF surveillance has become increasingly important and transparent. Most of the member countries now publish a ‘Public Information Notice’, which represents in summary form the views of the IMF staff and the Executive Board. In fact, most this work is also published by the IMF.

The IMF plays an important role through reviews of global and regional economic trends under surveillance. Its important instruments of global surveillance are the two publications - the World Economic Outlook (WEO) and the Global Financial Stability Report (GFSR). The WEO provides a detailed analysis of the state of the world economy, e.g. present global financial turmoil. The GFSR provides an up-to-date assessment of the global financial markets and prospects and also highlights imbalances and vulnerabilities that could pose risks to the financial market stability.

As part of its surveillance activity, the IMF also publishes Regional Economic Outlook Reports, providing detailed analyses of the major regions of the world, which have helped in disseminating important information and in deciding policy prescriptions by member countries.