



THE UK AND THE IMF 2005

Meeting the challenges of globalisation for all



HM TREASURY



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March 2006

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HM Treasury contacts

Comments on the coverage or presentation of this report should be sent to:

Ian Noon
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ
E-mail: ian.noon@hm-treasury.x.gsi.gov.uk

For enquiries about the Treasury and its work, contact:

Treasury Public Enquiry Unit:
Tel: 020 7270 4558
Fax: 020 7270 4574
E-mail: public.enquiries@hm-treasury.gov.uk

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FOREWORD BY CHANCELLOR OF THE EXCHEQUER

In 2005, the UK held the presidencies of the G7 and G8 and of the European Union; and used this opportunity to drive forward an ambitious international agenda including poverty reduction, and reforms to strengthen and modernise the international economic system. Important progress was made in 2005:

- a major initiative delivering 100% multilateral debt relief for the 38 HIPC countries, with 19 countries now benefiting from debt relief worth around \$3.3 billion; and separate debt relief arrangements for Nigeria;
- new commitments by the G8 to a doubling of aid for Africa; and
- the creation of two new instruments at the IMF: the Exogenous Shocks Facility to channel fast-disbursing resources to poor countries suffering the effects of shocks and disasters; and the Policy Support Instrument for countries seeking an explicit IMF endorsement of their policies, but which are not seeking financing from the IMF.

In 2005, we have taken the first steps to make poverty history, and now we must ensure 2005 is remembered not as a one-off, but as the beginning of step change in international development. As we start 2006, preventable diseases such as malaria and tuberculosis still kill 7 million children a year, and in South Africa half of all 15-year-olds are expected to die from Aids. By frontloading aid and investing an extra \$4bn in vaccinations now, the path-breaking International Finance Facility for Immunisation could save 5 million lives by 2015.

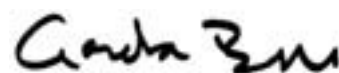
In 2006, we will be judged not just on willing the Millennium Development Goals but on delivering the resources and agreements to achieve them, with deepened support for health and education, and critically on trade we must achieve a comprehensive deal to conclude the Doha round.

Global growth has continued to strengthen, in spite of sustained rises in oil prices; with Asia and the US maintaining their strong growth and signs of improvement in Japan and Europe. However, the persistence of global imbalances may undermine prospects for sustained growth in the medium-term.

Stronger IMF surveillance will be critical to resolving the current imbalances and maintaining global economic stability in the medium-term. Discussions are underway on changes to IMF surveillance but deeper changes are needed to support the IMF in delivering the most objective, credible and persuasive advice to governments. In the UK, making the Bank of England independent was a key foundation for our economic stability; and we will call for the IMF to become independent of governments in the same way.

Preparing for the long-term economic challenges will require sustained effort at the IMF and by countries. The IMF's strategic review is an opportunity to engage with the challenges of the global economy looking forward and the UK will use it to pursue reforms which will build stronger global economic cooperation and a more effective institution.

I am pleased to publish this seventh annual report to Parliament and the public on the UK and the IMF.



Rt Hon Gordon Brown MP
Chancellor of the Exchequer

REPRESENTING THE UK IN THE IMF



RT HON. GORDON BROWN
Chancellor of the Exchequer UK
Governor of the IMF
Chairman of the IMFC



MERVYN KING
Governor of the Bank of England
Alternate UK Governor
UK representative on the IMFC



JON CUNLIFFE
Managing Director
Macroeconomic Policy and International Finance, HM Treasury
Chairman of the IMFC Deputies



STEPHEN PICKFORD
Director International Finance, HM Treasury
UK representative on the IMFC Deputies



RACHEL LOMAX
Deputy Governor of the Bank of the England
UK representative on the IMFC Deputies



TOM SCHOLAR
UK Executive Director

The Board of Governors of the IMF, on which all member countries are represented, is the highest authority governing the IMF. The Chancellor of the Exchequer is the UK's Governor. He is also Chairman of the International Monetary and Financial Committee (IMFC), the main committee of the Board of Governors and the main forum for discussing IMF policies at the Ministerial level. The Governor of the Bank of England is the UK's Alternate Governor of the IMF and represents the UK at the IMFC.

The day-to-day work of the IMF is conducted by the Executive Board of the IMF. The Board comprises 24 Executive Directors representing all 184 members of the IMF. The UK, as one of the five largest contributors to the IMF, has its own Executive Director - currently Tom Scholar.

The Treasury coordinates UK policy advice on IMF issues and the UK's operational interests at the Fund, working closely with the Bank of England, the Department for International Development, the Foreign and Commonwealth Office, the Financial Services Authority and other Government departments and agencies. Within the Treasury, the Macroeconomic Policy and International Finance Directorate is specifically responsible for preparing advice on the policy issues and specific country programmes that are brought before the Executive Board.

THE 2005 PRESIDENCIES

1.1 2005 marked a milestone year for both the UK and the IMF. In a year when the UK held the presidencies of both the G7 and G8 as well as the European Union, there was a unique opportunity to drive forward UK priorities in a number of key areas including poverty reduction, structural reform, trade, and climate change. And for the IMF, with 60 years having now passed since the founding of the institution at Bretton Woods in New Hampshire, 2005 was a year to reflect on the future strategy of the Fund. This report takes looks back at how UK international priorities have been pursued and met at the IMF in this year and outlines further work to be undertaken in 2006.

The Presidencies

The G8 is a forum of the Heads of State of the world's major industrial economies. It is made up of the United States, the UK, Germany, France, Italy, Canada, Japan, Russia and the European Union. The Presidency rotates annually between the members and passes to Russia in 2006 and Germany in 2007. In 2005, the G8 Summit was held in Gleneagles between 6 and 8 July. G8 Finance Ministers meet in advance of the summit to prepare financial issues.

The G7 is a Finance Ministers led process. The G7 normally meets three times a year including at the time of the IMF/World Bank Spring and Annual Meetings. In 2005, unusually, Finance Ministers met four times.

The Presidency of the EU rotates on a 6 monthly basis between all 25 member states. The UK held the Presidency in the second half of 2005.

1.2 The Presidencies, combined with the Chancellor's continued chairmanship of the International Monetary and Financial Committee (IMFC), provided the UK with a particularly important opportunity to play a leadership role on the international agenda during 2005. In addition, as one of the largest members of the IMF, the UK continues to hold a single seat at the IMF Executive Board where ongoing oversight of IMF work is conducted.

1.3 The UK works in these fora in a number of areas to ensure that the benefits of globalisation are shared by all. A key achievement in 2005 was the agreement for 100% multilateral debt relief for many of the poorest countries in the world. Chapter two of this report discusses this achievement in further detail whilst also looking at how the UK has worked with the IMF to fight global poverty and advance the development of low income countries.

1.4 A further key achievement was the endorsement by IMF shareholders of a new medium-term strategy for the institution that will provide focus and direction to the IMF in a rapidly changing global economy. Chapter three focuses on measures to help countries meet the challenges of globalisation through IMF work in surveillance, crisis prevention and resolution and measures to build institutions and capacity. Chapter four focuses on the changes needed within the IMF as an institution, in terms of budgetary frameworks, organisation, quotas and finances, to meet the challenges of the 21st century.

1.5 Important progress has been made in a number of areas during 2005. However, further work remains to achieve UK priorities and to ensure that the IMF can continue to help all countries meet the challenges of globalisation. Chapter 5 concludes the report by outlining the UK priorities for 2006.

2

FIGHTING GLOBAL POVERTY

2.1 NGOs, individuals, church groups and other local organisations came together to demonstrate an unprecedented level of support to fight global poverty in 2005. The UN's Millennium Review Summit further galvanised support for international action to fight poverty in developing countries. International poverty reduction was central to the UK's 2005 Presidencies of the EU and G7/G8 and this chapter sets out the substantial achievements made in debt relief and aid, progress on innovative financing mechanisms, developments in the trade agenda and the changing role of the IMF in low income countries including the creation of two new instruments aimed at assisting low income countries.

2.2 Close collaboration between the IMF and the World Bank has contributed to the progress made during 2005, a year in which the Presidency of the World Bank passed from James Wolfensohn to Paul Wolfowitz. The UK pays tribute to Wolfensohn's contribution and welcomes Wolfowitz to his new role. HM Treasury will continue to work with the Department for International Development, the lead UK department for relations with the World Bank, to coordinate efforts to tackle global poverty in both the IMF and the World Bank.

THE MILLENNIUM DEVELOPMENT GOALS (MDGs)

2.3 At the United Nations Millennium Summit in September 2000, all UN member states and every major international body, including the IMF, committed to meeting the Millennium Development Goals by 2015.

The Millennium Development Goals (MDGs)

The IMF will continue to align its programmes in low-income countries with broader efforts to reach the MDGs by 2015. The goals are to:

- eradicate extreme poverty and hunger: cut by half the proportion of people living on less than a dollar a day and those who suffer from hunger;
- achieve universal primary education: ensure that all boys and girls complete a full course of primary schooling;
- promote gender equality and empower women: eliminate gender disparity in primary and secondary education - preferably by 2005, and at all levels by 2015;
- reduce child mortality: reduce by two-thirds the mortality rate among children under the age of five;
- improve maternal health: reduce by three-quarters the maternal mortality rate;
- combat HIV/AIDS, malaria and other diseases: halt and begin to reverse the spread of HIV/AIDS; halt and begin to reverse the incidence of malaria and other major diseases;
- ensure environmental sustainability: integrate the principles of sustainable development into country policies and programmes; reverse the loss of environmental resources; reduce by half the proportion of people without sustainable access to safe drinking water; achieve significant improvement in the lives of at least 100 million slum dwellers by 2020; and
- develop a global partnership for development: develop further an open trading and financial system that is rule-based, predictable and non-discriminatory (includes a commitment to good governance, development and poverty reduction - nationally and internationally).

2.4 The MDGs provide the high-level framework through which international efforts are channelled towards poverty reduction. Progress towards the goals is primarily driven by poor countries themselves, including efforts to improve governance and tackle corruption. But crucially it also depends on the actions of the broader international community – to increase and improve aid, relieve countries from unsustainable debt built up in the past, and to reform global trade so that poor countries can participate and benefit more. The MDGs establish benchmarks for measuring progress and help to orientate the development programmes of donor countries and the multilateral institutions – including the IMF. It is already likely that, without a very substantial acceleration of efforts, many of the goals will be missed in Africa.

The Commission for Africa

The Commission for Africa was established in February 2004 to determine which policies have brought countries closer to achieving the MDGs and where more can be done to support Africa's development. The Commission was composed of 17 commissioners, mainly from developing countries, and included the UK Prime Minister, Chancellor and Secretary of State for International Development. The final report was published in March 2005 and sets out a comprehensive, bold and concerted plan of action to meet the Commission's goal of a strong and prosperous Africa. The report includes recommendations on governance and capacity building; peace and security; investing in people; growth and poverty reduction; trade; aid and debt relief. The UK has accepted the Report's recommendations in full.

DEBT RELIEF

Multilateral debt relief initiative (MDRI)

2.5 The UK believes that no poor countries should have to choose between servicing their debt obligations and making the investments in health, education and infrastructure necessary to meet the MDGs. The Government has been at the forefront of international efforts to cancel the debts of the most heavily indebted poor countries (HIPCs). This culminated in securing the G8 agreement in June 2005 for 100% cancellation of the debts owed by the HIPCs to the IMF, World Bank, and African Development Bank. The Government welcomes the speed with which the IMF has moved to implement the Multilateral Debt Relief Initiative (MDRI).

2.6 The MDRI was first agreed by G8 Finance Ministers in London in June 2005. The proposal to complete the process of debt relief for the HIPCs by providing 100 per cent stock cancellation on debts owed to the IMF and the concessional financing arms of the World Bank and African Development Bank (the International Development Association (IDA) and the African Development Fund (AfDF)) was endorsed by heads of state and government at Gleneagles on 8 July 2005. Significant progress has been made since then. Following endorsement for implementation of the MDRI at the Annual Meetings of the World Bank and IMF in September 2005, the IMF moved quickly to implement the initiative. In December 2005, the IMF Board approved 19¹ countries for debt relief under the MDRI and, following approval by the Board of Governors, this debt relief came into effect in January 2006. 19 countries are now benefiting from debt relief worth around \$3.3 billion. This figure will rise as more countries come through the HIPC process and qualify for the MDRI. Work continues at the World Bank and African Development Bank towards implementation of the MDRI in the first half of 2006.

2.7 Through the MDRI, HIPCs will receive irrevocable cancellation of 100 per cent of debt stock owed to these IFIs. This relief matches the 100 per cent debt relief which the UK and some other creditors provide on their bilateral loans to these countries. When the MDRI is implemented in both IDA and the AfDF alongside the IMF, up to 18 HIPCs initially will be benefiting from debt relief worth around \$35 billion, and this number will rise as more countries progress through the HIPC Initiative, with US\$50 billion provided for the 38 HIPC countries in total.

¹ Benin, Bolivia, Burkina Faso, Ethiopia, Ghana, Guyana, Honduras, Madagascar, Mali, Mozambique, Nicaragua, Niger, Rwanda, Senegal, Tanzania, Uganda, Zambia. A further two countries - Cambodia and Tajikistan - were also able to benefit from debt relief by the IMF. Further information can be found at: <http://www.imf.org/external/np/exr/facts/mdri.htm>

2.8 The MDRI will provide additional development resources to support countries' efforts to reach the MDGs, while ensuring that the financing capacity of the IFIs is not reduced. For the IMF, debt relief is being funded through the use of a combination of available internal resources which will not impact on PRGF lending going forward. In addition, the G8 have already committed to provide SDR 100 million² to the PRGF, and the UK has committed £50 million to the new Exogenous Shocks Facility established in the PRGF as part of the MDRI package. The financing capacity of IDA and the AfDF will also not be affected by the implementation of the MDRI, as donors will provide additional contributions to IDA and the AfDF to offset the foregone repayments of the cancelled debt. These additional donor contributions will be allocated to all IDA and AfDF recipients based on the existing IDA and AfDF performance-based allocation systems. Allocating additional resources in this way will assist recipients' efforts to achieve the MDGs while ensuring that assistance is based on country performance and that all resources are used for poverty reduction.

2.9 The UK attaches great importance to all of the poorest countries having access to the finance necessary to achieve the MDGs, including those countries not deemed eligible under the HIPC initiative. Therefore in addition to the G8 debt cancellation proposal, the UK will continue to pay its share of the debt service owed to the World Bank and African Development Bank by other low-income countries which meet criteria for ensuring that the debt service savings are used for poverty-reduction. Countries eligible for the UK's initiative will be those low-income countries accessing only concessional lending from the World Bank, and which have strong public financial management.

Heavily indebted poor countries initiative

2.10 The UK remains committed to the full financing and implementation of the Heavily Indebted Poor Countries (HIPC) initiative. The HIPC initiative was launched in 1996 with the aim of ensuring that no poor countries face unmanageable debt burdens. It was further enhanced in 1999 to provide broader, deeper and faster debt relief. The initiative involves the international financial community, including multilateral organisations and governments, taking coordinated action to reduce the external debt burdens of the most heavily indebted poor countries to sustainable levels³. Since the implementation of the initiative began, over \$70 billion in debt service relief has been committed.

2.11 The UK has provided commitments of around £2.4 billion of debt relief to eligible countries, and has pledged an additional £474 million through multilateral institutions to further support the initiative. The UK has also committed to going further by providing 100 per cent relief for eligible HIPCs when they reach Completion Point.

² Special Drawing Rights (SDR) are an international reserve asset which serves as the unit of account at the IMF. Its value is based on a basket of four key international currencies. Its value in December 2005 was equal to \$1.44.

³ Further details on how the HIPC initiative works can be found on the IMF website at: <http://www.imf.org/external/np/exr/facts/hipc.htm>

2.12 In 2005, Honduras, Rwanda and Zambia reached Completion Point under the Enhanced HIPC initiative, and Burundi passed its Decision Point. This brings to 18 the number of countries that have received debt relief on an irrevocable basis, and a further 10 countries who, having passed the Decision Point under the HIPC initiative, are receiving debt relief on an interim basis. In total, for those 28 countries, 24 of which are in Africa, \$38 billion (in Net Present Value terms) worth of debt relief savings will be made. In September 2004, an extension of the HIPC initiative for two years was agreed so that countries satisfying enhanced HIPC initiative income and indebtedness criteria using end-2004 data, would qualify for the HIPC initiative. A final list of countries qualifying under the sunset clause is expected to be released in early 2006.

Debt sustainability framework

2.13 The primary responsibility for determining debt policies lies with each country. The IMF and World Bank have a role to ensure that overall donor assistance is provided in a form that supports development and will not lead to the build up of unsustainable debt levels in the future. Borrowing should be in step with progress in strengthening capacity to repay, prudent debt management, and resistance to shocks.

2.14 In 2005, the IMF, working closely with the World Bank, introduced a new forward-looking Debt Sustainability Framework (DSF) aimed at avoiding future debt crises by ensuring that poor countries receive their aid in the appropriate combination of grants and concessional loans. The proposed framework is intended to inform creditors and provide guidance to low-income borrowers in designing financing strategies that will keep debt burdens at sustainable levels. The economic evidence suggests that the likelihood of unsustainable debt varies according to the strength of a country's institutions and policies. The debt sustainability framework suggests that each country's debt thresholds be set in a way that takes account of these factors. Directors of both the Fund and the Bank have endorsed a collaborative process in the preparation of debt sustainability analyses, with the objective of the IMF and the World Bank agreeing a single debt sustainability analysis (DSA), based on a clear division of labour, and in line with the mandates of the two institutions.

2.15 The UK has been a strong supporter of the work of the IMF and World Bank to refine this framework, and its implementation in a way that allows countries to access the resources they need to make progress towards the MDGs, without risking a return to unmanageable debt levels. The DSF will play a particularly important role given the implementation of the MDRI this year. Continued close collaboration between the IMF and World Bank will be needed to ensure that the framework is implemented in a manner which supports each country's development objectives. The UK looks forward to the first assessment of the DSF later in 2006.

Iraq debt relief

2.16 In 2005, the Iraqi authorities' policies under the Emergency Post Conflict Assistance (EPCA) succeeded in promoting overall macroeconomic stability despite the extremely difficult security environment. On 23 December 2005, the Executive Board of the IMF agreed a Stand-By Arrangement (SBA) for Iraq, which is designed to support the nation's economic programme over the next 15 months. The IMF arrangement, for an amount equivalent to SDR 475.4 million (about US \$685 million), is being treated as precautionary by the Iraqi authorities.

2.17 The Board's approval of the SBA triggered the second 30 per cent tranche of debt reduction from Paris Club creditors. Creditors have now cancelled a total of 60 per cent of Iraq's external debt. Under the terms of the 2004 Paris Club deal, the final 20 per cent tranche of debt reduction will be delivered once Iraq has successfully implemented three years of substantive IMF programmes.

Nigeria debt relief 2.18 On 17 October 2005, the Executive Board of the IMF approved a two-year Policy Support Instrument (PSI) for Nigeria under the IMF's newly created PSI framework. Further details of the PSI framework are contained later in this chapter. Agreement on the PSI facilitated the Paris Club debt deal on 20 October 2005 with Nigeria that will cancel approximately \$18 billion of debt. Creditors will write down the total value of Nigeria's external debt by 60%, and Nigeria will use part of its oil windfall to buy back the remaining debt to Paris Club creditors. By early 2006, Nigeria will have eliminated its \$30 billion debt to the Paris Club provided it adheres to the Paris Club deal and the path set out in its PSI. The UK will provide Nigeria with debt relief of approximately £2.9 billion. The Nigerian government will spend the savings from debt relief - starting with the \$1 billion debt service it would have paid the Paris Club next year - on programmes to accelerate progress towards the MDGs. This will enable Nigeria to make much needed investments in education, health, water and infrastructure, including employing an extra 120,000 teachers and putting 3.5 million children into school.

PROVIDING FINANCE FOR GROWTH AND POVERTY REDUCTION

Aid 2.19 During the course of the UK's Presidency of the G7 and G8, progress was made on aid for developing countries. The commitments of the G8 and others will lead to an increase of US \$25 billion a year to Africa by 2010, more than doubling aid to Africa, compared to 2004. The OECD Development Assistance Committee estimates that official development assistance (ODA) from the G7 and other donors will increase by around \$50 billion a year in total by 2010, compared to 2004. This built on the commitment made in May 2005 by the European Union (EU) to double overseas aid over the next five years – a commitment that will mean an increase in EU aid from around US \$40 billion today to over US \$80 billion in 2010. This is an increase in global aid from \$79 billion in 2004 to \$129 billion by 2010.

2.20 The UK Government had already planned to increase ODA to nearly £6.5 billion in 2007/08. This is equal to 0.47 per cent of Gross National Income (GNI) and represents a real terms increase in UK ODA of 140 per cent since 1997. The UK signed up to the 2005 EU agreement to provide an average of 0.56% ODA/GNI in 2010, with a minimum floor of 0.51% ODA/GNI, and has set out a clear timetable for reaching the UN target of spending 0.7% ODA/GNI by 2013.

Innovative Financing Mechanisms 2.21 For some countries, innovative financing mechanisms will be needed to help deliver and bring forward the financing urgently required to achieve these increases in aid, as well as supporting progress towards meeting the target for donors to provide ODA of 0.7% GNI. The International Finance Facility (IFF) is a mechanism that will specifically support these efforts to bring forward donor commitments. Using existing and new resources, the IFF is a stable and predictable financing mechanism that will be able to increase aid to the levels needed to meet the MDGs by 2015. Based on donors' legally-binding long-term commitments, the IFF will leverage money from international capital markets by issuing bonds. Bondholders will be repaid from future donor payment streams.

2.22 By frontloading aid, the IFF will be able to deploy a critical mass of aid that will allow investment across all sectors simultaneously, allowing aid to have the greatest impact possible. It has been shown that investment in one sector reinforces investment in others. For instance, it has been shown that a 10 per cent increase in female literacy is correlated with a 10 per cent decrease in child mortality, and a Moroccan study showed that investment in paving roads resulted in a doubling in school attendance by girls.

2.23 The UK and France have announced their joint commitment to implement the IFF using part of the revenues from air passenger ticket levies. The UK already has such an air ticket levy (Air Passenger Duty), and will use part of the existing revenue this generates to provide a long-term financial commitment to the IFF.

The IFF for Immunisation

2.24 An estimated 2-3 million children under 5 die each year from diseases that could be prevented by vaccines available now or likely to be available in the near future. The UK has worked with partners in the Global Alliance for Vaccines and Immunisation (GAVI) and other donors to use the IFF principles to fund an IFF for Immunisation (IFFIm). The IFFIm was launched in September 2005 with commitments from the UK, France, Italy, Spain and Sweden, alongside contributions from the Gates Foundation. Norway has subsequently announced that it will also participate in the IFFIm.

2.25 The IFFIm will bring forward resources to provide such vaccines and to strengthen health systems in the 72 poorest countries in the world. It will also demonstrate the technical feasibility of the IFF and the significant benefits of frontloading resources for development. Without the use of the frontloaded investments, it will not be possible to scale up immunisation coverage to the level needed to reduce child mortality and help meet the MDGs. By frontloading \$4 billion over 10 years through the IFFIm mechanism, it is estimated that 5 million lives will be saved in the years to 2015, and a further 5 million adult deaths will be prevented after 2015. This will make a significant contribution to the MDGs in the poorest countries throughout the world. In September 2005, the Development Committee noted the launch of the IFFIm and called on the Bank to assist with implementation issues.

Reducing trade barriers

2.26 Trade can be a central driver of economic growth, development and poverty reduction. The UK has used its 2005 Presidencies of the EU and G7/G8 to highlight that current protectionism damages developing countries and prevents their integration into the global economy. The need for a fairer international trading system and flexibility for least developed countries to decide, plan and sequence reforms in line with their country-led development and poverty reduction programmes have been key messages of the UK Presidency, as reflected in the G7/G8 Finance Ministers' communiqués of June and December 2005 and the G8 Gleneagles communiqué of July 2005.

2.27 During 2005, G7 Finance Ministers committed to additional support for trade capacity building to assist Least Developed Countries, particularly in Africa, to take advantage of the new opportunities to trade, which will result from a positive conclusion of the Doha Development Agenda. This expenditure on aid for trade is expected to increase to \$4 billion. In the context of their shared commitment to double aid for Africa by 2010, agreement was reached to give priority to the infrastructure necessary to allow countries to take advantage of the improved opportunities to trade.

2.28 The Sixth World Trade Organisation (WTO) Ministerial Conference took place in Hong Kong on 13-18 December 2005 as part of the Doha Development Round. Progress at this meeting was limited and did not meet the UK's level of ambition. However, agreement was reached to end all agricultural export subsidies by 2013; and for developed countries to grant duty free market access to Least Developed Countries on 97% of tariff lines by 2008.

2.29 While progress was disappointing, the agreement reached does provide a basis for continuing negotiations to achieving a comprehensive deal to conclude the Doha Round. The UK continues to work with fellow EU and WTO Member States towards an ambitious and pro-development conclusion to the Doha Round, which would: substantially increase market access for developing countries; substantially reduce all trade-distorting domestic support, not just export subsidies; and provide effective special and differential treatment to enable developing countries to capture the gains from trade. All WTO members need to maintain commitment to an ambitious outcome to the Round to ensure delivery on the promises of Doha.

2.30 While the WTO is the forum for multilateral trade negotiations, the IMF, working with the World Bank, can and should take actions to support and facilitate the process and help to enable all developing countries benefit from trade liberalisation. For example, the macroeconomic implications of member countries' trade regimes is a common topic in the IMF's annual surveillance discussions and trade-related measures have featured in IMF programmes where these have been critical to achieving macroeconomic objectives. The IMF has also been active in surveillance of the multilateral trading system and as a supporter of the Doha Round. Also, the IMF's Trade Integration Mechanism (TIM), formally approved in 2004, gives assurances that if implementation of WTO agreements give rise to balance of payments problems as a result of trade adjustment, the Fund will stand ready to assist.

2.31 In February 2005, the IMF conducted a review of their work on trade. The review examined issues such as what trade-related challenges member countries face, how the Fund has carried out its work on trade (in terms of surveillance, programme design, research and communication), and whether aspects of this work could be improved. The review also considered how the IMF collaborates on trade with other agencies, such as the World Bank and the WTO.

2.32 In advance of the Hong Kong WTO Ministerial, the Fund, together with the World Bank presented a package of aid for trade measures at the Annual Meetings. The Development Committee endorsed the proposal for an enhanced Integrated Framework for Trade-related Technical Assistance. It also called on the Fund and the Bank to:

- Examine further the adequacy of existing mechanisms to address regional or cross-country aid for trade needs and explore new mechanisms as appropriate;
- Better integrate trade-related needs into their support for country programmes; and
- Continue their global advocacy role on trade and development.

This package was well received in Hong Kong and the UK will continue to urge the Fund and the Bank to develop further these proposals in time for the 2006 IMFC Spring Meetings.

IMF SUPPORT FOR LOW INCOME COUNTRIES

IMF strategic review **2.33** During 2005, the IMF outlined a new approach for its work with low-income countries through its medium-term strategic review (discussed in greater detail in chapter 3), stressing that this new approach represents a different type, not a lower level, of Fund involvement. The new approach comprises four components:

- Greater focus – the Fund will focus on its core area of expertise, namely the macroeconomic aspects of stability;
- More flexibility – ensuring Fund facilities meet the needs of low-income countries through the introduction of a shocks facility and the Policy Support Instrument (PSI), further debt relief and by making the PRGF permanent;
- More emphasis on the Millennium Development Goals (MDGs) – the Fund will assess if the macroeconomic environment supports the MDGs and will also report on the achievability of the MDGs (in collaboration with the World Bank and donors); and
- Less procedure – the Fund proposes streamlining its procedures so that they are less onerous for both the Fund and its low-income members.

2.34 The UK welcomes the proposals to provide greater focus to the Fund’s work in low-income countries, though, as the Fund has stressed, it must ensure that this does not lead to a decreased role for the Fund. The IMF has a key role to play in low-income countries and should continue to strengthen that role. Ongoing Fund involvement in low-income countries is crucial if we are to make significant progress toward achieving the MDGs. The following sections look at ways in which the IMF supports low income countries including through its instruments, conditionality policies, collaboration with the World Bank and technical assistance.

IMF instruments for low income countries

Poverty Reduction and Growth Facility (PRGF)

2.35 The PRGF is the IMF’s main concessional lending programme for low-income countries. The PRGF was established in 1999 to make the objectives of poverty reduction and growth more central to the Fund’s lending operations in low-income countries. PRGF-supported programmes are framed around comprehensive, country-owned Poverty Reduction Strategy Papers (PRSPs). PRSPs are prepared by governments with the active participation of civil society and other development partners. The targets and policy conditions in a PRGF-supported programme are drawn from the country’s PRSP.

2.36 In September 2005, the IMF Executive Board reviewed the design of policy programmes supported under the PRGF. The marked reduction of macroeconomic imbalances and resumption of growth in an increasing number of low-income countries in recent years has meant that the policy challenges that these countries face have evolved. The review focused on selected policy issues facing low-income countries that have achieved broad macroeconomic stability, with particular emphasis on the role of institutions in economic growth, the macroeconomics of aid absorption, and the budgetary and monetary policies that will encourage growth and poverty reduction. The review highlighted two important challenges: firstly, ensuring the durability of the recent pick up in economic growth; and secondly designing appropriate policies to manage increased aid flows. The UK believes the review was helpful in identifying many of the future challenges and looks forward to further work on how future PRGF programmes will address these.

2.37 The PRGF has been successful in providing support to low-income countries and in raising growth and will remain the prime vehicle for the Fund's engagement in low-income countries. In 2005, there was significant debate on whether the Fund needed additional instruments to address the needs of low-income countries. This led to the introduction of the Policy Support Instrument and the Exogenous Shocks Facility which, along with the continuation of an adequately financed PRGF, should ensure that the Fund has an appropriate range of instruments in place to meet the needs of low-income countries going forward.

Exogenous Shocks Facility

2.38 The PRGF is an effective instrument for low-income countries seeking IMF support in addressing medium-term reforms and protracted balance of payments needs. However, it is slow to disburse, and its policy content is focused on medium-term reforms. There were concerns that the PRGF was not appropriate for low-income countries which did not have a need for ongoing Fund financing, but instead required temporary assistance in withstanding exogenous shocks, for example through changes in the price of oil and other key traded commodities or the effect of natural disasters. At their meeting in April 2005, G7 Finance Ministers called for the creation of a new window within the PRGF Trust, which could rapidly disburse concessional finance in response to exogenous shocks affecting low-income countries. The Exogenous Shocks Facility (ESF) instrument was developed by the Fund following discussion with IMF shareholders and staff, and was formally adopted by the IMF Board in November 2005.

2.39 The ESF is designed to provide concessional financing to PRGF-eligible countries which are experiencing sudden exogenous shocks, but do not have a current PRGF programme in place. The instrument is applicable to a range of exogenous factors including terms-of-trade shocks, natural disasters, shocks to demand for exports, or conflict or crisis in neighbouring countries. ESF loans will have the same interest rate (0.5%) and maturity (5½ - 10 years) as the PRGF. However, ESF programmes will be shorter than PRGF programmes, lasting only 1-2 years; and their structural reform component will be less demanding than in a PRGF programme. The level of financing available in an ESF programme is also expected to be smaller, reflecting their role in catalysing additional finance from other sources, including donors: the norm for ESF access will be 25% of a member's IMF quota. Countries with PRGF programmes in place which experience shocks will receive any additional assistance necessary through an augmentation of their existing PRGF programme.

2.40 The IMF estimate average annual demand for ESF lending will be SDR 400 million. To provide sufficient resources to support the first five years of lending through the new facility, the IMF is seeking advance commitments of SDR 2 billion of remunerated loans from members, and of SDR 500 million of grants from donors, which will be used to subsidise the rate of interest on ESF loans down from the IMF's standard SDR interest rate, to the ESF's concessional interest rate of 0.5%. The UK has pledged £50 million in grants to the ESF; and pledges have also been made by France, Japan, Canada, Russia, and Norway. Further contributions of SDR 325 million are needed from donors, particularly oil producers, in order to fully finance the facility.

Policy Support Instrument

2.41 The Policy Support Instrument (PSI), introduced in October 2005, is a non-financial arrangement designed to meet the needs of countries that do not need, or want, Fund financial assistance but do want an explicit IMF endorsement of their policies. The objectives of the PSI are to:

- promote a close policy dialogue between the Fund and the programme country;

- provide more frequent Fund assessments of a member's economic and financial policies than is available through regular surveillance; and
- deliver clear signals to donors, creditors and the public on the strength of these policies.

2.42 The PSI is available to all PRGF-eligible Fund members with a Poverty Reduction Strategy in place. However, it is designed principally to meet the needs of countries that have achieved a level of macroeconomic stability such that they no longer need Fund financial support, classified by the IMF as “mature stabilisers”. The PSI is voluntary, demand-driven, and intended to be supported by strong country ownership.

2.43 The UK welcomes the proposed new PSI, which will create a more effective means of support for low-income countries with sound policies that neither need nor want IMF financing, but are seeking policy advice, monitoring and signalling support from the Fund. The PSI will provide donors with a valuable assessment of the macroeconomic situation in recipient countries to help inform their financing decisions. However, bilateral financing decisions are the responsibility of donors, not the Fund. The UK does not require an on-track Fund programme as a condition of budget support: decisions are taken on the basis of a more graduated, multidimensional assessment of macroeconomic performance, rather than relying on on/off signals.

2.44 On 17 October 2005, the IMF's Executive Board approved a two-year PSI for Nigeria under the IMF's newly created PSI framework, which is intended to support the nation's economic reform efforts. Nigeria's PSI is based on the National Economic Empowerment and Development Strategy (NEEDS), Nigeria's Poverty Reduction Strategy, and focuses on rapid and sustainable non-oil growth and poverty reduction. The PSI will assist Nigeria to develop a well-articulated and sound policy framework, including prudent macroeconomic policies, a strengthening of institutions, and ensuring a governance structure conducive to private sector activity.

Conditionality in IMF programmes

2.45 The use of conditionality on aid is contentious, especially in sensitive policy areas such as privatisation and trade liberalisation. Inappropriate conditionality brings high transaction costs for countries, threatens national ownership of reform, and has largely been ineffective in leveraging sustained policy reform.

2.46 In March 2005, the UK published a new paper on conditionality⁴, calling for a new approach between donors and developing countries based on a shared commitment to poverty reduction and achieving the MDGs, strengthening financial management and accountability, and respect for human rights. In this new approach, the UK established that agreed benchmarks for measuring progress on the reduction of poverty will be the basis for UK bilateral support. The benchmarks will focus on the impact of the government's overall programme, rather than specific policy choices. To make aid flows more predictable, the UK will seek to be clear in advance about how much aid will be given and the basis on which funds will be reduced or stopped. A legitimate reason for retaining safeguards relating to financial management and accountability systems is to demonstrate to UK citizens and Parliament that overseas aid is well spent, and not misused through weak administration or corruption.

⁴ “Partnerships for Poverty Reduction: Rethinking Conditionality” available at <http://www.dfid.gov.uk/pubs/files/conditionality.pdf>

2.47 The IMF recently conducted an internal review of its own conditionality guidelines. This demonstrated progress in narrowing the range of conditions, but indicated room to improve the stress on country ownership, implementation and poverty focus. In addition, the Independent Evaluation Office will be conducting a review of IMF structural conditionality in 2006. The UK will work within the framework of these reviews, and in individual country discussions, to promote the new approach to conditionality adopted by the UK.

Working with the World Bank

In its work in low-income countries, it is essential that the IMF remains focussed on its areas of expertise, and works closely with the World Bank to ensure a comprehensive approach to meeting these countries' needs, combined with an appropriate division of labour. The Fund and the Bank maintain close collaboration through the framework of Poverty Reduction Strategies, including identifying which institution will lead on a particular policy area in each low-income country in question ("the lead agency model"). The Fund and Bank have also worked together on the new debt sustainability framework for low-income countries.

The Bank and Fund also work closely together in a number of other areas including: cooperation on financial sector reform through their joint Financial Sector Liaison Committee and the establishment of the Financial Sector Assessment Program (FSAP), the preparation of Reports on the Observance of Standards and Codes (ROSCs) and an expansion of their work on Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT).

Although collaboration between the IMF and the World Bank has worked well in the past, its effectiveness varies across countries and the IMF strategic review identified areas where the demarcation on specific issues, including financial sector work, donor coordination and the PRSP process, has blurred. The strategic review proposed to initiate a dialogue with colleagues at the World Bank on ways to further rationalise the division of labour between the two institutions and to strengthen the effectiveness of existing cooperation. This is being taken forward through a joint IMF-World Bank taskforce, which aims to clarify the institutions' responsibilities and create a basis for more effective co-operation.

The UK ensures its has a co-ordinated approach to the two organisations through a single Executive Director and a joint office to represent the UK in the Boards of the two institutions. This coordination is supported by close work between HM Treasury and the Department for International Development (DFID), the lead UK department for relations with the World Bank. The UK supports the intention of the institutions to continue to strengthen their joint working, including through the reconstituted Joint Implementation Committee throughout which senior Bank and Fund staff monitor and improve collaboration and communication between the two institutions. The UK will seek progress on this work, including coordinated follow up to the recommendations of the PRS reviews, and measures to ensure the coordinating framework the PRS provides in low income countries is matched in middle income members. UK aims for the debt sustainability framework were discussed earlier in this chapter. Further information on UK engagement with the World Bank is included in an annual statement to Parliament produced by the Department for International Development.

Technical Assistance 2.48 IMF technical assistance aims to support members in strengthening capacity of both human and institutional resources and to assist countries in the design of appropriate macroeconomic and structural policy reforms. It is one of the key pillars of IMF engagement for low income countries, accounting for 10% of the IMF budget. Further information about technical assistance and the 2005 IEO review into this area of IMF work is contained in chapter 3 under ‘Strengthening the Financial System’.

3.1 The IMF is designed to support global prosperity by assisting its members in building strong stable sustainable economies. In 2005, the IMF produced a medium-term strategic review to bring focus and direction to the IMF’s work in achieving its core goal. This chapter and the next reflect on the IMF strategic review and are organised around the five key tasks identified by the IMF going forward. In this chapter, measures to **improve surveillance**, meet new challenges and needs in different member countries (particularly **emerging market economies**) and measures to **build institutions and capacity** are discussed, alongside other related issues. In the following chapter, proposals for **delivering a modern budgetary framework and organisation** and the issue of **quotas and voice** are discussed.

THE IMF STRATEGIC REVIEW

3.2 The 60th anniversary of the creation of the Bretton Woods institutions provided an impetus to reflect on both the IMF’s achievements and on the IMF’s future role in a global economy that has been transformed since the 1940s. From an era of fixed exchange rates and relatively low capital flows, the IMF now operates in a global economy characterised by rapid and large shifts in capital, large global imbalances and divergences in income.

3.3 Recognising the fundamental changes to the global economy since the second world war, the UK considered it a priority to reconsider the Fund’s role going forward and to reflect on how the Fund should manage itself and prioritise so that it can effectively fulfil each of its existing and important mandates. The Managing Director of the IMF himself recognised the need for this critical self-reflection after a particularly intense period of change in the needs of the membership and functions of the IMF. More widely, there was a recognition that the Fund should take steps to ensure its capacity to meet the challenges that lie ahead. A strategic review could communicate a clear vision for the Fund and better enable the Fund to prioritise its activities and budget more effectively. This alignment of objectives and resources would bring the Fund closer to best practice in the public and private sector.

3.4 The Managing Director’s Report on the Fund’s Medium-Term Strategy¹ (the “strategic review”) was presented to and endorsed by shareholders at the International Monetary and Financial Committee (IMFC) at the Annual Meetings in September 2005. The report proposed that globalisation should be used as the organising principle for the IMF’s activities, noting that globalisation had brought enormous benefits in terms of growth and efficiency and through the transfer of goods, services and technology and had contributed to further vulnerabilities including global imbalances and greater risk of capital account crises. It therefore identified the main challenge for the Fund as being to prioritise its work so that members are able to adapt to the opportunities of globalisation whilst avoiding disorderly and damaging disruptions and shocks.²

¹ Available on the IMF website at <http://www.imf.org/external/np/omd/2005/eng/091505.pdf>

² The implications of globalisation for the UK and EU economy are discussed in two recent Treasury reports on the ‘Long-term global economic challenges and opportunities for the UK’ (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/assoc_docs/prebud_pbr04_adglobal.cfm) and ‘Long-term global economic challenges and opportunities for Europe’ (http://www.hm-treasury.gov.uk/documents/international_issues/int_global_index.cfm).

3.5 With globalisation as the organising principle for the IMF's work in the next three to five years, the report outlined five key tasks going forward:

- Making surveillance more effective;
- Adapting to new challenges and needs in different member countries;
- Helping to build institutions and capacity;
- Prioritising and organising work within a prudent medium-term budget; and
- Addressing the issue of fair quotas and voice.

3.6 In order to meet these key tasks, the IMF also put forward a number of proposals and suggestions on how to bring the medium-term strategy into operation. These suggestions are currently being refined by Fund staff via seven strategic working groups and will benefit from further discussion with all shareholders. The UK will play a full and ongoing part in these discussions to ensure that progress is made on key UK priorities. This chapter and the next considers these IMF proposals in more detail and outlines UK priorities and views in each and related areas.

3.7 In the longer term, it will be important to build on the priorities set out here to develop the strategic direction for the IMF. This should include more fundamental analysis of, for example, how the international and monetary financial system will evolve and the Fund's role in the global economy. The UK looks forward to further Fund analysis to develop a more comprehensive long-term strategic vision.

SURVEILLANCE

3.8 The strategic review describes surveillance as 'one of the most important public goods supplied by the Fund', a view which the UK strongly supports. In a world of large and increasing capital flows and increased economic integration, high quality, credible analysis and surveillance from the IMF is essential to inform and influence policy makers and support the smooth operation of the global economy. The IMF conducts surveillance at three levels:

- Global: analysis of the world economy through the IMF World Economic Outlook and the Global Financial Stability Report;
- Regional: key regional economic areas such as the Euro-area; and
- Country: the IMF holds what are known as 'Article IV' consultations with each member country about its economic policies.

The provision of regular reports on the state of the economy at a country, regional or global level is a crucial tool in enabling the IMF to prevent crises by identifying early warning signs and to provide incisive and high quality advice on policies and reforms.

3.9 Various important reforms of IMF surveillance have been undertaken in the past few years with the aim of providing greater focus and more contextual analysis. The medium-term strategy report seeks to build on this. The proposals for further improvements include:

- measures to improve the analytical quality of surveillance including deeper analysis of the longer-term aspects of globalisation and especially improved financial markets surveillance;

- measures to improve the focus and policy relevance of bilateral surveillance through greater streamlining and flexibility over the content of Article IV country reports to cover core macroeconomic issues and to free up resources to focus on the most systematically important countries; and
- measures to improve the influence of the IMF such as through greater engagement with civil society, an improved communications strategy and greater efforts to participate in public debates on reforms.

In addition to these proposals, further changes in surveillance will be made following the McDonough review into the Fund's financial sector work.

McDonough Review into the Fund's Financial Sector Work

The dispersion of financial sector and capital market work at the IMF across several functional and area departments raises questions about the effectiveness of the current organisation and the ability to provide comprehensive analysis of financial sector and private capital flows and the regulatory frameworks within which these activities are monitored by country authorities.

In response to concerns from the IMF Executive Board, in June 2005, the Managing Director of the IMF announced the formation of a review group on the organisation of financial sector and capital markets work with the aim of gaining an independent perspective on how the Fund organises its financial sector analysis and surveillance activities. The group was led by William McDonough, the U.S. Public Company Accounting Oversight Board Chairman and a former President of the New York Federal Reserve Bank.

The McDonough group reported to IMF management in November 2005 and diagnosed a need to:

- change the culture of the Fund to put financial issues at the centre of its work;
- foster greater cooperation among functional and area departments in this work; and
- ensure that financial expertise is brought to bear appropriately on the IMF's bilateral and multilateral surveillance.

The IMF outlined how it intends to implement the McDonough report in February 2006, announcing it will merge existing departments to create a new centre of excellence for financial, capital market and monetary policy work within the IMF. This should allow the Fund to take advantage of synergies in this area and facilitate better coordination between financial sector economists and area departments. The IMF will also establish a taskforce to review and update the Article IV surveillance template to give a central role to financial sector issues.

The McDonough group has been asked to return in a year to review the IMF's progress in this area.

3.10 The UK broadly welcomed the proposals on surveillance and looks forward to more detailed recommendations. The UK also welcomes proposals to streamline country Article IV consultations and would welcome further work on the implications of focussing IMF resources on the most vulnerable and systemically important countries. The 2006 Biennial Surveillance Review (BSR) provides a good opportunity to take forward much of this work. However, the UK believes there are four areas which continue to be a priority:

- i) independent and objective surveillance;
- ii) greater analysis of exchange rate regimes and international spillover effects;
- iii) a framework for assessing the effectiveness of surveillance; and
- iv) increasing transparency.

i) Independent and objective surveillance

3.11 The current structure of the IMF means that surveillance and lending are directly intertwined. Staff are often responsible for both devising and monitoring lending programmes and for policy advice through surveillance reports – which may need to reflect critically on policies under a lending programme. Fund management is also responsible for bringing both surveillance conclusions and lending programmes to the Board for approval. This conflict of interest could be seen to undermine the credibility of the Fund in both its lending decisions and surveillance advice. Therefore, a long standing objective for the UK is to see surveillance strengthened by making it more independent and objective. The UK believes this would:

- Ensure that surveillance is and is seen to be independent of decisions about programme lending and the use of Fund resources; and
- Establish the IMF as independent from political influence in its surveillance of economies.

To meet these objectives, the UK continues to believe that institutional reform at the IMF may be needed to more clearly delineate surveillance and lending activities.

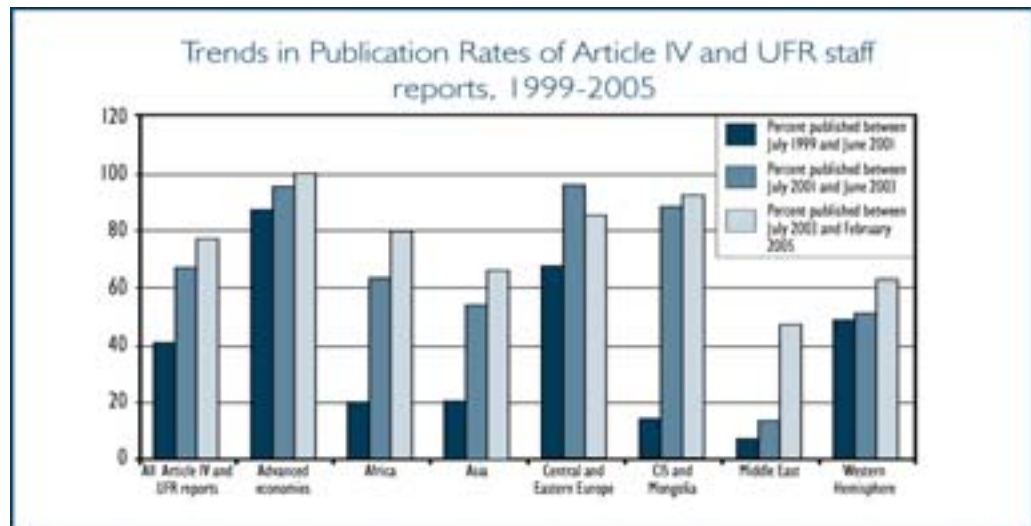
3.12 The 2004 report from the Independent Evaluation Office (see chapter 4) on the IMF in Argentina and the 2004 Biennial Surveillance Review added to existing evidence of problems due to the lack of political independence in surveillance. In addition, a range of academic studies indicate that many market participants believe political pressures already excessively influence published staff assessments, strongly undermining the credibility of IMF reports.

3.13 The IMF has taken incremental steps towards enhancing the rigour and objectivity of surveillance. In November 2005, the IMF published a paper, “Are Fund Staff Projections of Debt More Optimistic Under Program Contexts?” The paper compared IMF forecasts of debt in between countries with a lending programme with the IMF and those without and concluded that, whilst there is a tendency towards bias in growth forecasts in general, there is no evidence of bias or over-optimism in those countries with a lending programme.

3.14 The UK welcomes this progress. But as long as the lending and surveillance functions are intertwined within the IMF, the risk or perception of bias now or in the future will remain. The UK will therefore continue to build support for moves towards independent and objective surveillance among other member countries to ensure that IMF advice and analysis are fully credible and authoritative. This applies to the whole membership and not only to programme countries. The UK believes that the IMF should be free to make its best analytical judgement on a country’s economic performance free from political interference so that it can play its full role in policy formulation.

- ii) Surveillance of exchange rate regimes and international spillover effects** **3.15** As global economic integration continues to pose new challenges for the international monetary system, there is a need to consider how IMF surveillance should respond and advise on situations where the impact of member economic policies goes beyond their own borders. The IMF was established in an era of fixed exchange rates. However, since the early 1970s, countries have been free to choose their own exchange rate regimes independently. Recently, a shift has taken place as global economic integration has accelerated with a more diverse set of exchange rate regimes, with both fixed and floating rates, placing new pressures on the international monetary system.
- 3.16** It has recently been argued that the Fund should intensify surveillance of fixed exchange rate regimes; in the context of both the current global imbalances and the longer-term trend of increasing international economic and financial integration. However, the IMF's role in supporting the stability of the international monetary system requires a broader focus, including both exchange rate regimes in countries with fixed rates, and the international spillovers of domestic policies in countries with flexible exchange rates. As part of the implementation of the IMF strategic review, there should be a greater focus on the sustainability of all exchange rate regimes and how the international monetary system can adjust to imbalances; and on the potential spillover effects of domestic policies on other countries and their transmission through exchange rates and the balance of payments. There is therefore a need for a more candid treatment of exchange rate issues in the Fund's surveillance activities to ensure that the choice of exchange rate regime made by country authorities is consistent with other policies and constraints.
- iii) Framework for assessing the effectiveness of surveillance** **3.17** A central objective for IMF surveillance is to be effective in identifying appropriate policy prescriptions and influencing any necessary policy reforms. However, the IMF currently lacks a framework or methodology for assessing this. The 2004 Biennial Surveillance Review argued this would be a central step forward in strengthening surveillance and suggested the use of monitorable strategic objectives in reviews of surveillance, promoting identification of priorities and enhancing discussions of effectiveness in individual Article IV consultations. Such a methodology should look at the question of traction (the extent to which advice is adopted) and an assessment of the accuracy of assessments made by the IMF.
- 3.18** Although the UK recognises the complexity of creating an analytical framework for assessing the effectiveness of surveillance, the UK nevertheless considers this to be a priority for the IMF. Although progress has been slow, the IMF is due to bring forward proposals to address this as part of the 2006 Biennial Surveillance Review. The UK will continue to press for progress.
- iv) Increasing transparency** **3.19** Transparency is an essential part of a framework where the IMF's role is to be increasingly open and independent in its policy judgements and to engage with the wider public. Consequently, the UK regards transparency as an important complement to improving surveillance. Increased publication of IMF work can support an improvement in quality of IMF advice, by opening it to wider scrutiny and accountability, and increase the traction of surveillance by giving wider exposure to IMF recommendations to member authorities.

3.20 The IMF agreed a new transparency policy in 2003 which included the introduction of the policy on voluntary but presumed publication for Article IV country papers. This policy came into effect in July 2004 and the policy was subsequently reviewed by the IMF in May 2005. Publication of Article IV and Use of Fund Resources (UFR) reports was found to have increased dramatically over the past two years from 67% to 77%, whilst differences in publication rates across regions and stages of economic development have declined. There is also evidence that readership of Fund reports has risen, with a fourfold increase in downloads from the IMF external website.



3.21 The UK strongly welcomed the increased momentum in publication rates, and welcomed many of the proposals in the 2005 review, including on: improving the consistency and resource costs of implementation; clarifying the boundaries between factual corrections and publication-related modifications; shortening the lags in the publication of reports; and better defining the grounds and scope for decisions relating to publication. However, with nearly a quarter of reports still unpublished, the UK believes that further progress should be a priority and remains in favour of moving towards a policy of mandatory publication for all country reports.

The UK's approach to surveillance

3.22 Surveillance discussions in the Executive Board are used to bring cross-country experience to surveillance reports and to provide an element of peer review that is part of the founding principle of Fund surveillance work. Although the nature of UK interventions will vary depending on the circumstances and level of economic development in the country being discussed, the UK considers the following broad themes and questions when formulating interventions at the Board.

Presentation of outlook and vulnerabilities:

- Is there an explicit discussion of the risks, both faced and posed by the country under review, of most significance to both the member country and the world economy?
- Have the various components of vulnerability assessments and the balance sheet analysis been integrated within the main body of the Article IV?

- Does the Article IV demonstrate debt sustainability? Have alternative scenarios been used in the presentation of these risks and vulnerabilities, and has their potential impact been qualified?

Macroeconomic policy frameworks:

- Have alternative macroeconomic policy frameworks been analysed?
- Is the current fiscal framework appropriate? Or could the country benefit from some form of fiscal rule? Is the monetary framework effective?
- How transparent are the macroeconomic policy frameworks?
- Have necessary structural reforms been implemented fully and effectively?

Exchange rate regime:

- Has the Article IV considered the adequacy and sustainability of the exchange rate regime?
- Is there a clear identification of the de facto exchange rate regime?
- Have staff used a broad range of indicators to assess external competitiveness?
- Has the policy dialogue between staff and the authorities on the exchange rate been presented, and is it balanced?

Financial sector issues:

- Does the Article IV consider the key vulnerabilities in the financial sector?
- Is the country suitable for a ROSC / FSAP? If they have undertaken one, how do they plan to implement recommendations? Could they be eligible for FIRST funds? (see paras 3.40 to 3.46 for discussion of ROSCs/FSAPs and FIRST)

3.23 For low and middle income countries, UK interventions also emphasised the need for IMF surveillance to comprehensively assess progress towards the Millennium Development Goals (MDGs). For low income countries, the UK also concentrated on the need for effective public expenditure management, for resources to be allocated towards pro-poor expenditure, the need for improved donor co-ordination and to consider whether the country has an external financing gap and a need for more resources to assist progress towards the MDGs. In developed country surveillance discussions, the UK supported IMF work on monitoring trade policies, and encouraged progress towards the 0.7% ODA/GNI ratio.

The UK Article IV 3.24 The 2004 Article IV consultation with the UK was concluded in March 2005. An IMF mission visited the UK in December 2005 to conduct its 2005 Article IV consultation. In summing up, the IMF mission noted that “Macroeconomic stability in the United Kingdom remains remarkable. Over the past decade, the growth of real GDP per capita has been strong and stable. Unemployment and inflation have been low, and the current account deficit has been moderate.” The mission noted that this impressive performance owes much to “good macroeconomic, financial, and structural policies, underpinned by sound policy frameworks”. Looking ahead, the mission emphasised the importance of continuing with efforts to improve institutions for fiscal transparency, financial sector oversight, and labour market flexibility. The IMF Executive Board is due to discuss the Article IV in early 2006. The concluding statements of the IMF mission can be found in Annex C whilst further information about the IMF surveillance of the UK is available on the IMF website³.

THE ROLE OF THE FUND IN EMERGING MARKET ECONOMIES

3.25 The IMF strategic review outlines the following four areas where action by the Fund is required to improve its work with emerging market economies:

- Crisis prevention – the key priority is to obtain early warning of vulnerabilities and disturbances through enhanced surveillance, as outlined in the previous section.
- Financing and insurance – to ensure that the Fund’s range of financing instruments adequately meets the needs of emerging market countries.
- Crisis resolution – to give impetus to market initiatives and to find orderly solutions to financial crisis.
- Capital account liberalisation – by deepening its knowledge of this issue, the Fund will be better able to advise on the principle and process of liberalisation and to properly design Fund programmes in the light of this.

Crisis prevention 3.26 The global economy is undergoing a major transformation with far reaching and fundamental changes in technology, production and trading patterns. These changes bring enormous opportunities, but many emerging market countries remain vulnerable to the volatility of global capital flows and much still needs to be done to establish stable macroeconomic foundations that are robust to shocks. The UK strongly supports the view that the IMF has a key role to play in assisting countries crisis prevention efforts through surveillance, policy advice and its facilities.

3.27 The twin objectives of providing incentives to implement good policies, and preventing crises in those countries pursuing good policies, lay behind the introduction of the Contingent Credit Lines (CCL) facility in 1999. The CCL recognised that emerging market countries’ vulnerability to capital account crises means that large-scale Fund financial support might be needed. The CCL lapsed at the end of November 2003, at which time no country had applied for it.

³ <http://www.imf.org/external/country/GBR/index.htm>

3.28 Since the lapse of the CCL, there has been an ongoing debate amongst the IMF's membership about the adequacy and efficacy of the Fund's instruments for tackling the challenges posed by increasingly integrated global capital markets. The perception amongst some members is that the lack of adequate and reliable insurance against financial catastrophes has prompted many countries, particularly in Asia, to self-insure through a massive build-up of reserves rather than to depend on the Fund.

3.29 The UK believes that the Fund's facilities should be used to prevent crises, as well as to resolve them and continues to support the original objectives of the CCL as the natural complement to improvements in surveillance and believes there is a potential gap in the range of Fund facilities for countries that have significant market access and strong policy frameworks. The UK believes that the Fund's financial facilities should be enhanced in a number of ways, in particular to:

- increase the speed and certainty of financial assistance in times of need;
- improve the Fund's signalling role in support of strong policies; and
- provide increased protection from contagion.

3.30 Taken together these features would encourage countries to take measures to reduce economic vulnerabilities and strengthen their financial positions, and contribute to crisis prevention by stabilising market expectations and reducing the risk of large-scale capital flight. The UK also feels that a contingent facility could be helpful in assisting countries with large exposures to the Fund to achieve an orderly exit from Fund financial support.

3.31 Precautionary arrangements also play a role in crisis prevention. As gross financing needs can be very large in capital account crises, it should be possible for such programmes to provide large scale financing (known as exceptional access) to countries that have taken appropriate policy measures, should they face capital account pressures. The UK, along with some other advanced economies and many emerging market countries, remains strongly supportive of keeping open the possibility of exceptional access under precautionary programmes. Consequently, the UK welcomes the proposal of the IMF strategic review to initiate a second round debate on both high access precautionary arrangements and a successor to the Contingent Credit Line.

Crisis resolution

3.32 As recent cases such as Argentina demonstrate, sovereign debt crises entail significant economic costs for all parties. Improving the timeliness and clarity of the framework for restructuring unsustainable sovereign debt would help to minimise these costs. The UK has been at the forefront of efforts by the international community to improve the framework for crisis resolution. A number of proposals have been explored which aim to facilitate the orderly resolution of sovereign debt crises, based upon the following three complementary approaches:

- a voluntary approach, involving the adoption of a set of voluntary Principles to guide the actions of debtors and creditors before and during a crisis. The Principles were agreed in 2004 as the culmination of a co-operative dialogue involving the Institute of International Finance (IIF), other private sector representatives and major sovereign issuers of international bonds.

- a contractual approach, involving the use of Collective Action Clauses (CACs) in international sovereign bonds. CACs in bond contracts allow a qualified majority of bondholders to agree changes to the terms of a bond with the issuer, and ensure that those changes are binding on all bondholders.
- a statutory approach, based on the Fund's proposal for a Sovereign Debt Restructuring Mechanism (SDRM) which would create a statutory framework under international law to allow a qualified majority of a country's creditors to approve a restructuring agreement which would be binding on all. The proposal aimed to facilitate negotiation and creditor co-ordination, curb the ability and incentives for creditors to litigate against sovereigns in default, and create a forum for dispute resolution.

3.33 In September 2005, the IMFC welcomed the rapid progress on the inclusion of collective action clauses in international sovereign bonds. In the first half of 2005, with one exception⁴, all newly issued international sovereign bonds included CACs. The outstanding stock of emerging market sovereign bonds that include CACs has increased from 31% at end-2002, in value terms, to 53% as of end-June 2005. The Committee also welcomed the efforts by emerging market issuers and private sector creditors to broaden the consensus on the Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets and looked forward to further work on the orderly resolution of financial crises, including a review into the IMF's Lending Into Arrears policy. To date the SDRM proposal has not been further advanced but the UK continues to support the development of a practical operational framework for the restructuring of unsustainable sovereign debts. During 2005, the IMF also published papers on the determinants and prospects for market access by countries emerging from a crisis, and managing systemic banking crises during sovereign debt restructurings, both of which improved the Fund's understanding of crisis resolution. The UK will continue to push for further work to promote the orderly resolution of financial crises.

Capital account liberalisation

3.34 The strategic review proposes that the Fund undertakes a work programme to deepen its knowledge of the issues surrounding capital account liberalisation. The UK believes that the liberalisation of the capital account can yield essential efficiencies and benefits. However, countries opening their capital account should proceed prudently in order to avoid an excessive volatility of capital flows. Fund advice in this area should be based on the individual circumstances and priorities of the country concerned, reflecting the broader macroeconomic, financial and structural situation. The UK has argued that the Fund's work in this area should have a stronger analytical base and, as such, welcomes the introduction of a work programme by the Fund to more fully understand this issue.

⁴ The only country that did not include CACs in its New York law-governed bond was Jamaica.

The IMF's Approach to Capital Account Liberalisation – Report by the Independent Evaluation Office

This report, released in April 2005, finds that in the 1990s the IMF encouraged countries to move ahead with capital account liberalisation but there is no evidence that it pushed countries to move faster than they were willing to go. Indeed, the process was often driven by a country's own economic and political agendas. However, the risks of opening the capital account, as well as the need for a sound financial system, were not sufficiently highlighted by the Fund until later in the 1990s.

The report concludes that the Fund has learned over time, responding gradually to new developments and evidence. In recent years, more consistency and clarity has been evident, with the Fund taking a more cautious approach, emphasising country ownership of the pace of reform and recognising the usefulness of capital controls under certain conditions.

The evaluation highlighted two main areas in which the IMF could improve its work on capital account issues:

- The need for more clarity on the IMF's approach to capital account issues.
- The Fund's analysis and surveillance should give greater attention to the supply-side factors of international capital flows and what can be done to minimise the volatility of capital movements.

STRENGTHENING THE INTERNATIONAL FINANCIAL SYSTEM

3.35 The IMF strategic review also identifies building institutions and capacity as a priority for the IMF since many countries need assistance in putting in place the economic institutions crucial for growth and stability in a globalised economy of integrated financial markets. This agenda covers work being undertaken by the IMF on technical assistance, the standards and codes initiative and measures to tackle anti-money laundering and counter terrorist financing.

Technical Assistance 3.36 The IMF strategic review stated that technical assistance plays a “crucial role” in helping low income countries to strengthen their economic institutions and design appropriate macroeconomic and structural policy reforms. Technical assistance therefore assists the development of low income countries whilst contributing to a more stable and robust global economy. There is strong demand for technical assistance which the IMF prioritises by considering the issues that emerge in the course of IMF's surveillance and programme activities. Technical assistance is funded by the IMF and a wide range of bilateral and multilateral donors. Two reviews of technical assistance were undertaken this year with both putting forward a number of important insights and recommendations.

IEO Review of Technical Assistance and IMF Task Force follow-up

In January 2005, the IEO published an evaluation of IMF technical assistance. It praised the quality of expertise provided by IMF staff and noted there had been a successful focus on low income countries. It also made a number of recommendations to address some perceived weaknesses, including:

- Better priority setting through establishing country policy frameworks to identify medium-term country needs and capacity through, in most cases, more effective use of Poverty Reduction Strategy Papers.
- More systematic tracking of progress on technical assistance activities, particularly to identify where shortfalls have occurred.
- Greater collaboration with country authorities on the design and implementation of technical assistance to ensure greater ownership by authorities.

An IMF Task Force was subsequently set up to consider these recommendations and wider issues including the link between technical assistance and surveillance and the IMF strategic review. The Task Force reported to the Executive Board in July 2005, making a number of further recommendations, including:

- Production of Technical Assistance Country Strategy Notes (TACSNs) to help area departments develop a more country-focused, medium-term technical assistance framework.
- More systematic consultations with country authorities in the design and follow-up of technical assistance, based on priorities set out in Poverty Reduction Strategy Papers.
- Strengthening the Technical Assistance Evaluation Programme to ensure the effectiveness of IMF expenditure in this area.

The Executive Board endorsed the conclusions of the Task Force and new operational procedures are now being put into place.

3.37 The UK welcomed the important work done in this area by the IEO and the IMF Task Force. The recommendations made were in line with the UK priorities of ensuring a more co-ordinated and integrated approach to technical assistance where priorities are established through the Poverty Reduction Strategy approach. The UK believes that to be effective, technical assistance has to be country led, focussed on institutional strengthening and capacity building, and be part of this joint donor strategy. The UK also believes that given the fixed resources available the IMF should focus on producing higher quality and more effective technical assistance rather than a greater volume of activities. The UK looks forward to full and timely implementation of the new operational procedures.

Technical Assistance Regional Centres

3.38 Technical Assistance Regional Centres aim to provide a regional, more tailored approach to delivery of technical assistance to countries with similar economic and institutional problems. There are five regional centres - in the Pacific, Caribbean, East Africa, West Africa and the Middle East - funded by the IMF as well as bilateral and multilateral donors.

3.39 An external evaluation of these regional centres was conducted in 2005 and agreed that the centres have provided significant benefits to the countries they serve. The evaluation made a number of recommendations to build on the achievements of the centres and strengthen their management, organisation and financing modalities. Executive Directors agreed that further integration with IMF technical assistance and a greater strategic focus within the context of the strategic review and the above changes to technical assistance more widely would be of benefit, whilst ensuring that the benefits of regional and country ownership, responsibility and expertise are retained. Executive Directors also agreed that alternative financing strategies should be drawn up to minimise the risk of disruptions to external financing to both the IMF and participating countries.

Standards and Codes

3.40 The UK strongly supported the launch of the standards and codes initiative in 1999 as a key step in strengthening the international financial architecture and has been a strong advocate of the initiative since then. Through adoption and implementation of internationally agreed individual standards and codes, countries can strengthen their policy frameworks and institutions to help reduce the likelihood and impact of financial crises. Where details of compliance with these standards and codes are published, the initiative can also improve the functioning of markets by improving the availability of information and facilitating objective comparisons between countries.

3.41 There are 12 individual standards and codes, devised by the IMF and World Bank in consultation with other key bodies with the aim of providing clear and transparent benchmarks of good practice. The modules cover data quality; monetary and financial policy transparency; fiscal transparency; banking supervision; securities; insurance; payments systems; anti-money laundering; corporate governance; accounting; auditing; and insolvency and creditor rights. Financial sector modules are usually undertaken within the framework of the Financial Sector Assessment Program (FSAP), which is specifically designed to assess the strength and weaknesses of financial sectors. Observance of these standards and codes is examined by IMF and World Bank staff and summarised in Reports on the Observance of Standards and Codes (ROSCs). All Article IV consultations now routinely provide an overview of members' performance against ROSCs and the FSAP.

3.42 The UK is committed to supporting the ability of developing countries to implement international financial standards and codes and to effectively follow up on weaknesses identified in ROSCs. A multi donor technical assistance initiative FIRST (the Financial Sector Reform and Strengthening Initiative) was launched in April 2002 to provide technical assistance for short and medium term capacity building projects to address financial system weaknesses. The UK provided an initial contribution of £20 million to FIRST for the first four year period.

3.43 The standards and codes that underpin the FSAPs have become a key component in the global financial system but for these international standards to be truly effective it is vital that those subject to them – both developed and developing countries, and companies active in the international financial markets – have confidence in them. Standards must be set in a sensible and proportionate way, and those in both the public and private sector that are subject to them must have an opportunity to make an input into the standard setting process. With this in mind, the UK used the opportunity of the recent G7 Presidency to launch a tripartite Treasury/Bank of England/Financial Services Authority initiative tasking the Financial Stability Forum (FSF) to review the way that these vital international standards are set. In particular, it looked at the extent to which standard setting bodies have open and transparent consultation procedures and made use of quantitative techniques in assessing the evidence base for, and impact of, their proposals. The initiative received a very good response at the FSF meeting in London in September 2005 and was endorsed by G7 Finance Ministers in December 2005. An FSF work stream is now underway and a report will be made to the Sydney FSF meeting in March 2006.

3.44 In July 2005, the IMF published an internal review of the effectiveness of the standards and codes initiative. It concluded that the initiative had been effective and that member countries had found the initiative to have been valuable in helping to identify vulnerabilities and priorities for further action. The review noted that the impact in terms of implementation of recommendations by ROSCs was not clear but suggested that many institutional reforms would take time to deliver and that a longer time frame was needed to judge the initiative in this respect. The review also noted that participation had been uneven and a number of key systemic countries had yet to undertake any ROSCs. To address these points and build on the strength of the initiative, the review suggested that there be greater integration between the initiative and technical assistance and ongoing surveillance activities. The use of Article IV papers and greater awareness of the initiative by area departments should assist the IMF to prioritise further action and to highlight the need for implementation of recommendations contained in ROSCs.

3.45 The UK welcomed the IMF review, agreeing that the focus should now be on building on the success of the initiative. Going forward, the UK believes more effort is needed to encourage systemic countries to participate in the initiative and that the clarity and usability of ROSC papers could be improved to ensure wider accessibility through, for example, an executive summary and a prioritised list of recommendations. The UK also supports measures to better integrate ROSCs into Fund surveillance and technical assistance.

3.46 The importance attached to the standards and codes initiative is also demonstrated by the inclusion of standards and codes as part of HM Treasury's Public Service Agreement (PSA) targets. Objective V, target 8 commits the Treasury to promoting increased global prosperity and social justice in a number of ways, one of which is through working to increase the number of countries successfully participating in the global economy on the basis of a system of internationally agreed and monitored standards and codes. Progress against this target continues to be strong and steady. As of October 2005, 126 countries (around two thirds of the membership) have now completed at least one module, up from 109 in June 2004 and 94 in June 2003. 723 individual reports and updates have been produced of which 75% have been published. The UK will continue to work to increase take up of standards and codes and will also continue to lead by example. The UK is committed to undertaking all 12 modules, having already completed 8.

Anti-money laundering and counter-terrorist financing

3.47 The UK is committed to the fight against those who seek to abuse the international financial system for criminal or terrorist purposes. The tragic events in London in July 2005 and elsewhere during 2005 highlighted the critical need for continued action by the international community against such threats. Anti-money laundering and counter terrorist financing (AML/CTF) has been one of the UK's key G7 and European Presidency Priorities in 2005. The UK has taken actions internationally and through the European Union (EU) to disrupt the financing of terrorism and criminality.

3.48 In 2005 the IMF renewed its commitment to implementation of the 40 recommendations and 9 Special recommendations of the Financial Action Task Force (FATF) – the international AML/CTF standard setter. The Board indicated its commitment to the long-term and continuing work of the IMF in evaluating the implementation of these standards as part of the Financial Sector Assessment Program. The threat from money laundering and terrorist finance will not diminish quickly and the UK welcomes the IMF and World Bank's ongoing work to counter these long-term threats.

3.49 At the IMFC meeting in September, it was agreed that the international financial institutions, in addition to bodies such as the United Nations, would develop mechanisms to ensure that significant multilateral programmes of technical assistance are delivered in a way that targets those countries who need it most, and that avoids duplication. This will contribute to global implementation of AML/CTF safeguards and reduce opportunities for money launderers and terrorists to take advantage of geographical vulnerabilities. Going forwards, the IMF will ensure that its country surveillance activity contributes to assessing the AML/CTF safeguards in place, identifying technical assistance needs, and evaluating assistance that has been provided.

3.50 The IMF also contributes valuable policy work on the development of the international AML/CTF framework. Its review of assessments of the revised FATF standards has helped our understanding of where the challenges for implementation lie. Indeed, the assessment of standards is crucial in raising AML/CTF standards and reducing vulnerabilities. The IMF is also exploring with the FATF how it can help ensure that FATF-Style Regional Bodies (FSRBs) have the experience and capabilities to develop international standards amongst their members in a structured and effective way. The IMF also endorsed the Financial Action Task Force (FATF)'s Special Recommendation IX concerning measures to deter cross-border movements of currency and monetary instruments, related to the financing of terrorism and money laundering.

3.51 The UK has also pursued globally action to disrupt and detect criminal and terrorist activity through other international fora. Under the UK G7 Presidency, G7 financial experts have increased international efforts in combating AML / CTF through:

- Improving processes for concerted freezing of terrorist assets;
- Enhancing international information sharing; and
- Exploring new financial tools to disrupt crime through enhancing the enforcement role of the FATF.

3.52 The fight against money laundering and terrorism has also formed a central pillar of the UK's Presidency of the EU. In relation to terrorist finance, the UK has sought to accelerate the implementation of the EU's Action Plan on terrorism agreed in the wake of the Madrid bombings. In addition, substantial progress has been made in a number of areas which will help deliver international AML/CTF standards across the EU as a whole:

- The Third Money Laundering Directive has been adopted, meeting one of our presidency priorities and showing our commitment to Europe's fight against money laundering and terrorist financing.
- Unanimous EU agreement has been secured to introduce more robust asset freezing powers at the European and domestic levels.
- A regulation on the cross-border movement of cash has been agreed which will require substantial cash transfers to be declared.
- The UK supports the ongoing development of a code of conduct to prevent abuse of charities by terrorists.
- Work on agreeing the Payments Regulation, which implements FATF Special Recommendation 7, is progressing well, with a Council General Approach being agreed under the UK Presidency in December 2005.

4.1 A priority for the UK is that the IMF, as an institution, is at the forefront of institutional best practice drawing on the private and public sectors, has the resources necessary to perform its key responsibilities and is credible and representative. The IMF strategic review identified implementation of a **modern budgetary framework and organisation** and addressing the issues of **quotas and voice** as priorities, both of which are discussed in this chapter. This chapter goes on to outline developments in other key areas of **Fund finances** and the **Independent Evaluation Office**.

DELIVERING A MODERN BUDGETARY FRAMEWORK

The Medium-Term Budgetary Framework (MTBF)

4.2 The IMF are in the process of developing a new medium-term budgetary framework, as one of the priorities of the IMF strategic review and which the UK has strongly supported. Until recently, the budget has been set for one year ahead only. A more medium term focus will become particularly important in a scenario of declining lending. It will also assist with prioritisation of Fund activities and help to integrate the budget and the strategic review more effectively. The first budget prepared under the new framework will be considered by the Board in April 2006. Progress was made during the Budget discussions this year on introducing greater detail on Fund outputs, making use of a top-down and bottom-up exercise to identify priorities, outlining an illustrative three-year capital budget and beginning to move towards greater flexibility of budget practices. The UK welcomed this progress and looks forward to implementation of the new budgetary framework.

The IMF Budget for FY 2006

4.3 The Executive Board approved a gross budget of US \$937 million for the 2006 financial year (FY 2006). The ceiling on full-time staff positions was unchanged at 2,802. The administrative budget for FY 2006 has been formulated as a transitional budget, pending completion of the strategic review and two other major reviews—of employment, compensation, and benefits, and information technology, respectively. The latter two cover areas of expenditure that account for more than 75 percent of the total administrative budget. Within a zero-real growth constraint, the FY 2006 budget increases resources devoted to surveillance, with emphasis on the financial sector and low-income countries, and to work on Fund programmes.

ORGANISATION

4.4 The governance structure of the IMF has remained largely unchanged since the institution was founded sixty years ago. As shareholders to the IMF, member countries appoint governors to the Fund. A committee of these governors, the International Monetary and Financial Committee (IMFC) meets twice a year to discuss IMF policies and provides strategic direction to the work programme of the IMF through communiqués published following the meetings. Communiqués from the last two meetings can be found in Annexes D and E. In addition to their representation through the IMFC, the full Board of Governors assembles at the Annual Meetings every autumn and governors vote on a limited number of specific decisions. However, much of the ongoing oversight of IMF management and staff is undertaken by the Executive Board, composed of 24 Executive Directors. Executive Board meetings are chaired by the Managing Director of the IMF and is in ‘continuous session’ in Washington DC, meeting as often as needed.

4.5 The IMF strategic review recognised that staff of the IMF were highly skilled but that to ensure the effectiveness of the institution in response to the changes brought by globalisation, organisational reform should be considered, including:

- Devolution of routine decision making from management to staff;
- Streamlining of papers to the Executive Board;
- Considering whether changes can be made to the IMFC meetings to encourage more frank and interactive discussions; and
- Rationalising the division of labour between the IMF and the World Bank and strengthening co-operation.

Elsewhere, as discussed in chapter 3, the IMF will undertake some organisational restructuring in response to the McDonough review into the way that financial sector work is undertaken at the IMF.

4.6 The strategic review provided a good opportunity to assess whether the IMF was still organised in a way that ensures the institution's effectiveness and accountability to its members and the UK welcomed the proposals put forward. However, to ensure that the IMF is at the cutting edge of modern best practice and that IMF internal governance is fully aligned with its role and responsibilities, there may be a need for further reflection on the organisational structure of the IMF. For example, the UK believes that consideration should be given to:

- Clear objectives for the activities of the IMF;
- Measuring results against objectives, to enable an assessment of performance and the effectiveness of various delivery mechanisms as well as to design specific incentive programmes for areas of work of particular importance;
- Basing management remuneration on performance contracts, clearly linked to the institutions objectives and measured by performance indicators;
- Making the budget process a key internal process through which management aligns resources and objectives; and
- Improving its arrangements for risk management and external audit.

QUOTAS AND VOICE

4.7 Representation at the IMF is a multi-dimensional issue, covering voting power, access to Fund resources, and representation at the Executive Board. There is broad agreement that if it is to remain effective, the IMF should be a global institution, with near universal membership, and that members' representation should broadly reflect their economic weight. As the global economy has changed in important ways in recent years, the issue of the representativeness of the major international economic institutions has risen up the international agenda. There is now an expectation that the international community will make progress on this issue in the year ahead.

4.8 IMF quotas are the basis for determining members' financial contributions to the IMF, their access to IMF resources, and their voting share and representation in the IMF Board. The sum of members' quotas also determines the size of the IMF's total lending capacity. Quotas are reviewed by the Fund at least every five years, to ensure the size of the Fund and the distribution of quotas among members reflect developments in the world economy. Past quota increases have generally taken place only against a background of rising pressure on Fund liquidity, and a pressing need to increase the commitment capacity of the IMF. The Twelfth General Review concluded in January 2003 without proposing an increase of quotas, as the IMF's liquidity position remained adequate and there was no need for changes at that time. The 13th General Review is now underway, and is due to conclude by no later than 2008.

4.9 However, in recent years, reform of quotas and representation has been a particular concern of China and some other Asian economies which have experienced strong economic growth. As a guide in these issues, quota formulae have been in place for some time to provide a quantitative basis for determining countries' contribution to the Fund and hence, the distribution of voting power within the IMF, based on a range of economic variables including potential need, and capacity to contribute resources to the Fund. A number of countries in Asia and other regions have IMF quota shares which are considerably out of line with their quota shares as calculated by the current quota formulae.

4.10 The strategic review highlighted fair quotas and voice as crucial to the legitimacy of a universal institution, and one of the key issues to be addressed. The Managing Director's report suggests that a reallocation of quotas is necessary to address imbalances between members' weights in the global economy and their representation at the IMF, and that these imbalances are sufficiently pressing that a reallocation of existing quotas should be considered, in order to adjust members' relative weights even though there is no pressing need to increase the IMF's total lending capacity.

4.11 At the 2005 Annual Meetings, the IMFC agreed that the distribution of quotas should reflect developments in the world economy, and looked forward to a report on progress at its next meeting. Discussion of quotas is underway at the Fund and in other fora, including the G20 and G7. Work on quotas is expected to continue through 2006, and they are likely to be a key issue for discussion at the 2006 Annual Meetings in Singapore.

4.12 The adjustment of quotas should be accompanied by further measures to ensure an effective voice for developing and transition countries at the IMF. This reflects the fact that these countries form the bulk of the call on Fund resources and the commitments made in the Monterrey consensus¹. One way of enhancing voting power would be to increase the level of 'basic votes'. The IMF's Articles of Agreement allocate 250 basic votes to each member, irrespective of their quota or economic weight. As each country has the same basic vote allocation, raising that allocation could be used to increase the relative voting power of the IMF's smaller or poorer economies. Alongside discussion of an adjustment of quotas and basic votes, the UK continues to support operational measures to ensure an effective voice for developing and transition countries, including capacity building in capitals; the analytical trust fund to support Executive Directors representing sub-Saharan Africa; greater openness and transparency; and increased decentralisation and staff diversity.

¹ At the March 2002 International Conference on Financing for Development, in Monterrey, Mexico, all governments committed to finding ways of enhancing the voice of developing and transition countries in the international financing institutions, including the IMF.

FUND FINANCES

4.13 The IMF's lending operations are conducted through a number of facilities, including the core facility, the Stand-By Arrangement (SBA). To help the poorest member countries facing protracted balance of payments problems, the IMF also provides concessional lending through the Poverty Reduction and Growth Facility (PRGF). In the past year, the Fund has established a new lending facility, within the PRGF facility, specifically to assist low-income countries in responding to economic shocks (the new shocks instrument is discussed in more detail in chapter 2).

4.14 The majority of IMF lending is financed through the General Resource Account (GRA) of the IMF whilst concessional lending is paid for through various trust fund arrangements such as the PRGF Trust Fund. At the beginning of 2005, the total credit outstanding to the GRA stood at SDR² 52.7 billion. Credit outstanding to the PRGF Trust Fund stood at around SDR 6.8 billion. At the beginning of 2005, there were 48 countries with an IMF programme in operation with approximately 70% of borrowing being concentrated in the three then largest borrowers of Brazil, Argentina and Turkey who all had an exceptional access programme with the IMF. Further information on these borrowers and the exceptional access framework is contained below.

Brazil 4.15 Brazil announced on 13th December 2005, its intention to repay its entire obligations to the IMF two years ahead of schedule on 27th December 2005. Total repayment amounted to US \$15.57 billion (SDR 10.79 billion). Brazil will save an estimated US \$900 million in interest payments to the Fund. The IMF has welcomed the repayments by Brazil.

Argentina 4.16 Following Brazil's lead, Argentina announced on 15th December 2005 that it would also repay, in full, its entire outstanding obligations to the Fund. This amounted to US \$9.8 billion, repaid on 3 January 2006. The IMF welcomed Argentina's repayment of its outstanding obligations to the Fund, stating that the Fund looks forward to maintaining a productive relationship with the Argentina authorities.

Turkey 4.17 Turkey is now the IMF's largest debtor. Turkey's exposure to the Fund stands at around US \$15 billion (SDR 10.25 billion). It agreed a three-year Stand-By Arrangement (SBA) with the Fund in May 2005 for an estimated US \$10 billion.

4.18 The IMF Executive Board completed its first and second review of Turkey's SBA in December 2005 after significant delays, due to the authorities' failure to pass key legislation that would allow structural reforms under the programme to be met. Completion of the review enabled Turkey to draw immediately an amount equivalent to SDR 1.11 billion (about US\$1.58 billion).

4.19 Growth is expected to remain strong, in line with Turkey's potential, in 2006. However the country's widening current account deficit leaves it vulnerable to a possible tightening of global credit conditions. Successful implementation of the Fund-supported programme will help strengthen Turkey's resilience to external shocks.

² Special Drawing Rights (SDR) are an international reserve asset which serves as the unit of account of the IMF. Its value is based on a basket of four key international currencies. In mid December 2005, one SDR was equal to US \$1.44.

Access limits and the exceptional access framework

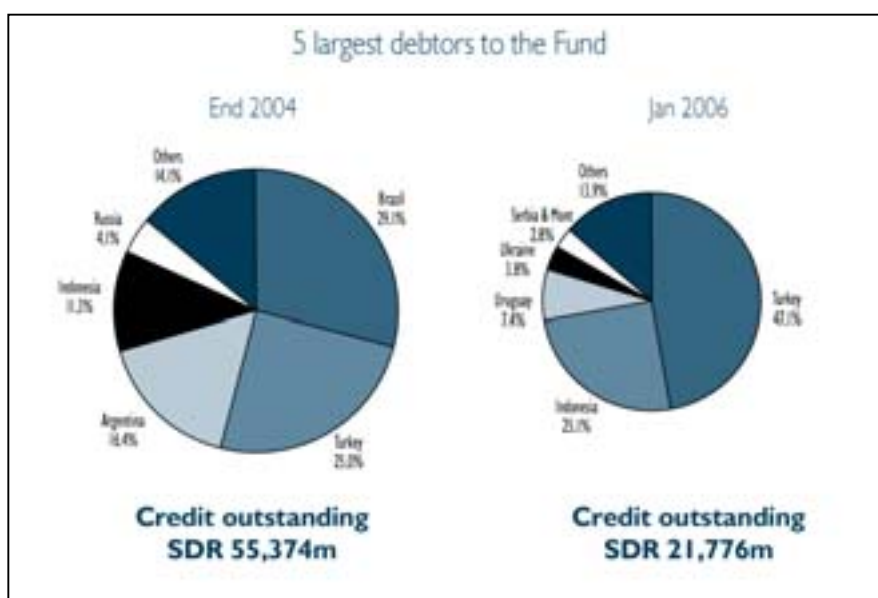
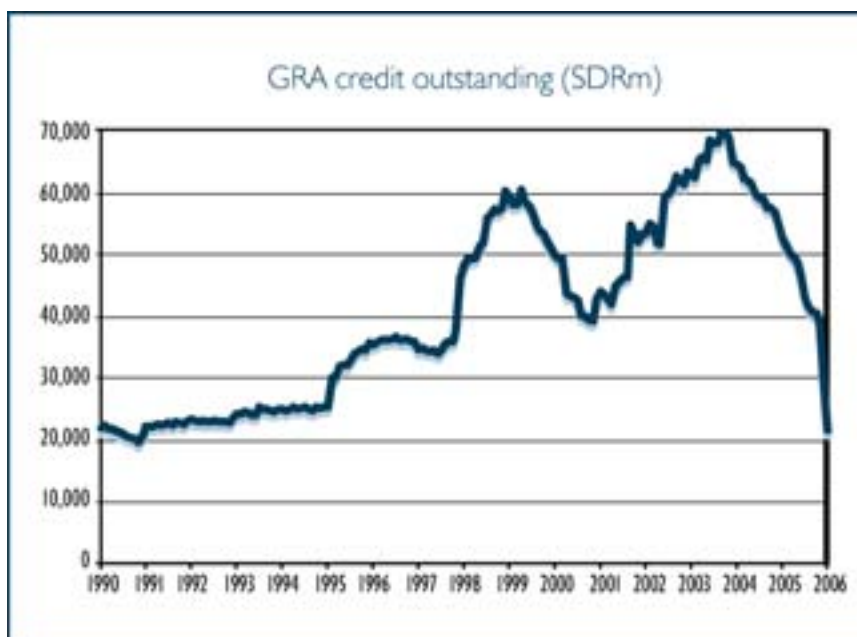
The amount a country can borrow from the IMF is based on access limits. Normally, access to IMF resources is limited to 100% of quota within any 12 month period and a cumulative limit of 300% of quota on the level of Fund credit outstanding. However, in cases such as those highlighted above, Fund lending exceeds these limits and are known as 'exceptional access' cases. In 2003, the IMF Executive Board agreed a framework for handling such cases. The improved procedures in this framework require earlier and fuller information to the Board as negotiations towards a programme continue and that specific criteria should be used to judge each case to provide greater clarity to members and other creditors about when exceptional access should be provided.

In April 2005, the Executive Board considered an IMF review of access policy and broadly agreed that existing access policy and limits remain appropriate whilst emphasising the need for continued vigilance over changes in potential need for access. Directors also agreed to measures to improve programme documents under the exceptional access framework.

The UK continues to support the exceptional access framework and its rigorous application. The original decision noted that there may be special circumstances where exceptional access is appropriate but not all the criteria are met. Handling these special cases is a matter of ongoing debate. The UK has supported exploring ways in which IMF facilities – including those offering exceptional access – can be used to support stronger policy frameworks. The UK also believes ways to improve programme design in large access cases should be considered to increase the likelihood of successful graduation from IMF financial support and to reduce the likelihood of successor programmes being required.

Current liquidity and income position

4.20 The repayments by Brazil and Argentina, amounting to 61% of Fund credit at the time, have dramatically changed the Fund's financial position. Most noticeably, as the following charts illustrate, the total credit outstanding to the GRA has fallen to SDR 21.8 billion whilst the composition of the Fund's lending portfolio has also changed. The total credit outstanding in PRGF loans dipped slightly to SDR 6.3 billion, down from SDR 6.8 billion at the end of 2004. A total of 43 countries had a borrowing programme with the IMF in January 2006.



4.21 The IMF's income is largely generated from interest on loan payments. The repayments by Brazil and Argentina and the relatively low number of current Fund loans are welcome from the point of view of global financial stability, but also have important implications for the IMF's income position. At the beginning of January 2006, the Fund's income position was lower than expected but it was judged that no immediate action was needed at that time. However, considering ways of broadening the Fund's income base, and improving the tools for considering income and expenditure in a more integrated manner have been identified as key priorities by the IMF and the Fund is due to report back in early 2006.

4.22 One option would be to set up an investment account. The IMF Articles of Agreement already give the IMF the power to establish an account, subject to certain constraints. The IMF will be discussing further proposals on an investment account in early 2006 as well a range of other options such as the scope for making greater use of user fees; changing the way the income target is calculated and examining ways of making charges for loans more sensitive to borrower risk. The UK is keen to see the IMF diversify their income base and undertake measures which would strengthen their balance sheet. The UK will therefore carefully consider any such proposals as well as possible longer-term reforms to the Fund's financial framework.

4.23 Fund liquidity is kept under close review by the IMF Executive Board and is measured by the Forward Commitment Capacity (FCC). The FCC is derived using a series of calculations to identify the amount of resources available for lending by the IMF, allowing for retention of a prudential balance. At the end of 2004, the FCC stood at SDR 71.9 billion. This had increased to SDR 117 billion by January 2006, a relatively high figure for the IMF in recent years.

4.24 Further details on the IMF's financial position more widely is available on the IMF website³.

IMF risk management

4.25 By virtue of its purpose, the Fund has recently had a concentrated lending portfolio which demonstrated the need for the Fund to adopt a modern and credible risk management framework that, based on rigorous analysis, anticipates key risks going forward and considers possible strategies to mitigate their impact. Executive Directors have consistently stressed the need to improve the Fund's ability to assess and manage its own financial and operational risks. For example, a rigorous procedure for assessing the appropriate level of precautionary balances – as a safeguard against the risk of a major loan default or long-term arrears – has been called for. During 2005, IMF staff considered measures to improve the risk management framework and discussed best practice in other country authorities, including the UK. Their proposals will be discussed by the Executive Board in early 2006 and the UK will be looking to see comprehensive reforms that bring the Fund into line with modern best practice.

IMF review on Safeguards Assessments

In April 2005, Executive Directors reviewed the safeguards assessments policy. This policy was introduced in 2000 and aims to provide confidence that central banks have adequate financial control systems in place to manage their resources and Fund disbursements. Directors agreed that the policy has resulted in considerable improvements in the governance and control frameworks at many central banks and that the existing framework for assessing central banks' operations continues to be broadly appropriate. Directors also broadly agreed that flexibility should be applied to take into account country specific circumstances, provided this does not undermine the essence of the initiative, and that the IMF should continue to work closely with central banks and seek to improve their communications with them on safeguards issues.

³ http://www.imf.org/cgi-shl/create_x.pl?fa

Board discussions on programmes

4.26 As with surveillance decisions, the Executive Board usually acts on the principle of consensus in its lending decisions. However, the use of members' assets as the basis for Fund lending gives Executive Directors a fiduciary responsibility to their taxpayers. Executive Directors also strive to ensure that any programme is of maximum benefit to the programme country and their citizens.

4.27 In discussions on regular lending programmes (Stand-By Arrangements and Extended Fund Facilities), the UK assesses programme design on a case by case basis, against factors related to the need to promote not only macroeconomic stability, but also sustainable economic growth and poverty reduction. For example, the UK seeks to ensure that assessments of monetary and fiscal policy and financial sectors within the programme are sound, that the programme is sustainable and that there are clear and appropriate assumptions regarding private sector involvement in the programme country.

4.28 In the specific cases involving IMF lending to poor countries under the PRGF, the UK prepares a view of country progress based partly on in-country analysis by development experts from the Department for International Development. The Government also monitors progress on the key features that PRGF programmes are expected to meet in pro-poor countries, for example, through reporting on pro-poor budgets and Poverty and Social Impact Assessments (PSIA).

4.29 PRGF arrangements are typically 3 years in length, with programmes agreed annually and biannual reviews of progress brought to the Board. During discussions of PRGF countries, UK interventions have focused on questions related to the programme design, including:

- Does the programme support the country-led PRSP, adequately reflect the needs of the country, and embody reforms that are well sequenced and realistic?
- How does the PRGF measure up against its objectives? In particular, the UK encourages use of PSIA and a focus on improving public expenditure management and fiscal flexibility.
- For HIPC countries, where is the country in the HIPC initiative? For example, is it moving towards completion point?
- On performance, have targets been met? If not, are waivers justified and is commitment to ongoing reform and poverty reduction sufficient?
- On aid, has there been effective donor co-ordination? Are proposed conditions essential to achieve the objectives of the programme, well-timed and appropriately sequenced?

THE INDEPENDENT EVALUATION OFFICE (IEO)

4.30 The IEO was set up in 2001 with the objective of improving the effectiveness and credibility of the IMF by carrying out thorough and objective evaluations on issues relating to the Fund's work. Being fully independent from IMF management and staff ensures that the IEO can stand back and offer an alternative, more considered view of the IMF's operations in key areas.

4.31 The IEO typically produces three or four reports a year with the work programme being decided in collaboration with the Executive Board. In 2005, the Fund has published reports on IMF assistance to Jordan, IMF technical assistance policies and the IMF's approach to capital accounts liberalisation. Reports on the Financial Sector Assessment Program (FSAP) and multilateral surveillance are due in early 2006, and the work programme for the 2006 financial year will feature reports on IMF structural conditionality, IMF advice on exchange rate policy, the IMF's role in selected African countries and bilateral surveillance. The reports are published in full and are available on the IEO website⁴, along with details of their work programme. The report on IMF assistance to Jordan is discussed below whilst the other two 2005 reports, on technical assistance and capital accounts liberalisation, are discussed in chapter 3 of this report.

IEO report on IMF assistance to Jordan

The IEO reviewed IMF support to Jordan in the 15 years from 1989 to 2004 that Jordan had a lending programme with the IMF and looked at the extent to which the IMF tackled key macroeconomic problems. The report was published in November 2005.

The IEO concluded that IMF support had been broadly successful, noting that Jordan had successfully graduated from an IMF programme in 2004 with greater macroeconomic stability and restored external viability. However, a number of structural and fiscal rigidities remain and the IEO identified areas where the IMF should have taken a longer-term perspective at the outset and where greater candour over the challenges and risks faced and the rationale behind programme recommendations would have been helpful. The IEO noted that adjusting to lower levels of foreign grants and reducing fiscal rigidities should remain key priorities for Jordan.

The IEO also noted that technical assistance had made substantial and concrete contributions to the work of the IMF but that a wider dissemination of technical assistance reports within government and externally would have contributed to more informed public discourse.

Executive Directors broadly agreed with the report's overall conclusions and welcomed the broad policy lessons drawn.

4.32 Towards the end of 2005, an independent review on the IEO began its work, seeking to establish whether the IEO is meeting its objectives in strengthening the Fund's credibility and supporting the Executive Board as they oversee the work of IMF staff. It is expected to conclude its work in early 2006. The UK continues to believe that the IEO has made a strong contribution and their reports have contained valuable lessons for the Fund's work. Going forward, the UK would like to see greater follow up on previous Board-approved recommendations and greater external dissemination of the lessons learnt.

⁴ www.imf.org/ieo

5

THE 2006 AGENDA

5.1 2005 was a year of significant achievements and advances. The challenge for 2006 is to ensure momentum is maintained; that the UK successfully delivers and implements our 2005 agenda as well as the UK's existing long-term priorities for the IMF; and to develop a new ambitious agenda of reforms for 2006. This chapter sets out the goals which the UK will work towards in the following year.

DELIVERING THE 2005 AGENDA AND EXISTING PRIORITIES

Development **5.2** During the G7/G8 and EU presidencies in 2005, agreement was reached on a number of initiatives to assist the development of low income countries and on which the focus is now on implementation. As discussed earlier in this report, these include:

- implementation of the multilateral debt relief initiative;
- ensuring successful implementation of the new debt sustainability framework;
- increases in aid of around \$50 billion a year by 2010, compared to 2004, including an increase of \$25 billion a year to Africa by 2010;
- improved facilities for low income countries in the form of the shocks instrument and the policy support instrument; and
- continuing negotiations on trade to achieve a comprehensive deal to conclude the Doha round.

The UK will continue to work with the IMF and the World Bank, as well as with other members of the G7/G8, EU and the WTO to ensure progress on these existing commitments.

IMF strategic review **5.3** The IMF strategic review also provided a key opportunity to pursue UK priorities for the institution and to ensure a continuing focus on key existing IMF mandates. The strategic review is currently being taken forward by seven working groups, each led by senior members of the IMF which will develop specific proposals and operational guidance to implement the key tasks identified as priorities in the strategic review. IMF management expects to bring a series of recommendations drawing from this work to the Board in early 2006. The UK will work to ensure that progress is made on key UK priorities. In particular, the UK will be looking to see work to:

- improve surveillance to ensure adequate coverage of financial sector vulnerabilities, exchange rate regimes and spillovers as well as further progress on a framework for assessing the effectiveness of surveillance;
- consider the creation of a new instrument to allow precautionary access to lending where countries have significant market access and strong policy frameworks;
- ensure that the delivery of technical assistance to low income countries continues to be of high quality;
- further embedding the standards and codes initiative to further strengthen the international financial system and reduce the risks of economic crises;

- implement a modern budgetary framework for the Fund; and
- work with other IMFC shareholders on reaching an agreement on quotas.

A GLOBAL NEW DEAL

5.4 Building on the achievements of the last year is the key challenge for the UK in 2006 to ensure that progress continues to be made in empowering developing countries. The UK proposes an ambitious agenda for 2006 based on a global new deal whereby developed countries honour commitments on finance, debt, trade and the environment enabling developing countries to grow, invest and trade, and defeat hunger, illiteracy, disease and underdevelopment. In exchange, developing countries should pursue transparent monetary and fiscal regimes, create ambitious poverty reduction plans for investment and trade and tackle corruption. The following sections outline the policy changes that the UK will pursue to make the global new deal a reality.

Further finance for growth and poverty reduction

5.5 Multilateral debt relief has been given to 19 of the world's most indebted countries. However, the UK believes further steps are needed to complete the process of debt write off and that the debts should be cancelled for all 67 of the world's poorest countries who demonstrate that savings from debt reduction will be used for poverty reduction.

5.6 Achieving a comprehensive trade deal that delivers substantial increases in market access for developing countries and substantially reduces agricultural protectionism and other trade barriers remains an urgent priority for 2006. The UK will continue to push for an ambitious pro-development outcome to the Doha trade round and measures that deliver aid for trade, strengthen infrastructure in low income countries and empower low income countries to take advantage of the improved opportunities to trade.

5.7 Turning the greater financing that debt relief, aid and trade provide into programmes that bring lasting progress are key challenges for developing countries. The UK believes that all developing countries should produce poverty reduction and development plans not only to tackle corruption and build transparent open economic institutions but also to outline an ambitious path to meeting the Millennium Development Goals.

Innovative financing mechanisms

5.8 Innovative financing mechanisms are needed to help deliver and bring forward the financing urgently needed to achieve the MDGs. The UK proposal for the International Finance Facility (IFF) is a mechanism that will specifically support these efforts to bring forward donor commitments. Using existing and new resources, including those raised from other innovative financing mechanisms such as air ticket levies, the IFF will be able to increase aid to the levels required to achieve the MDGs.

5.9 The benefits of frontloading are already being demonstrated by the IFF for Immunisation, which is applying the IFF principles to the health sector by frontloading aid and immediately investing \$4 billion in vaccinations for preventable disease. It is estimated that this upfront investment will save 5 million lives between now and 2015. The UK believes that the IFF and other innovative financing mechanisms can be extended further to make significant and necessary long-term investments now across a range of sectors, including health, education, water and infrastructure. The UK has recently launched a joint working party with the French government to move forward proposals on the IFF and will continue to work with our global partners to widen the use of such innovative financing mechanisms and to accelerate progress towards the Millennium Development Goals.

**Disaster relief
and co-
ordination**

5.10 Natural disasters in 2005 exposed weaknesses in the capacity of the international community as a whole to prepare for and respond to natural disasters and underscored the urgent need for the international community to improve its preparedness and coordination; and the speed and scale of its response. This will require concerted efforts involving all actors: the international institutions, bilateral and multilateral donors, developing countries, non-governmental and private sector organisations.

5.11 The reform in December 2005 of the United Nations' Central Emergencies Revolving Fund is another key element in strengthening the response to emergencies and disasters, also with a large and early contribution from the UK of £40 million. Instead of a small, slow-to-act fund, the UK calls on rich countries to finance and regularly replenish the CERF as a fast-responding UN disaster relief and reconstruction fund. But these facilities are only a first step, and in 2006 the UK will propose as a matter of urgency further changes to ensure better, swifter and more coordinated disaster relief and reconstruction.

Energy

5.12 Following the agreement by world leaders in Gleneagles, there is a new commitment in the G8 to tackling climate change, and the international financial institutions can make a key contribution. The UK has proposed that the Energy Investment Framework agreed by G8 leaders at Gleneagles should be implemented through a new World Bank fund to channel \$20 billion in new financing for alternative energy sources, energy efficiency and adaptation to climate change.

**Strengthening
international
institutions**

5.13 To ensure long-term growth, private investment and monetary and fiscal stability in low income countries is key. The UK believes that strengthening the role of the IMF and other international financial institutions can help achieve this goal for the benefit of all members, in particular, through:

- reforming the way surveillance is conducted to ensure it has greater authority, transparency and credibility and to ensure greater focus on the realities of the global economy. Making surveillance politically independent and more transparent could eliminate any concern that IMF views have been compromised by actual or anticipated political interference and removing any possibility of conflict of interests between the IMF's surveillance and lending roles.; and
- encouraging greater collaboration between the IMF and the World Bank to contribute to reducing poverty and promoting development and continuing to work with the World Bank and the UN to ensure the global institutions together achieve the reforms necessary to rise to the global challenges and opportunities of the 21st century.

A

THE UK'S VOTING RECORD

A.1 This Annex provides information on the formal votes taken by the Board of Governors of the IMF in 2005, and an explanation of the UK position in each vote. Most decisions are taken in the IMF Executive Board, which usually works on the convention of consensus, without recourse to formal voting. A summary of Board votes registered by the UK is also included below.

Votes by the Board of Governors

A.2 The IMF's Articles of Agreement and by-laws specify the issues which require a vote by the Board of Governors. These are relatively few and include subjects such as changes to quotas, remuneration of Executive Directors and the Managing Director, decisions on the allocation and cancellation of Special Drawing Rights, amendments to the Articles of Agreement, election and changing the number of Executive Directors, forcing the withdrawal of a Fund member and liquidation of the Fund.

A.3 The resolutions that are passed as a result of Governors' votes are currently published by the IMF, with a two-year delay, in the 'Summary Proceeding of the Annual Meeting of the Board of Governors'. Governors voted on the following decisions in 2005:

NO.	RESOLUTION	VOTING RESULT	EFFECTIVE DATE	UK POSITION
60-1	Forthcoming Annual Meetings--Change of the 2005 Annual Meetings Date	Passed	May 24, 2005	Approve
60-2	Direct Remuneration of Executive Directors and their Alternates	Passed	August 24, 2005	Oppose
60-3	Financial Statements, Report on Audit, and Administrative and Capital Budgets	Passed	September 24, 2005 Annual Meeting	Approve

A.4 Decision 60-1 related to a proposal to modify the length and sequence of the Annual Meetings in order to reduce the demands on participants and to take account of security concerns.

A.5 Consistent with the firm stance of the UK on budget and remuneration issues, the UK opposed the increase in remuneration for Executive Directors and their Alternates (Decision 60-2). The UK believes that the remuneration of Executive Directors and their Alternates should reflect their primary role as appointed public officials and representatives.

A.6 Decision 60-3 gave Board of Governors' certification that the audited accounts, financial statements, and administrative and capital budgets fulfil the requirements of the Articles of Agreement and by-laws. The UK is content that this is the case.

A Summary of Executive Board Votes

A.7 In the Executive Board, the UK chair objected on two occasions in 2005, on February 16 and on September 9, both on further consideration of the complaint with respect to Zimbabwe's compulsory withdrawal in connection with its overdue financial obligations to the Fund.

B

THE UK'S FINANCIAL RELATIONSHIP WITH THE IMF

B.1 There is no annual subscription for IMF membership. Rather, there are two elements that define the UK's financial relationship with the IMF, namely the UK's:

- quota; and
- historic SDR allocation from the IMF.

Both of these have implications for the UK reserves.

QUOTAS

B.2 The primary source of the IMF's financing is through members' quotas. Each member of the IMF is assigned a quota, which is denominated in Special Drawing Rights (SDRs), the IMF's unit of account. Quotas broadly reflect the member's relative size in the global economy and are assigned to each member on the basis of macroeconomic variables including GDP, balance of payments, and the official reserves¹. It also establishes the member's financial and organisational relationship with the IMF in respect of its financial commitments, voting power and access to IMF financing. The UK's quota as at 31 March 2005 was SDR 10,739 million, about £8.6 billion at the exchange rate at the time or about £8.9 billion at the exchange rate for 31 December 2005. The UK's quota has remained at this level in SDRs since 2000, when it was increased from SDR 10,461 million.

B.3 All members of the IMF are required to pay a minimum proportion of their quota (up to 25 per cent) in 'reserve assets' (SDRs or specified, freely usable currencies such as the dollar, pound, euro or yen). The remaining balance is payable in the member countries' own currency, or in the form of non-interest bearing promissory notes denominated in that currency (which is the situation in the UK's case).

B.4 When the IMF lends to a country, it provides them with reserve assets. Therefore, in the first instance, the borrowing country can call back the proportion of its quota originally paid in reserve assets from the IMF. However, the borrowing country can also request additional funds. The IMF finances these additional amounts by using the reserve asset subscriptions of other member countries such as the UK.

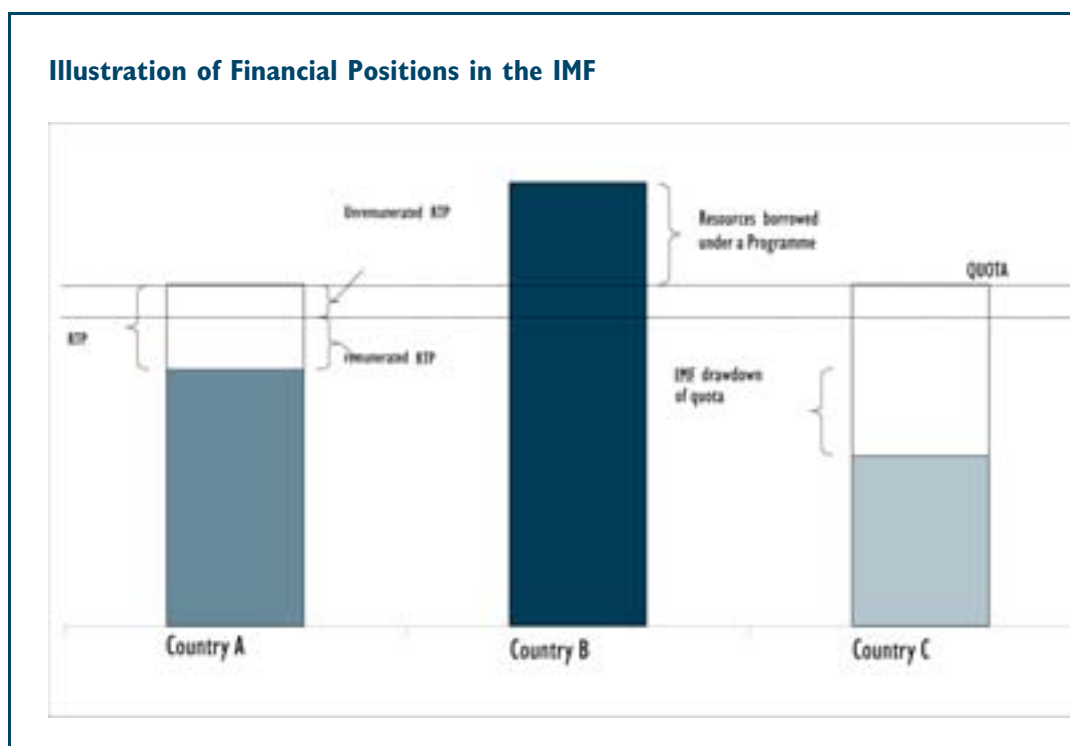
B.5 Such transactions result in a range of situations. On one hand, some borrowing countries have called back their reserve assets from the IMF and requested additional resources. Conversely, some creditor (net lending) countries have provided more than the minimum proportion of their quota in reserve assets, which is currently the UK's position.

B.6 The amount by which the UK's quota exceeds the Fund's holding of non-interest bearing sterling notes is referred to as the Reserve Tranche Position (RTP). This consists of the proportion of our quota originally paid in reserve assets, plus the part of our quota that the IMF has drawn upon. In the UK, the RTP forms part of the official reserves. As a result, when the IMF draws on the UK quota, our RTP rises, up to a maximum of 100 per cent of quota.

¹ For more information on the quota system, including the periodic quota reviews that the Fund conducts, see <http://www.imf.org/external/np/exr/facts/quotas.htm>

B.7 The UK policy of neutralising changes in the level of the RTP on the official reserves continued during 2004-05. Other things being equal, repayment of loans to the IMF in sterling would lead to a fall in the UK's SDR denominated assets and therefore in the official reserves. To offset this reduction in the reserves during 2004-05, the EEA² bought other foreign currency assets with the sterling repayment. Conversely, when the IMF make loans in sterling and so increase the UK's RTP, this causes the official reserves to rise (other things being equal). Selling foreign currency offsets such increases in the RTP.

B.8 The UK's RTP as at 31 March 2005 was SDR 3.4 billion, about £2.7 billion and approximately 32 per cent of quota. The UK's RTP as at 31 December 2005 was SDR 1.2 billion, about £1.0 billion. The RTP is an asset of the National Loans Fund (NLF).



Country A Member has paid its quota subscription in full and not drawn on its reserve tranche. Some of this reserve tranche is remunerated at the SDR rate and the remainder is unremunerated.

Country B The member is using IMF resources, in addition to having drawn its reserve tranche. The level of holdings in excess of the members' quota is subject to charges.

Country C The IMF has made use of the member's currency and pays the member remuneration on its enlarged Reserve Tranche Position, which is the UK's current position in respect of the IMF.

² The Exchange Equalisation Account (EEA) is the account that holds the UK's official reserves of foreign exchange, gold and IMF Special Drawing Rights (SDRs). The accounts are audited annually and can be viewed on the HM Treasury website: see http://www.hm-treasury.gov.uk/documents/uk_economy/exchange_equalisation_account_1999_to_2000/ukecon_eea_index99.cfm.

The Opportunity Cost of the RTP

B.9 A member country can call back its reserves assets (up to the value of its RTP) from the IMF in event of a balance of payments need. With regards to the UK's RTP, this forms part of our reserves, therefore any increases in its size are not regarded as public expenditure or as an increase in net public sector debt (we acquire a reserves asset that matches the liability created when the promissory notes are cashed in by the Fund in exchange for sterling). SDRs are, however, less liquid than conventional reserves assets (such as dollars, euros, yen) and in some instances can earn a lower rate of return. There can therefore be an opportunity cost associated with membership of the IMF.

B.10 The IMF remunerates most of our RTP at slightly below the level of the SDR interest rate³. However, SDR 700 million is unremunerated reflecting the element of the UK's quota that was made available to the IMF before 1st April 1978 in gold. The UK does not receive any interest on this portion.

B.11 For the RTP in 2004-05, the interest loss (driven by the difference between the SDR-based interest rate earned on the RTP and the sterling interest rate paid on the NLF liability that funds the RTP) was £91 million and the capital loss (due to exchange rate movements) was £25 million. The total loss on the UK RTP was therefore £116 million.

SDR ALLOCATION

B.12 In addition to our quota, the UK has received one-off SDR allocations from the IMF totalling SDR 1.9 billion, about £1.5 billion at the exchange rate for 31 March 2005 (or £1.6 billion at the exchange rate for 31 December). The UK pays the IMF interest on this allocation at the SDR rate. At the same time, the Fund remunerates any UK SDR holdings at the SDR rate. Therefore, if we held our full allocation in SDRs, the interest paid on this allocation would cancel out the interest received, resulting in a net interest cost of zero.

B.13 However, members have the option to sell part of their SDR allocation and to hold alternative reserve assets instead. The UK has tended to sell SDRs and invest the proceeds in dollars, euros and yen assets for portfolio management reasons. In FY 2004-05, we held on average £0.2 billion in SDRs and £1.4 billion in foreign currency. As a result, we paid interest to the IMF on our full allocation and received interest from the IMF on our £0.2 billion SDR holdings. We also received interest on our £1.4 billion in foreign exchange holdings at the market interest rates⁴ in the respective currencies. If the average interest rate on these holdings is lower than the SDR rate then we make a net loss on the allocation. This was the case in 2004-05 for the UK, when we made a net loss of £7 million. A small capital loss⁵ on the allocation meant that there was a total loss of £8 million overall on the UK SDR allocation.

³ The rate of remuneration, which is close to the SDR interest rate, is adjusted downwards for the financial consequences of protracted arrears under the burden sharing mechanism. These adjustments are determined after the end of each financial quarter (July 31, October 31, January 31 and April 30). On average the downwards adjustment is of the order of 0.1 percentage points.

⁴ The assumption about the income we receive is based on 3-month market interest rates.

⁵ A capital loss (gain) will occur if a basket weighted 40:40:20 Dollar:Euro:Yen weakens (strengthens) against the SDR; this means that the sterling value of the FX reserves funded from the SDR allocation will fall (rise) relative to the sterling value of the liability that constitutes the SDR allocation. If we chose to hold the whole allocation in SDRs there would of course be no capital gains or losses, as both asset and liability would be denominated in SDRs and thus move in line with each other.

NET FINANCIAL COST OF IMF MEMBERSHIP

B.14 For 2004-05, the portfolio of reserves associated with the IMF membership therefore cost the UK approximately £124 million, consisting of a cost of £116 million on the RTP and £8 million on the SDR allocation as outlined above. However, had we not been a member of the IMF and instead held a portfolio of conventional reserves, the net cost would have been approximately £181 million. This figure is calculated by assuming that an amount equal to the RTP and the SDR allocation are funded in sterling from the NLF and invested in reserve assets, keeping total UK reserves unchanged, in line with existing policies on neutralising changes in the RTP. The reserve assets are invested 40% in dollars, 40% in euros and 20% in yen, in line with the existing holdings in the EEA, and are assumed to earn interest at the 3-month repo rates in the respective markets⁶. The difference in cost between membership of the IMF and holding conventional reserves led to a saving of £57 million for 2004-05.

The table below shows the net cost of membership for the last two years. A positive number indicates a saving to the UK, whilst a negative number indicates a cost.

A summary of the cost of UK membership of the IMF

Financial Year	Gain/loss from membership (£m)	Gain/loss of non-membership (£m)	Net benefit/cost of membership (£m) ²⁰
2004-05	-123.88	-181.08	+57.20
2003-04	-374.56	-529.56	+155.00

B.15 The estimated net financial cost to the UK of membership of the IMF is therefore driven by movements in the sterling, SDR and foreign interest rate differentials and by exchange rate movements (dollar, euro, yen and SDR versus the pound). This analysis does not, however, include the non-financial benefits of IMF membership such as voting powers and access to IMF financing.

⁶ The calculation of the gain/loss of non-membership depends on the counterfactual (that is what reserves assets are held in place of the RTP). The assumption used is chosen for reasons of transparency and plausibility; it also means that the FX assets are comparable to the RTP in terms of lacking interest rate risk.

THE UK ARTICLE IV STATEMENT

UNITED KINGDOM—2005 ARTICLE IV CONSULTATION CONCLUDING STATEMENT OF THE IMF MISSION

C.1 Macroeconomic stability in the United Kingdom remains remarkable. Over the past decade, the growth of real GDP per capita has been strong and stable. Unemployment and inflation have been low, and the current account deficit has been moderate. This impressive record owes much to good macroeconomic, financial, and structural policies, underpinned by sound policy frameworks and supported by a generally favorable external environment. Our discussions have focused on recent cyclical and other influences on the economy and on how policies and policy frameworks can continue to support robust and steady macroeconomic performance.

C.2 The economy hit a soft patch this past year, but growth is expected to pick up in 2006 and 2007. The slowdown in 2005 reflected the relatively strong cyclical position in 2003 and 2004, the stabilization of the housing market, earlier monetary policy tightening, a sharp increase in energy prices, and a rise in tax revenues. Our near-term forecast is similar to those in the PBR and of the Bank of England—a well-balanced recovery with real GDP growth rising to about 2¼ percent in 2006 and about 2¾ percent in 2007. Both consumption and investment should accelerate with the waning of most negative influences at play in 2005, and export growth should continue to be supported by strong external demand. At roughly constant policy interest rates and with inflation expectations well-anchored, we expect CPI inflation to fall below 2 percent during 2006 and to rise to about target in 2007.

C.3 Uncertainties surrounding the growth forecast are substantial. Apart from the inherent uncertainties in understanding economic interactions, some specific risks to the assumed environment stand out. House prices are still richly-valued by some metrics, though a year of steady prices gives some comfort that risks of an abrupt adjustment have lessened. Immigration could be changing the landscape of the labor market, creating the potential for a larger workforce with stable wage growth. On the external side, a disorderly unwinding of global imbalances or an abrupt adjustment of presently low worldwide risk valuations poses large, though low-probability, downside risks.

Monetary policy

C.4 Monetary policy has been successful in addressing the combined effects of a cyclical slowdown and rising energy prices. Increases in interest rates during 2003 and 2004 helped cool demand and contain, so far, the second-round effects of energy price increases. The small cut in the interest rate in August recognized the faster-than-expected slowdown in demand, which in our view opened a small gap vis-à-vis potential output even after adjusting for the negative effects of oil price increases.

C.5 Looking ahead, the uncertainties in the forecasts are likely to make monetary decisions finely balanced. An immediate priority is to ensure that monetary conditions continue to prevent any second round effects of energy costs on prices and ensure that demand adjusts to the energy-price-induced slowdown in potential non-oil growth. Once these adjustments are more secure, interest rate decisions should be increasingly guided by whether the gentle pick-up in aggregate demand is proceeding as now forecast. A potentially important source of uncertainty for monetary policy will come from immigration: it will be important to understand the nature of its effect on the economy and assess the possibility that it could boost supply relative to demand.

Fiscal policy C.6 Recent deficits, while not an immediate threat to economic performance in a benign world environment, needed to be reined in. Following surpluses around the turn of the century, the fiscal position shifted into deficit owing to sizable real spending increases—largely current but also capital—and a move off cyclical revenue peaks. These developments must be viewed against the backdrop of relatively low public debt. Nevertheless, at about 3 percent of GDP during the past few years, the overall deficit needs to be reduced to stabilize net debt below the 40 percent ceiling. Accomplishing this adjustment through the current budget is important for avoiding the pitfalls in earlier periods when capital spending often bore the adjustment burden.

C.7 The PBR contains welcome plans for an appropriate adjustment. The FY2005/06 budget appears to be on track to achieve a modest reduction in the overall deficit relative to GDP and a somewhat larger adjustment in the current deficit. This reflects revenues associated with higher energy prices and strong personal income and corporate tax revenues, especially from the booming financial sector. In addition, the announcement of an increase in the tax rate on oil company profits, combined with increasing resource utilization and fiscal drag, contribute to a further reduction in the deficit over the next few years. And lastly, the PBR reiterates the government's intention to constrain current spending growth starting in FY2008/09. In our central projection, this would round out a reduction in the overall deficit to about 2 percent of GDP by FY2009/10—sufficient to stabilize net debt at about 40 percent of GDP, an objective we strongly endorse. Reaching the government's forecast of an overall deficit of 1½ percent of GDP would, in our view, require better outcomes than in our central projection or measures beyond those included in the PBR.

C.8 The envisaged spending restraint, a critical ingredient of the planned adjustment, will require careful planning. The 2005 PBR projects that the growth of current expenditure will slow to 1.9 percent in real terms for the three years starting in FY2008/09, and our projections fully incorporate this intention. With Annually Managed Expenditure (AME), such as social security benefits and interest payments, amounting to about 40 percent of total spending, the real growth of discretionary spending (DEL) will need to fall to less than half of recent rates. Such adjustments are difficult, though far from impossible, and can be a catalyst for good changes in the role of the government in the economy. Preparation for the 2007 Comprehensive Spending Review will be the lynchpin in the process of ensuring that the restraint is accomplished and is well prioritized.

C.9 A strength of the fiscal framework is a system of auditing by the National Audit Office. The NAO, which is independent of the government, now audits on a rolling basis 11 assumptions in the budget forecasts and this year the list was expanded to include the change in the dating of the starting point of the current economic cycle. This reliance on independent audit puts the United Kingdom, along with some other countries, on the frontier of institutional development. That frontier is moving, however, and we urge the government to further expand the role of the NAO in auditing the assumptions and methodologies underlying the preparation of the fiscal projections.

C.10 The fiscal rules are playing an important role in disciplining fiscal policy, although at times this role is overshadowed by peripheral controversies. We strongly endorse the objectives of the golden rule—within the net debt ceiling of 40 percent of GDP—to avoid pro-cyclical policy and to ensure adequate capital spending. This is particularly important in view of the United Kingdom's significant infrastructure needs, including in the transport sector. However, the current form of the golden rule requires a precise dating of the cycle. Not only is this difficult, but the adjustments in the definition of the cycle have proved an unhelpful distraction from the more important considerations of what a sustainable fiscal policy is and how it should be achieved. And assuming the broad stability in economic performance continues, dating cycles will become even less meaningful and more difficult. Therefore, once the current budget has moved back into balance, the government should consider an implementation of the golden rule that replaces the constraint now coming from measuring performance over the cycle with expanded NAO audits.

Financial stability

C.11 The financial sector is well-regulated and the outlook for the banking system is favorable, though there are risks. Banks are well-capitalized, highly profitable, and highly cost efficient. Levels of non-performing loans are very low. That said, retail asset quality has deteriorated somewhat with the uptick in personal insolvency rates and the growth in sub-prime lending. Banks' exposures to commercial property have grown rapidly as concerns about overvaluation in this sector rise. There are also some signs of a loosening of corporate lending standards, as banks compete with each other and with capital markets to provide funding in a low-yield environment.

C.12 Credit risk transfer (CRT) instruments are providing important diversification benefits, but their rapid growth is also creating risks. A key concern is that the pace of innovation may have exceeded the development of market infrastructure and banks' risk management systems. Consequently, any shock to the financial system could be exacerbated by financial institutions' increased exposures to these instruments. Therefore, we welcome the efforts of the Bank of England and the FSA to publicize the risks associated with these instruments and the more general evidence that risk may be underpriced. While we appreciate the need for cost-benefit analyses of new regulatory burdens, we encourage supervisors to continue to enhance their surveillance of the CRT market and to encourage private sector initiatives to increase disclosure of exposures to these instruments. We welcome the efforts by the FSA to address the transactions backlog problem in collaboration with the Federal Reserve Bank of New York and market participants.

C.13 Building on strengthened payment and settlements systems, the authorities should further improve risk mitigation in clearing arrangements within banks. Over the past two years, the authorities have taken actions to reduce the level of intraday interbank exposures and reduce settlement risk in money market instruments and retail payments. However, as greater clearing activities are undertaken within banks, for example in the processing of transactions related to credit risk transfer instruments, these are becoming important for financial sector stability.

C.14 While the health of the insurance sector has improved substantially over the past two years, supervisors should continue to push for a strengthening of core capital. Insurance companies have reduced their portfolio risk and have been helped by the recovery in equity prices. However, the quality of capital remains suspect for some firms. The introduction of the Individual Capital Assessment regime in January 2005 is aimed at improving risk assessment through an interactive process between insurance companies and the FSA.

Structural policies **C.15** The current debate on pensions brings to the fore a number of key questions. In approaching these questions, an important objective will be to maintain a state pension system that does not place an undue burden on public finances. There is evidence that a portion of the population is not saving enough to ensure retirement income that will meet its aspirations. Future governments may therefore be forced to increase the generosity of the state pension system. Obstacles to adequate private saving appear to be the difficulty of making rational decisions about long-term saving, the high cost of private pension products, the complexity of the state pension system and uncertainty about how it will evolve. These obstacles could be addressed through changes that create a simpler and more coherent system of public and private pension provision. These could include the introduction of a national, defined-contribution scheme with automatic enrolment and low operating costs, changes to the state pension system that simplify it and strengthen incentives for private saving, and increases in the state pensionable age as life expectancy rises. Options such as these involve important social choices that need to be debated to form a consensus on the share of scarce public resources devoted to pensions.

C.16 The authorities' efforts to create a flexible and dynamic labor market are welcome and should continue. The United Kingdom is one of only three countries to have relaxed border regulations in May 2004 to allow new members of the EU full access to its labor market. This is likely to have helped relieve specific skills shortages and thus acted to reduce inflationary pressures. The government's strategy of stimulating productivity growth by addressing five issues—innovation, enterprise, competition, investment, and skills—is appropriate. Priorities will be, first, to reduce the regulatory burden from an already relatively low level by implementing the recommendations of the Hampton Review and, second, to further develop policies to improve the skills base, building on the forthcoming final report of the Leitch Review. With the employment rate already high by international standards, the aspiration of increasing it to 80 percent is ambitious. In this context, the Pathways to Work pilots for incapacity benefit claimants have been successful and their planned rollout to one-third of the country by October 2006 is welcome.

C.17 The United Kingdom has fared well in a year of large increases in oil prices alongside a sharp slowing in house price appreciation. The mild impact of these developments is another marker in the enormous change in economic performance relative to that in periods even as recent as 15 years ago. Yet efforts to improve institutions—for fiscal transparency, financial sector oversight, and labor market flexibility—continue. Pushing ahead with such objectives will help protect a vibrant economic performance and set an international standard for economic policymaking.

December 19, 2005

D.1 The International Monetary and Financial Committee held its eleventh meeting in Washington, D.C. on April 16, 2005 under the Chairmanship of Mr. Gordon Brown, Chancellor of the Exchequer of the United Kingdom.

The Global Economy and Financial Markets—Outlook, Risks, and Policy Responses

D.2 The Committee welcomes the continuing global economic expansion, underpinned by supportive macroeconomic policies, improving corporate balance sheets, and benign financial market conditions. While returning to a more sustainable pace, global growth will likely remain robust in 2005. The Committee notes, however, that widening imbalances across regions and the continued rise in oil prices and oil market volatility have increased risks. The potential for a sharper-than-expected rise in long-term interest rates from their very low levels and for increased exchange rate volatility also calls for vigilance. The Committee emphasizes that in the coming months IMF surveillance should focus on promoting policies for reducing global imbalances over time; addressing the impact of higher oil prices, in particular on the most vulnerable countries; managing the policy response to potential inflationary pressures; and ensuring the sustainability of medium-term fiscal frameworks.

D.3 The Committee reiterates that all countries have a shared responsibility to take advantage of the current favorable economic conditions to address key risks and vulnerabilities. To ensure orderly adjustment of global imbalances and to help achieve more sustainable external positions and stronger medium-term growth, the Committee calls for concrete actions by all to implement the agreed policy response in a timely and effective manner. This includes fiscal consolidation to increase national savings in the United States; greater exchange rate flexibility as appropriate, supported by continued financial sector reform, in emerging Asia; further structural reforms to boost growth and domestic demand in Europe; and further structural reforms, including fiscal consolidation, in Japan.

D.4 The Committee notes that conditions in the oil market will remain tight in the medium term, reflecting strong global demand, low excess capacity, and supply concerns even after investments in some countries. It underscores the importance of stability in oil markets for global prosperity, and recognizes the impact of higher oil prices especially on poorer communities. In this context, the Committee calls for efforts to remove disincentives to investment in oil production and refining capacity, and to promote energy sustainability and efficiency, including through new technologies and removing barriers to the development of alternative fuels. It encourages closer dialogue between oil exporters and importers, and further efforts to improve oil market data and transparency.

D.5 Inflation remains relatively subdued in most countries, reflecting in part greater credibility of monetary policy. However, with inflationary pressures likely to increase as the expansion matures, a smooth transition to more neutral interest rates remains a priority in many countries, although the appropriate timing and pace will vary, depending on countries' cyclical positions. In countries receiving strong capital inflows, exchange rate flexibility would facilitate monetary management.

D.6 Steps to strengthen fiscal positions within sound frameworks and address structural weaknesses will also be critical for supporting medium-term growth and macroeconomic stability, and meeting demographic challenges. Fiscal deficits remain high in many industrial countries and should be reduced. In emerging markets, fiscal indicators have generally improved, but in countries with high levels of public debt continued efforts will be needed to reduce them to more sustainable levels. In both industrial and developing economies, structural reforms need to be advanced to remove rigidities and ensure sustainable growth. The Committee welcomes Argentina's rapid recovery. The recent debt exchange offer represents an important step toward the long-term goal of sustainable growth. Argentina will now need to formulate a forward-looking strategy to resolve the remaining arrears outstanding to private creditors consistent with the IMF's lending into arrears policy, and to continue with necessary structural reforms.

D.7 Poverty reduction must remain at the top of the international agenda. The Committee welcomes the strong growth performance across developing countries, particularly in sub-Saharan Africa, but notes with concern that most of them are at risk of falling well short of the Millennium Development Goals (MDGs). With improved macroeconomic stability in most countries, the key challenge remains to press ahead with reforms to strengthen the investment environment and foster private sector-led growth. The global community, in turn, needs to support these reform efforts through meeting commitments to increased and better coordinated financial and technical assistance, further debt relief, policies to improve remittance flows, and improved market access for developing countries.

D.8 The Committee emphasizes that successful and ambitious multilateral trade liberalization is central to sustained global growth and economic development. The immediate priority is for WTO members to translate the mid-2004 framework agreements into a viable policy package in time for the December 2005 WTO Ministerial Conference. The Committee encourages Doha participants to aim for ambitious and comprehensive results, notably in agriculture; substantial reductions in barriers to other trade, including liberalization in financial and other services; and strengthened multilateral trade rules. The Committee supports the IMF's continued role in advocating trade liberalization and assisting members to benefit from it. It encourages the IMF to work with other partners in the Integrated Framework to explore further ways of easing adjustment to trade liberalization, including through the Trade Integration Mechanism, and building capacity in low-income countries. The Committee looks forward to consideration of proposals at its next meeting.

Shaping the IMF's Strategic Direction

D.9 The Committee welcomes the discussions underway on the IMF's medium-term strategy, and looks forward to reaching conclusions by the 2005 Annual Meetings and further reflection on longer-term issues. The Committee agrees that the central elements of the IMF's mandate as set out in its Articles of Agreement remain as important as ever. The challenge is to enhance the IMF's effectiveness in pursuing its core objectives, while continuing to adapt to changing global economic circumstances. This would ensure that the IMF remains relevant for all its members, which would further foster the coherence, credibility, and evenhandedness of the IMF.

D.10 The Committee calls for further work on the following emerging priorities that will help shape the institution's strategic direction:

- Surveillance is a central task of the IMF and determined efforts are required to enhance its effectiveness and impact, building on the conclusions of the Biennial Review of Surveillance. Surveillance should become more focused and selective in analyzing issues, in an evenhanded way across the membership. Regional and global surveillance should play an increasingly important role, and be better integrated with bilateral surveillance.
- Work on financial sector issues and international capital markets should be further strengthened to reduce vulnerabilities and promote financial stability. This, including the Financial Sector Assessment Programme, should be integrated more fully into surveillance and other activities, and complemented by advice to members on ways to improve access to international capital markets and on orderly capital account liberalization.
- The IMF's lending function is a central pillar of its mandate. All lending should be selective and anchored in strong country ownership and institutional frameworks, putting members firmly on the road to external viability. The Committee looks forward to further reflection on how the needs of members could be met through IMF arrangements, and whether new instruments or revisions to existing facilities are required.
- The IMF has a critical role to play in helping low-income countries in their efforts to reduce poverty and achieve strong, sustainable growth through sound policies and institutions for macroeconomic stability. Efforts should continue to adapt the IMF's activities and instruments to the special circumstances and challenges of low-income countries, based on strong cooperation and clarity of responsibilities with the World Bank.
- The IMF must meet the highest standards of internal management, control, auditing, and governance. This will require further deepening of budget reforms, further work on the IMF's finances and financial structure, and efficient deployment of resources to reflect priorities. The Committee also looks forward to further work on risk management and control, and personnel management systems.
- The IMF's effectiveness and credibility as a cooperative institution must be safeguarded and further enhanced. Adequate voice and participation by all members should be assured, and the distribution of quotas should reflect developments in the world economy. The Committee emphasizes that the period of the Thirteenth General Review of Quotas provides an opportunity for the membership to make progress toward a consensus on the issues of quotas, voice, and participation.

IMF Support for Low-Income Members' Efforts Toward Poverty Reduction and Strong, Sustainable Growth

D.II The Committee underscores the conclusion of this year's Global Monitoring Report that bold actions are urgently needed by the developing countries and their partners to realize the MDGs. The U.N. Summit in September 2005 will mark an important milestone to review progress and lay out actions going forward. The IMF has a critical role in supporting—through policy advice, capacity building, and financial assistance, including debt relief—low-income countries' efforts to achieve macroeconomic stability, debt sustainability, and strong, sustainable high growth needed to make progress toward the MDGs.

D.12 Work is underway to refine the operational aspects of the Poverty Reduction Strategy (PRS) approach, improve the design of PRGF-supported programmes, and enhance PRGF-PRS alignment. This will be underpinned by more extensive analyses of the sources of and obstacles to growth, and of the linkages between growth and poverty reduction. The Committee looks forward to further work to ensure adequate financing of the PRGF to meet future demands as assessed by the IMF, and other IMF instruments to assist low-income countries, including to help members deal with shocks. It also looks forward to further work on a policy monitoring arrangement to enhance the IMF's signaling role for countries that do not need or want IMF financing.

D.13 The Committee supports work by the IMF and World Bank on aid effectiveness and financing modalities. On innovative sources of development financing, such as the International Finance Facility (IFF) and its pilot—the IFF for immunization—global taxes which could also refinance the IFF, the Millennium Challenge Account, and other financing measures, it welcomes the joint IMF and World Bank note outlining progress that has been made. The Committee asks to be kept informed of the further work ahead of the U.N. Summit.

D.14 The Committee notes the recent progress in providing debt relief under the HIPC Initiative. It encourages countries to take the necessary actions to benefit from the Initiative, and urges full creditor participation. The Committee supports the joint IMF-World Bank framework to assist low-income countries' efforts to achieve and maintain debt sustainability while pursuing their development objectives, and a review of experience under the framework.

D.15 The Committee welcomes the IMF's work and the preliminary discussion of key issues regarding proposals for further multilateral debt relief and its financing options, and calls for further discussion with shareholders and examination of these issues, including the possible use of the IMF's resources, by the time of its next meeting. It notes that any possible further debt relief from the IMF should be part of a wider international effort.

Other Issues

D.16 The Committee welcomes progress toward meeting the objectives of IMF surveillance identified at its last meeting, including in the areas of exchange rate issues, financial sector surveillance, better integrating debt sustainability analysis and regional and global spillovers into country surveillance, and balance sheet vulnerabilities. It also welcomes the Africa Regional Economic Outlook. The Committee looks forward to the upcoming review of the Standards and Codes Initiative to assess its effectiveness in informing surveillance, enhancing crisis prevention, and strengthening countries' institutions.

D.17 The Committee welcomes the increased adoption of collective action clauses in international sovereign bonds, and calls on the IMF to continue to promote progress in this area. It notes the "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets" being developed by a number of sovereign issuers and the investor community, and encourages further efforts to improve the Principles aimed at achieving a broad consensus. The Committee looks forward to further work on the orderly resolution of financial crises, including the implementation of the IMF's lending into arrears policy.

D.18 The Committee takes note of the recent review of IMF conditionality, including the design of IMF-supported programmes. Progress has been made in streamlining conditionality and fostering national ownership. The Committee encourages the IMF to incorporate the findings of the review into its operational work, and to deepen further its analysis of key elements of programme design.

D.19 The Committee recommends completion of the ratification of the Fourth Amendment.

D.20 The Committee wishes to thank James Wolfensohn for his great contribution as President of the World Bank. During his time at the helm of the Bank, great strides have been made in cooperation and partnership between the IMF and the World Bank, and in progress toward realizing our dream of a world free of poverty.

D.21 It is expected that the next meeting of the IMFC will be held in Washington, D.C. on September 23, 2005.

E.1 The International Monetary and Financial Committee held its twelfth meeting in Washington, D.C. on September 24, 2005 under the Chairmanship of Mr. Gordon Brown, Chancellor of the Exchequer of the United Kingdom.

The Global Economy and Financial Markets—Outlook, Risks, and Policy Responses

E.2 The Committee welcomes the ongoing global economic expansion, although it notes that growth divergences between countries remain wide. Global growth is expected to continue, although downside risks to the outlook have increased, especially high and volatile oil prices, recently exacerbated by the effects of Hurricane Katrina, the widening of global imbalances, increasing protectionist sentiment, and the possibility of tighter financial market conditions. While core inflation generally is contained and inflation expectations remain well anchored, higher oil prices remain a risk to price stability. The Committee notes that these areas should be a particular focus of IMF surveillance and policy advice in the coming months.

E.3 The Committee emphasizes that oil producers, oil consumers, and oil companies will all have their part to play in working together to promote greater stability in the oil market. First, the Committee welcomes the action by members of the International Energy Agency and oil-producing countries to continue to increase supplies to the market. Second, the Committee calls for further investment both now and in the long term throughout the supply chain, particularly in refining capacity including of heavy oil, and for efforts to create a favorable investment climate. Third, the Committee also stresses the importance of policies to promote energy conservation, efficiency, and sustainability, including through new technologies, alternative sources of energy, and reducing subsidies on oil products. Fourth, the Committee encourages closer dialogue between oil producers and consumers, and further efforts to improve oil market data and transparency to improve market efficiency. Fifth, the IMF should stand ready to provide assistance to help members, especially poor countries, deal with oil price shocks.

E.4 The Committee welcomes recent progress in implementing the agreed policies to address global imbalances and foster growth, but urges further action to promote orderly adjustment in view of the heightened risks to the outlook. This includes: fiscal consolidation to increase national savings in the United States; greater exchange rate flexibility in emerging Asia; further structural reforms to boost potential growth in the euro area; and further structural reforms, including fiscal consolidation, in Japan, where the economy is regaining momentum. Measures to promote a more investor-friendly environment, including in a number of emerging market economies, would also contribute to reducing imbalances. Oil-exporting countries will also need to play their part, including through efficient absorption of higher oil revenues in countries with strong macroeconomic policies.

E.5 Steps to strengthen medium-term fiscal positions remain crucial for supporting global growth and stability. Fiscal deficits in many industrial countries need to be lowered further, and reforms to address pressures from aging populations and ensure the sustainability of pension and health care systems need to be accelerated. Improvements in the fiscal positions and debt structures of many emerging market countries are welcome, but in countries with high public debt levels continued fiscal consolidation efforts are needed. The Committee also calls for more ambitious efforts to address rigidities in labor and product markets in many countries. Regulatory and supervisory authorities should remain alert to risks stemming from ample global liquidity and associated risk taking and leverage.

E.6 The Committee emphasizes that a successful outcome to the Doha Round by the end of 2006 remains of critical importance for global growth and poverty reduction. Serious challenges remain in reaching agreement at the WTO ministerial meeting in Hong Kong SAR in December. As finance ministers and central bank governors of WTO member countries, we have a vital interest in successful multilateral trade liberalization. Benefiting from a useful exchange of views with Mr. Pascal Lamy, the Director-General of the WTO, the Committee calls on all countries to ensure progress on ambitious trade liberalization with the urgency that the timetable now demands. Key areas for action are: increasing market access, especially for developing countries; significantly reducing trade distorting domestic support; eliminating all forms of export subsidies in agriculture; and making significant progress on services, including financial services, and on issues of intellectual property. The Committee welcomes the joint IMF-World Bank staff report on proposals to enable low-income countries to benefit fully from trade liberalization, and urges the Executive Board to consider these proposals expeditiously.

E.7 The Committee welcomes the enhanced growth performance and prospects of many of the world's poorest countries, reflecting improvements in their underlying policies. With ten years remaining to meet the Millennium Development Goals (MDGs), those countries should move rapidly to strengthen policies needed for sustainable growth and poverty reduction, including through sound macroeconomic frameworks and building the sound, accountable, and transparent institutions that are essential for fostering growth and supporting vibrant private sector growth. Also, the international community must follow through expeditiously on its renewed commitments to provide additional resources, including at the Gleneagles Summit and the Millennium Review Summit. An ambitious outcome to the Doha Round is also essential for poverty reduction.

IMF Objectives and Medium-Term Strategy

E.8 The Committee welcomes and supports the broad priorities set forth in the Managing Director's Report on the Fund's Medium-Term Strategy to improve the IMF's effectiveness in support of its members. In the coming years the IMF will continue to work to help members meet the economic challenges of globalization within its mandate in the macroeconomic and financial areas. The Committee looks forward to specific proposals and timelines on the main tasks identified in the medium-term strategy in the Executive Board's work programme, within the context of the IMF's medium-term budget framework and the staff compensation review.

E.9 The broad priorities set out in the Managing Director's report are to:

- Make surveillance more effective;
- Adapt to new challenges and needs in different member countries;
- Help build institutions and capacity;
- Prioritize and reorganize the IMF's work within a prudent medium-term budget; and
- Address the issues of fair quotas and voice.

The Committee agrees that the IMF needs to deepen its analysis of globalization and continue to develop its strategy for responding to the long-term challenges it poses.

Strengthening IMF Support for Low-Income Countries— Instruments; Financing; and Debt Relief

E.10 The Committee reiterates that the IMF has a critical role in supporting low-income countries through policy advice, capacity building, and financial assistance. The PRGF remains the main instrument for IMF financial support for low-income country members. The Committee agrees that the IMF's concessional lending should be financed at an appropriate level as assessed by the IMF. The Committee calls for incorporation of the lessons from the recent review of the design of PRGF-supported programmes in the future work of the IMF in low-income countries.

E.11 The Committee welcomes the progress made on new instruments that will strengthen IMF support for low-income countries. The Policy Support Instrument (PSI) will be available to members that do not need, or want, IMF financial assistance, but voluntarily request IMF endorsement and continued assessment of their policies as meeting the standard of upper credit tranche conditionality. The country-owned policy frameworks designed by the authorities would consolidate medium-term macroeconomic and financial stability, and deepen reforms in support of poverty reduction and economic growth. A new window in the PRGF Trust will also be available to complement existing instruments by providing timely concessional support to low-income members without a regular PRGF arrangement and who are facing exogenous shocks, and we look forward to contributions from countries.

E.12 The Committee supports the proposal to provide 100 percent cancellation of debts owed by Heavily Indebted Poor Countries (HIPCs) to the IMF, the International Development Association and the African Development Fund. This will provide significant additional resources for countries' efforts to reach the MDGs and reinforce longer-term debt sustainability. The Committee welcomes the approach subsequently discussed in the IMF to ensure that the IMF's resources will be used consistently with the principle of uniformity of treatment. It stresses the importance of ensuring that the IMF's capacity to provide financing to low-income countries is maintained, and therefore welcomes G-8 countries' commitments to provide additional resources. It also emphasizes that countries benefiting from irrevocable debt relief should have demonstrated sound policies and high standards of governance. Following this agreement now reached on all the elements, the Managing Director has informed the Committee that he will now call the Executive Board together to complete its approval of the arrangements to deliver debt relief by the end of 2005. The implications of debt cancellation for the new debt sustainability framework should be addressed in the review scheduled for Spring 2006. There should be a regular report on progress at future meetings of the Committee.

E.13 The Committee underscores the importance of full creditor participation, including by non-Paris Club creditors and private creditors, in contributing their share to implementing the enhanced HIPC initiative. It takes note of the work on identifying low-income countries with unsustainable debts as of end-2004, with a view to finalization by early 2006 of the list of countries potentially eligible for HIPC assistance.

E.14 The year 2005 is the International Year of Microcredit. The Committee notes the IMF's role in improving data availability on microcredit and in addressing microcredit issues in the Financial Sector Assessment Programme.

Other Issues

E.15 The Committee welcomes the rapid progress on the inclusion of collective action clauses in international sovereign bonds, and the efforts by emerging market issuers and private sector creditors to broaden the consensus on the "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets." The Committee looks forward to further work on the orderly resolution of financial crises, including the implementation of the IMF's lending into arrears policy.

E.16 The Committee calls for continued actions by all countries to develop strong programmes on anti-money laundering and combating the financing of terrorism (AML/CFT). The Committee supports the IMF's efforts to implement its intensified AML/CFT work programme, and notes the critical importance of supporting countries' efforts with well-targeted and coordinated technical assistance.

E.17 The Committee recommends members' acceptance of the Fourth Amendment of the Articles of Agreement. The Committee reiterates that the IMF's effectiveness and credibility as a cooperative institution must be safeguarded and further enhanced. Adequate voice and participation by all members should be assured, and the distribution of quotas should reflect developments in the world economy. The Thirteenth General Review of Quotas presents an opportunity to address the issue, and we look forward to progress on this issue and a report back at our next meeting.

E.18 The Committee looks forward to continued high-quality reports by the Independent Evaluation Office (IEO) under the leadership of its new Director, Thomas Bernes, and to the upcoming external evaluation of the IEO.

E.19 The Committee paid tribute to Alan Greenspan, in his last meeting of the IMFC, for his outstanding leadership of the Federal Reserve and his unprecedented and much valued contribution to the Committee's work over the last eighteen years.

E.20 The next meeting of the IMFC will be held in Washington, D.C. on April 22, 2006.