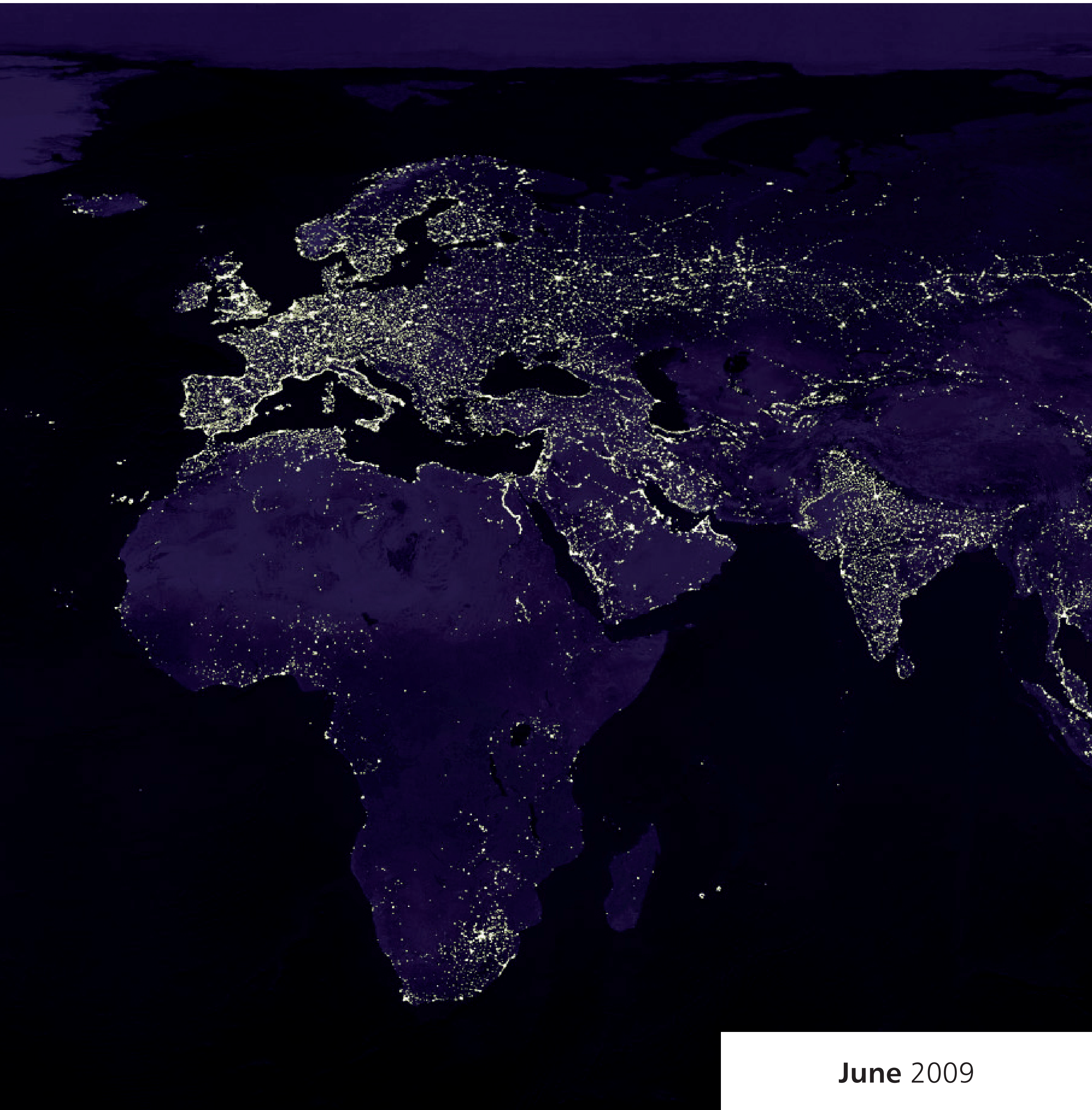
HM TREASURY

# The UK and the IMF 2007 and 2008:

## responding to global economic challenges



**June** 2009

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# Foreword

This report covers a period of extraordinary activity at the International Monetary Fund. At the time of publication, the IMF has already committed $150 billion in new lending to support countries affected by the current economic and financial crisis. This includes significant increases in lending to the poorest countries in the world. The UK and its international partners have reacted swiftly to the needs of the IMF, with agreement at the London Summit in April to treble the Fund's resources to $750 billion so it can continue to provide much needed financial support. Alongside this substantial increase in resources, Leaders also supported a package of wider reforms, recognising that the IMF must adapt if it is to remain a relevant, effective and legitimate organisation that can respond the challenges of an increasingly, integrated global economy.

The events of the past eighteen months have highlighted the importance of the international community working together through international financial institutions such as the IMF. As cross-border financial, economic and trading links grow, it presents challenges that no one nation can solve in isolation. Shared action at the international level is therefore crucial. All of us stand to benefit from a strong and flexible IMF that is able to support and promote global growth and stability.

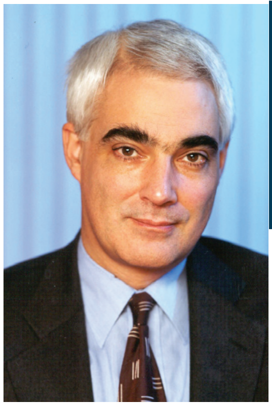
The UK has been at the forefront of the IMF reform agenda, including through its Chairmanship of the G20 this year, and the Government remains committed to building on the progress made to date. Our immediate priority is to ensure rapid implementation of the agreements made at the London Summit in April so that the IMF is equipped to do its job, both during the current crisis and in the years ahead.

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

Rt Hon Alistair Darling MP

Chancellor of the Exchequer

# Representing the UK in the IMF



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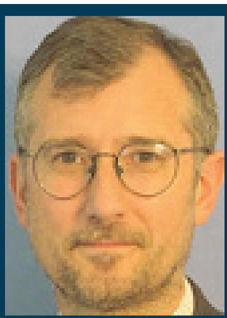
*UK Governor of the IMF*

**MERVYN KING**
*Governor of the Bank of England*
*Alternate UK Governor of the IMF*



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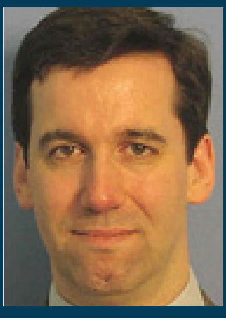


**ALEX GIBBS**
*UK Executive Director*

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 represents the UK at 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.

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 185 members of the IMF. The UK, as one of the five largest contributors to the IMF, has its own Executive Director - currently Alex Gibbs.

The Executive Director is supported in Washington D.C. by a team of advisors drawn from HM Treasury, the Bank of England and the Department for International Development.

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 International and Finance Directorate is specifically responsible for preparing advice on the policy issues and country programme that are brought before the Executive Board

# 1 Introduction

## Achieving stability in the world economy and financial markets

1.1 The past year has seen the world economy face the greatest challenges of modern times. The financial crisis, which began in the summer of 2007 led to a global recession affecting all countries. It has highlighted regulatory and institutional failures at the national and international level and its resolution therefore requires coordinated action nationally and globally.

1.2 The Leaders of the Group of Twenty (G20) countries have committed to do whatever is necessary to restore confidence, growth and jobs and to repair the financial system to restore lending. First meeting in Washington in November 2008, G20 leaders agreed wide ranging actions to address the global downturn, which they built on at their meeting in London under the UK's leadership, in April 2009 – setting out an ambitious plan for global recovery and reform. Strengthening and reforming the International Monetary Fund (IMF) to ensure its longer term relevance, effectiveness and legitimacy, is a central part of this plan to help manage the current crisis and prevent future crises.

1.3 Through its core responsibilities for economic surveillance and the provision of financial assistance, the IMF has a critical role in promoting economic growth and financial stability. Like other institutions, the IMF has not fully kept pace with the challenges of the modern, global economy and fell short in helping to prevent the current crisis. A reinvigorated IMF, with greater resources and a well-focused mandate is needed to ensure that the response to the crisis is coordinated and comprehensive, and that the global economy is put on a sustainable path to recovery and growth. The UK has been a longstanding champion of IMF reform, and welcomes the increased momentum provided by the G20 for further and faster reform of the IMF.

1.4 The immediate priority for the IMF in responding to the crisis has been to provide urgent support to those emerging markets facing a sudden stop or reversal in capital flows enabling them to provide liquidity to their financial sectors, support trade and corporate finance, and avoid unnecessary and pro-cyclical fiscal policy corrections that would undermine domestic and global growth. IMF lending is now at record levels (approximately US$157 billion), including a sharp increase in concessional lending to the world's poorest nations. The UK strongly welcomes the agreement at the London Summit to a trebling of the IMF's lending capacity to $750 billion, and to an allocation of Special Drawing Rights worth $250 billion. The UK will work closely with others in the G20 to ensure that these commitments are delivered. These resources will be targeted at supporting growth in emerging markets and developing countries by helping finance counter-cyclical spending, bank recapitalisation, balance of payments support, social support, debt rollover and trade finance.

1.5 To ensure that these resources are delivered flexibly and in a timely and effective manner, the IMF overhauled its lending framework in early 2009. The IMF moved quickly to put in place large programmes using existing instruments (primarily Stand-By Arrangements) for a number of countries – which have been fast-tracked under the emergency financing mechanism. A central part of the wide-ranging reform is the introduction of the Flexible Credit Line to provide support to Emerging Market Economies which have been following strong policies but have been hit by contagion. The FCL, which is based on pre-qualification rather than traditional IMF conditionality, is helping to address the political stigma that has been associated with IMF arrangements and Mexico, Poland and Colombia have now agreed arrangements under the FCL.

1.6 And because the current crisis has a disproportionate impact on the vulnerable in the poorest countries, Leaders at the London Summit also agreed to double the amount of concessional lending provided to the poorest nations by the IMF, funding this in part through the proceeds of gold sales. To ensure those resources get quickly to those that need them, the IMF has been reforming its instruments for Low-Income Countries including streamlining conditionality and doubling the access levels for its concessional lending instruments. Modification of the Exogenous Shocks Facility in September 2008 has made it faster to access, easier and more flexible to use and capable of providing more financing. The conditionality associated with the ESF is tailored to members' needs and circumstances with less emphasis on the broad structural adjustment that often characterises other IMF-supported programs; other requirements have also been streamlined and made more flexible. Given the current crisis, at the Spring Meetings in April 2009 the Chancellor of the Exchequer also called for the interest rate on concessional lending to be reduced to zero for the next two to three years.

1.7 The current crisis has also reinforced the need to strengthen the IMF's surveillance to ensure that the Fund can identify and address significant vulnerabilities in the international financial and economic system, and increase its ability to gain traction with policy makers. The UK has continued to press for more candid, even-handed, and independent surveillance that focuses on the impact of countries' policies on one another, and on the risks facing the global economy. The 2007 Surveillance Decision and the adoption of the Statement of Surveillance Priorities at the Annual Meetings in 2008 were important steps toward achieving this goal. We are continuing to press for greater collaboration between the IMF and the newly established Financial Stability Board to prevent future crises by identifying and providing early warning of the key systemic risks and vulnerabilities. The Fund is also playing an important role in the near term to ensure countries take coordinated action to restore growth, including the use of fiscal measures to stimulate domestic demand, as well as rejecting protectionism and barriers to trade.

1.8 The Fund's overall effectiveness also depends on it having widespread legitimacy and support among its members. A first stage of quota reform was agreed by the IMF Governors in 2008, an important step in ensuring that the governance and voting structure in the Fund better reflects the economic weight of countries in the modern global economy. In particular it gives greater recognition to the increased role of the Emerging Markets, whilst also enhancing the voice of the world's poorest nations. However, further reform is needed, and G20 Leaders called for completion of the next quota review by January 2011. The UK believes that this quota reform should be complemented by reforms to the Fund's overall governance structure, including to enhance the role of Ministers in setting the Fund's strategic direction, and improving its decision-making arrangements.

1.9 The development of the economic and financial crisis means that the period covered by this report is one that has already seen much activity and reform at the IMF – of which the UK has been a strong supporter and driver. However, the period ahead will also be one of further reform to ensure that the Fund has a mandate and role which is fit for the demands of the global economy; has the policy frameworks in place to fulfil that mandate; and a governance and representation structure which enables it to be a legitimate, effective and relevant institution serving the needs of all its members.

1.10 This report outlines the key activities of the IMF over the past two years including the role the UK as a major shareholder has played. It also outlines the main activities that the Fund will be undertaking over coming months, highlighting the UK Government's priorities for action, including those agreed at the London Summit in April 2009, to ensure that the global economy is put back on a recovery path towards sustainable growth; and is more resilient to challenges in the future.

# 2 Supporting a return to sustainable growth

2.1 The Fund's core purpose is to support sustainable global economic growth, by promoting policies through which all members can work together to increase the prospects for economic growth and stability. The IMF's surveillance activity, which it undertakes at the global, regional and national level, is its key mechanism for carrying out this work.

**Box 2.A: IMF surveillance outputs:**

Surveillance is the process of monitoring and consultation through which the IMF has a dialogue with member countries on the domestic and international consequences of their economic and financial policies. The legal basis for IMF surveillance and the responsibilities of members and the Fund are set out in Article IV of the Fund's Articles of Agreement. Surveillance includes work at three different levels:

- Global – including analysis of the world economy through the twice yearly IMF World Economic Outlook and the Global Financial Stability Report;
- Regional – including analysis of key regional economic areas such as the Eurozone; and
- Bilateral – the IMF holds Article IV consultations with each member country – usually on an annual basis – about its economic policies which may affect external stability. This accounts for the vast majority of its surveillance work; during 2007 and 2008 over 250 Article IV reports were brought to the IMF's Executive Board for peer review.

2.2 However, the current crisis has demonstrated the Fund's shortcomings in this area. The evolving and increasingly interconnected nature of the global economy means that risks to international stability can be created by countries pursuing policies that make sense from their own point view, but are ultimately incompatible with global sustainable growth. Analysis of regional and global issues should be at the forefront of the Fund's work, which in the past has focused predominantly on bilateral surveillance. Another feature of the current crisis is that it originated with instability in financial markets, but that it quickly and widely spread to the macro-economy. In order to fulfil its role as guardian of the global economic and financial stability, it is vital that the Fund's approach to surveillance places much greater emphasis on assessing macro-financial linkages and spillovers.

2.3 The UK's priorities for reform of IMF surveillance focus on addressing these two critical issues. To achieve these goals, the UK believes that it is extremely important that the IMF's surveillance focuses on:

- creating a better understanding of countries' policy objectives and how they are likely to respond to external changes, understanding better the external spillover effects and providing a forum in which countries can discuss risks and the appropriate responses;

- developing a more rigorous and systematic macro-financial surveillance framework to ensure interactions and transmission channels between the financial sector and real economy are understood, risks to international economic and financial stability are identified, and spillovers are taken into account; and
- developing a mechanism for more effective collaboration between those that monitor the health of the global economy and national regulators – and also for collaboration between national regulators themselves.

## Reforming surveillance

2.4 As advocated by the UK and others, the IMF has taken steps in recent years to improve the focus and quality of its surveillance. In 2007, it amended the 1977 Surveillance Decision. The new Surveillance Decision places much greater focus on whether countries' policies promote external stability and pose risks to the international system (for further details see box 2.B below). The IMFC also endorsed a new Statement of Surveillance Priorities at the 2008 Annual meetings, to guide and focus the work of the IMF. The priorities for 2008 to 2011 can be found at annex C and set out a range of economic and operational priorities for that period. Taking account of the current economic context, the economic priorities include resolving financial market distress, and promoting orderly reduction of global imbalances. Operational priorities include focusing on financial sector surveillance and analysis of exchange rates and external stability risks.

**Box 2.B: 2007 Surveillance Decision**

The 1977 'Decision on Surveillance Over Exchange Rates' set guiding principles, which were designed to promote exchange rate stability against a backdrop of global economic turbulence. However, in recent years it has become very clear that these guiding principles needed to be updated to reflect the huge transition that has taken place in the global economy since the 1970s. Following the reform agenda set at the UK-chaired IMFC meeting in April 2006, the Executive Board adopted the 'Decision on Bilateral Surveillance over Members' Policies' in June 2007. This Decision was grounded in the notion of external stability, defined as "a balance of payments position that does not, and is not likely to, lead to disruptive exchange rate movement." The revised Decision is not intended to impose additional obligations on members, but will:

- assist in better defining the scope – broadened to include relevant domestic policies – and focus – using a principle of proximity to ensure that only relevant policies are discussed – of surveillance, firmly anchored to the organising principle of maintaining external stability;
- place greater emphasis on the linkages between multilateral and bilateral issues, with potential international spillover effects highlighted; and
- emphasise the importance of dialogue and the need for candour and even-handedness with all members.

2.5 In addition to changes to its surveillance framework, the Fund has made a number of changes to its operations and products including: the establishment of a new macro-financial surveillance unit focusing on developing a comprehensive framework to analyse macro financial linkages; further strengthening its Global Financial Stability Report (GFSR) to provide and disseminate in-depth assessments of vulnerabilities in the global financial system; expansion of the IMF's vulnerabilities exercise to advanced economies; and piloted an early warning exercise.

2.6 The UK has called for the Fund to link its macro-financial surveillance with work on specific financial sector and institutional policy issues. Since the start of the financial turbulence, the Financial Stability Board (FSB – formerly the Financial Stability Forum) has demonstrated effectively its ability to develop concrete policy actions and bring together policy makers, central bankers and regulators. This underscores the need for strengthened co-operation between the IMF and the FSB.

## The early warning exercise

2.7 Following a UK-led initiative, the IMF and FSB have been developing their capacity to give early warning of the risks to macroeconomic and financial stability. The aim of an early warning exercise is for the two institutions, drawing upon their respective comparative advantages, to identify common issues, market activities or classes of institutions that pose a systemic risk to financial and economic stability. It should monitor indicators such as the degree of leverage in the financial system and developments in particular markets and sectors. In this assessment, the potential external stability implications of the vulnerabilities both nationally and internationally would be drawn out. It would highlight both the macroeconomic risks and spillover effects. The FSB would use this analysis to identify mitigating measures to be implemented in a coordinated way; and policy makers - Finance Ministers, Central Bank Governors and where appropriate regulators - from major financial centres and systemic economies would be asked to respond to the suggested policy responses and ideally agree on a collective course of action. Specific issues and recommendations might be followed up bilaterally through surveillance.

2.8 The IMF and FSB's advice would be underpinned by detailed analytical work set out in the WEO and GFSR, and the analysis of the risks would inform the Fund's approach to Article IV missions. Subsequent EWE reports to the IMFC would reappraise the risks and appropriate policy actions, but they would also provide follow-up analysis on the evolution of risks previously identified. A pilot of such an exercise was developed for the 2009 Spring Meetings and the IMFC welcomed the work so far.

## Commitment to effective surveillance

2.9 While calling for surveillance to be technically excellent and well-focused, the UK has also been a strong advocate for ensuring that the advice provided has influence on policies critical to macroeconomic stability. In order for surveillance to be most effective and to maintain credibility, it must be independent, transparent and accountable – and seen to be so. It is crucial that the Fund is able to hold member countries to account for the policy actions that they take and ensure that they have policy frameworks in place that are consistent with global stability and growth. While the IMF's surveillance and policy advice is very valuable for some emerging and low-income member countries, it is commonly perceived to have little traction in advanced economies. In recognition of the need for greater commitment from the membership, at the Washington G20 Summit all G20 members committed to undertaking a Financial Sector Assessment Program (FSAP) report, and support the transparent assessments of countries' national regulatory systems.

2.10 Looking ahead, a key priority for the UK is to ensure successful implementation of the 2007 Surveillance Decision, including rapid conclusion of overdue Article IV reports. The UK also supports the planned reporting on the Fund's delivery against the Statement of Surveillance Priorities by the Managing Director, at each set of Annual Meetings, and the further development of the early warning exercise.

**Box 2.C: Improved Institutional Transparency, Standards and Codes**

**Increasing transparency:**

Increased transparency of bilateral surveillance is an important precondition of creating more accountable, effective and high quality surveillance advice. The UK supports the progress made on transparency, as demonstrated by the increase in publication rates of country Article IV consultation reports since the agreement on a new IMF transparency policy in 2003. Publication of Article IV and Use of Fund Resources (UFR) reports has increased in recent years, from 67 per cent between 2001 and 2003 to 87 per cent in 2008.[1] However, this still leaves a sizeable proportion of unpublished reports and the UK regards further progress in this area as an important element of surveillance reform. The Executive Board will complete another review of the IMF's transparency policy by the end of 2009.

**Standards and Codes:**

Another important element in the international community’s work to ensure that countries have robust capacity and institutions capable of reducing the threat and consequences of financial crises is the effective implementation of the Standards and Codes initiative, which was launched in 1999. Fund and Bank staff monitor observance of these standards and codes, and regularly publish progress on compliance in Reports on the Observance of Standards and Codes (ROSCs). This may then be referred to in Article IV consultations.

The UK remains committed to promoting increased participation in the Standards and Codes initiative, and welcomes progress made in this area. As of the beginning of December 2008, 145 countries (over three quarters of the IMF membership) had participated in the Standards and Codes initiative. This has risen from 137 in December 2006 and 109 in June 2004, with 1057 assessments, reassessments and updates having been produced by December 2008, compared with 914 in December 2006 and 724 in April 2005. Over three quarters of the assessments, reassessments and updates have been published. Whilst it acknowledges the success achieved to date in promoting adherence to the initiative, the UK believes it is important to encourage further participation and transparency, and to ensure that better integration of ROSCs into IMF surveillance and TA functions.

## UK Article IV

2.11 The UK is fully committed to leading by example on the surveillance reform agenda, and values and publishes the recommendations made by IMF UK Article IV missions and the conclusions of the Executive Board. The 2008 UK Article IV consultation was carried out in May, discussed by the Executive Board on 30 July, and published on 5 August. Details, including concluding statements from previous missions, can be found on the IMF website. The 2009 Article IV mission took place in May 2009 and will be discussed by the Executive Board shortly.

2.12 The UK Government highly values the advice and analysis provided through the Article IV process. In particular, as we have been responding to the global downturn, the IMF’s analysis and advice, for example on ways to reform the resolution regime for failing financial institutions, has been a useful input to the UK policy process.

[1] Key Trends in Implementation of the Fund’s Transparency Policy 2009.

## Additional support for member countries

### Strengthening capacity

2.13 The IMF also plays an important role in providing technical assistance often in partnership with donors. This is to enable authorities particularly in low and lower middle-income countries – which account for 80 per cent of the Fund's programme spend – to improve the management of their economies and ensure that they implement sound macroeconomic policies which are conducive to stability and growth. Provision of technical assistance (TA) and training to developing countries is a core component in the Fund's drive to make bilateral surveillance outputs operational, as it better enables authorities in these countries to implement recommendations from their Article IV consultations. This improves the IMF's ability to promote macroeconomic and other policies at national level that will positively impact on external stability, which in turn will improve conditions for stability and growth at the regional and global level.

2.14 Technical assistance accounts for approximately one-fifth of the IMF's budget and is funded primarily by the IMF with contributions from a range of bilateral and multilateral donors[1]. In August 2008 the Fund took the decision to introduce a mechanism for country contributions towards Fund-provided TA. These fees were introduced from May 2009 onwards. The purpose of introducing fees was to strengthen ownership and improve allocative efficiency, and the UK helped ensure the contribution rate will be graduated according to the recipient country's per capita income level, with Low-Income Countries paying 10 per cent of the cost of the TA, lower middle income countries paying 30 per cent, upper middle income countries paying 50 per cent, and high income countries the full cost. The Board will review the success of this changing regime in early FY 2011.

### Anti money-laundering and counter terrorist financing

2.15 In responding to the global challenge of crime and terrorism, the international community has prioritised work to combat money laundering and the financing of terrorism. The UK has continued to work with its international partners to enhance further the global implementation of the 40 +9 Recommendations on anti-money laundering/counter financing of terrorism (AML/CFT) developed by the Financial Action Task Force (FATF). The UK was President of the FATF between July 2007 and July 2008 and pursued a rigorous set of objectives to protect the international financial system from abuse.

2.16 In its April 2007 Communiqué the IMFC called "for closer cooperation between the IMF and Financial Action Task Force in promoting stronger implementation of international anti-money laundering and combating terrorist financing (AML/CFT) standards". The FATF has continued to work closely with international bodies including the IMF on AML/CFT issues. Furthermore, during the UK Presidency a FATF Ministerial Meeting was held in the margins of the IMF and World Bank Spring Meetings, in line with UK objective on increased accountability to Ministers.

2.17 The IMF has continued its important country surveillance activity including assessments of AML/CFT systems in place, identifying TA needs and evaluating assistance that has been provided. The Fund is also active in researching and analysing international practices on implementation of AML/CFT regimes as a basis for providing policy advice and TA. These activities have been closely coordinated with the FATF and FATF Style Regional Bodies.

[1] The UK's financial relationship with the Fund is set out in Annex A.

## Sovereign wealth funds

2.18 Sovereign wealth funds (SWFs) – government-backed investment vehicles, funded by foreign exchange assets – have been around for a number of decades, but the recent growth in the number and size of SWFs means that they are becoming increasingly important elements of the international financial system. Estimates from 2007 indicate total assets held by SWFs amount to around $2 trillion to $3 trillion, less than two per cent of total managed funds globally. As SWFs continue to invest internationally across a wide range of assets, their growth brings benefits, but also raises security concerns in recipient countries that these investments could be made for non-commercial reasons. These concerns were heightened by the opaque nature of many SWF investment strategies.

2.19 At the 2007 October Annual Meetings, the IMFC called for the IMF to develop best practice guidelines for SWFs. On the recommendation of the IMF, an International Working Group (IWG) of twenty-six SWF countries was created to develop a set of principles to guide SWF practice and objectives. The IWG was co-chaired by senior representatives of the Abu Dhabi Investment Authority (ADIA), the Government of Singapore Investment Corporation (GIC) and the Director of the IMF's Monetary and Capital Markets Department who were selected by the participating SWFs. In October 2008, the Generally Accepted Principles and Practices (GAPP) for SWFs (also known as the Santiago Principles) was endorsed by the IMFC and publicly released, with a set of voluntary best practices for SWFs, consisting of 24 principles, focusing on governance, transparency and accountability and aimed at easing the concerns of recipient countries. These principles reflect the collaborative and consultative spirit among SWF sponsor and recipient countries and demonstrate commitment to consensus building. The IMF played a crucial role in this process through facilitating and coordinating the work of the IWG, providing technical support and acting as the groups' secretariat. Following the recommendations from member countries, the IWG is now creating a Standing Group for SWFs to keep the principles under review and explore the scope for collecting and disseminating aggregated information on SWF operations.

# 3 Strengthening the global financial safety net

## IMF crisis response

3.1 Through its surveillance function, the Fund has a key role to play in identifying potential crises and taking preventive action. However, it cannot safeguard against all risks, and the Fund's other key function is to provide financial support to countries facing difficult economic and financial circumstances – a role it has performed extensively throughout the current crisis.

3.2 When G20 Leaders met in April, they were strongly focused on the urgent need to ensure that capital continued to flow to emerging and developing countries, to protect their economies and support world growth. For much of 2007 and 2008 emerging market economies (EMEs) appeared relatively isolated from the financial market crisis due to their limited exposure to sub-prime and other toxic assets. However, many of these countries started to experience severe problems in late 2008 as increased risk aversion turned the financial crisis into a global downturn. Markets in Eastern Europe, Asia and Latin America experienced severe capital outflows, tumbling equity markets and sharp exchange rate depreciations, as financial deleveraging accelerated and foreign investors reduced their exposure. They have faced difficulties in securing access even to basic trade finance and as the severity of the crisis in advanced markets became more apparent, prospects for EME exports and growth duly fell.

3.3 The IMF has stepped in to provide additional resources, to stabilise markets and restore confidence in the international financial system. It has provided assistance to countries that had reached a crisis point, and helped prevent contagion leading to full-scale crisis in countries pursuing sound economic policies. The provision of insurance through 'precautionary' financial support via new lending facilities has been one of the key improvements to the IMF's toolkit. Ensuring the Fund had enough resources to meet these needs was a key priority, and one of the main outcomes of the London Summit in April.

3.4 The IMF is primarily funded by its member countries' quota subscriptions. At the time the crisis deepened in late 2008, the IMF's loanable resources from quotas stood at about $200 billion. It also had access to around $50 billion of contingent financing, from the New Arrangements to Borrow (NAB), to which some IMF members contribute. As the crisis deepened during the final few months of 2008, the Fund was called on to provide over $40 billion to four of its members, and it became apparent that given conditions in the global economy, further substantial calls were likely to follow. Box 3.A summarises the crisis-related lending undertaken by the Fund in recent months.

**Box 3.A: Overview of IMF lending commitments**

Activation of the Emergency Financing Mechanism (EFM) in October 2008 has ensured that resources provided by IMF financing instruments could be disbursed through "fast track" procedures, and with streamlined conditionality.

Working closely with the EU, the Fund has played a particularly active role in Central and Eastern Europe, with programmes provided for:

- Hungary: a 17-month $15.7 billion Stand-By Arrangement, representing 1,015 per cent of quota (accompanied by $8.1 billion from the EU Balance of Payments (EU BoP) facility, and $1.3 billion from the World Bank);
- Ukraine: a $16.4 billion 24-month Stand-By Arrangement, accounting for 802 per cent of quota (additional $1.5 billion provided by the World Bank);
- Latvia: a $ 2.4 billion 27-month Stand-By Arrangement, accounting for 1200 per cent of quota (in addition to $4.3 billion from the EU BoP facility, and $ 3.7 billion from bilateral and other sources); and
- Romania: a $17.1 billion 24-month Stand-By Arrangement, accounting for 1111 per cent of quota (plus $6.6 billion from the EU BoP facility, $1.3 billion from the World Bank, and $1.3 billion from EBRD, IFC and EIB combined).

The Fund has also agreed major packages for Pakistan ($7.6 billion), Serbia ($3.9 billion); Iceland ($2.1 billion); Belarus ($2.1 billion) as well as a number of smaller programmes, some of which have been provided on a precautionary basis. In addition to the support provided through IMF Stand-By Arrangements, three countries with strong track-records have requested and qualified for access to the IMF's Flexible Credit Line on a precautionary basis: Mexico ($47 billion), Poland ($20.5 billion) and Colombia ($10.4 billion). As a result, total IMF lending commitments have now reached a record level of $157 billion.

**UK approach to IMF lending requests:**

The UK has supported all requests for IMF programmes and access to the Flexible Credit Line. The UK has encouraged countries to come forward at an early stage to seek appropriate support from the IMF, as in a number of cases access to a precautionary arrangement can provide reassurance to the markets and prevent the need for a full IMF programme. In IMF Board discussions, the UK has reiterated the need for programmes to be appropriately financed to ensure that Emerging Markets facing a sudden stop or reversal in capital flows, are able to provide liquidity to their financial sectors, support trade and corporate finance, and avoid unnecessary and pro-cyclical fiscal policy corrections that would undermine domestic and global growth. The UK has also emphasized the need to tailor conditionality to the minimum adjustment necessary to get countries back on a sustainable path.

## Additional resources for the IMF

3.5 It also became clear that the IMF might not have sufficient resources to deal with the range of potential needs of its members, especially if it was to play a full role in preventing contagion, as well as mitigating the effects of the crisis in countries that had already become exposed to significant problems. In addition, any uncertainty over the IMF's ability to support its members would also undermine confidence and exacerbate the problem rather than contain it.

3.6 Responding to these needs, when the G20 met in April it agreed to substantially increase the resources available through the IMF – and other international financial institutions, so that they are able to address the crisis in a coordinated and comprehensive manner. The goal is to support growth and deliver counter-cyclical spending, bank recapitalisation and balance of payments support. In summary the G20 Leaders agreed to support:

- A tripling of the IMF's lending capacity to $750 billion to be achieved by expanding and modernising its New Arrangements to Borrow (NAB) by up to $500 billion;
- In the immediate term, fast, temporary bilateral financing of $250 billion from member (which will subsequently be rolled into the reformed and expanded NAB);
- A general allocation of Special Drawing Rights (SDRs) equivalent to $250 billion; and
- A commitment to accelerate the next quota review to be completed by January 2011 to ensure the IMF's finances are on a sustainable footing commensurate with the needs of the international monetary system.

3.7 To ensure the necessary funding could be provided quickly, many countries, including the UK, agreed to provide bilateral loans to the IMF – funded through their reserves. This includes $100 billion pledged by Japan and $100 billion in total by European Union Member States. A number of other countries intend to support the Fund through the purchase of bonds, including China (up to $50 billion), Russia ($10 billion) and Brazil ($10 billion). The UK has made a strong commitment to support the Fund, and will contribute as part of the collective EU commitment announced by EU leaders at the Spring European Council.

3.8 Such bilateral arrangements are outside the Fund's usual financing framework so G20 Leaders agreed in London that these loans were intended to be incorporated subsequently into medium-term contingent financing for the IMF through the New Arrangements to Borrow (NAB). The NAB was created in 1997 in response to the Mexican financial crisis in 1994 and became effective in November 1998. It provides a multilateral framework for borrowing from a group of member countries – currently twenty-six contributors. In total, through contributions from current and prospective new members the NAB will grow by up to $500 billion, enabling the IMF to have access to much greater levels of funding should it be needed by its members. At the June European Council, EU Leaders agreed that EU Member States stood ready to take their share of further financing needs through the NAB, in line with their economic weight and in the context of fair burden-sharing at the global level.

3.9 In addition to providing additional resources to the IMF, G20 Leaders, and subsequently the IMFC, affirmed their support for a general allocation of Special Drawing Rights equivalent to $250 billion. A new allocation of SDRs will provide an important boost to member countries' holdings international reserves, which may have weakened as a result of the global financial crisis. SDRs can be exchanged for liquid useable currency at the SDR interest rate with another participating member. At its simplest, the drawing down of SDRs represents the loaning of hard currency reserves from countries who can spare them to those who need them, thereby serving as a form of mutual insurance. In this way, the SDR allocation will particularly help the emerging market and developing economies, whose access to hard currency may be limited by unfavourable market rates that incorporate a high risk premium.

3.10 In addition, Leaders at the London Summit called for the urgent ratification of the Fourth Amendment to the IMF's Articles of Agreement. This will enable the one-off special SDR allocation (agreed in 1997 to include more Emerging Markets and Low-Income Countries in the SDR system) to be implemented.

## Reform of the lending framework

3.11 The crisis has also heightened the need to ensure that the IMF has an effective lending framework and suite of policies in place to meet its members' needs. The UK has long been a strong advocate for reform of this framework, so that it is better placed to meet the needs of its members, provide appropriate incentives and avoid issues of stigma.

3.12 A particular focus has been on the need for Fund finance to be deployed to prevent crises developing – an objective that has been hampered by a number of factors, including the perceived stigma of receiving IMF support. A first step was taken as the crisis heightened in 2008, with the adoption of the short term liquidity facility (SLF) designed for countries with strong economic policies which were facing temporary liquidity problems. However, it was not available on a precautionary basis, and it allowed access to relatively low levels of financing for a short time – and hence did not get any uptake.

3.13 As the crisis deepened Ministers called for wider reform of lending at the 2008 Annual Meetings. This has resulted in significant, multi-faceted reforms to the IMF lending instruments and conditionality so far in 2009.

3.14 The key elements of the reform are summarised in box 3.B, and together represent a major step forward in the Fund's approach to lending. These include a much greater focus on precautionary lending, recognising that the economic and social costs of preventing crisis are often less than mitigating crises after they occur. Complementing the greater availability of such resources is a drive towards much more focused conditionality. For very strong performing economies with sound policies, but which are affected by the current crisis and faced with a sudden stop in capital flows, the Fund created the Flexible Credit Line (FCL) – which replaced the SLF. The key differences in the new tool are that greater financing can be accessed, for longer periods, and importantly for precautionary purposes, as well as to address an actual balance of payments need. Given the need to demonstrate a strong track record before being able to access the instrument, the FCL has also helped to soften the perceived stigma of receiving IMF support.

3.15 The IMF also increased the level of financial support members can access – which is much needed, given the evolving nature of the crisis and the important role of the capital account in the current crisis (and the larger financing and liquidity needs that this implies).

3.16 Collectively the reforms are designed to better meet countries' needs, encourage them to seek support for the Fund before crisis hits, and to enable counter-cyclical policies. Signs of success are apparent, with Mexico, Poland and Colombia already accessing the FCL. The focused conditionality should strengthen countries' ownership of the policies that are linked to the programme, and ensure that the conditions attached are tightly focused on delivering economic outcomes.

3.17 This package of lending reform was strongly promoted and welcomed by the G20. They provided impetus for such reform when they met in Washington in November 2008, and in April strongly welcomed the creation of the new Flexible Credit Line, and the rapid take up of the new instrument. Like the rest of the G20, the UK agrees that these reforms go a long way to address members' needs, but believe the framework should be kept under review, to ensure it remains relevant and responsive. It will also be important to monitor implementation of the new lending framework to ensure policies are applied consistently.

**Box 3.B: Key Features of IMF lending reform**

Creation of the Flexible Credit Line (FCL) to provide large and upfront financing to members with very strong fundamentals and policies. Access to the FCL is restricted to those members that meet strict qualification criteria, and countries do not have to adopt specific policy goals. The flexibility built into the design of the FCL relates to its uncapped access, its long repayment terms and unrestricted renewals. Importantly it also has a dual-use – for contingent (precautionary) and actual balance of payments needs. Already the Fund has approved requests under the FCL to Colombia, Poland and Mexico amounting to $78 billion.

Enhancing Stand-by Arrangements (SBA) to provide flexibility in lending to countries that may not qualify for the FCL and need similar insurance. These countries can now access High Access Precautionary SBAs (HAPAs). Like the FCL, precautionary SBAs take account of country-specific circumstances and can be front-loaded based on the strength of a country's policies and the external environment.

Modernising conditionality so that conditions linked to IMF loan disbursements are focused and adequately tailored to the varying strengths of members' policies and fundamentals (there have been criticisms in the past that some IMF loans had too many conditions that were insufficiently focused on core objectives). This modernisation is achieved by relying more on pre-set qualification criteria (ex-ante conditionality) rather than on traditional (ex post) conditionality. In addition, structural reforms are now monitored in the context of programme reviews rather than through the use of structural performance criteria, which will be discontinued in all Fund arrangements, including those with Low-Income Countries.

Doubling lending access limits so that the normal annual and cumulative access limits for non-concessional lending are 200 and 600 per cent of quota, respectively. These higher limits are designed to give confidence to countries that adequate resources will be accessible to them to meet their financing needs. There continues to be scope for higher access under intensified scrutiny by the IMF's Executive Board.

Simplifying the lending toolkit and charging structures to create the right incentives for borrowing from the Fund, and to eliminate some seldom-used facilities.

Reform of facilities for Low-Income Countries to strengthen the IMF's capacity to provide concessional short-term and emergency financing. Access levels have been doubled, and the Fund also intends to at least double its concessional lending capacity for Low-Income Countries.

# 4 The IMF in Low-Income Countries

4.1 The IMF has a vital role to play in supporting poverty reduction, development and economic stability in Low-Income Countries (LICs) by providing economic policy advice, technical assistance and financial support, including the provision of debt relief.

4.2 In recent years, IMF support has played an important role in supporting sustained improvements in the macroeconomic performance and policies of LICs. Due to their relative lack of integration with international financial markets, LICs were initially less exposed than other economies to the direct effects of the crisis. However, export concentration and limited resources leave these countries vulnerable to falls in commodity prices, uncertain trading conditions, and reduced foreign direct investment and aid. Preserving their hard-won macroeconomic stability is critical for growth, poverty reduction and ensuring government expenditure reaches the poor. The Fund's continued involvement in LICs is therefore more important than ever.

4.3 It is for these reasons that, in April this year, G20 Leaders committed to a doubling of the IMF's concessional assistance to $6 billion, alongside the reform of concessional financing, including the doubling of access limits. However, much remains to be done to ensure the IMF provides effective and timely support to the poorest nations in the world.

## Crisis response and Low-Income Countries

4.4 The small size and limited diversity of many LICs exposes them to particular stress from external crises and shocks. Over the past two years, unprecedented surges in the price of food and fuel; and the recent unfolding consequences of the financial crisis have required the IMF to respond. The UK has encouraged the IMF to play a supportive role in helping countries withstand these stresses while protecting the most vulnerable sections of society.

4.5 The IMF's response to rising food and fuel prices has taken three forms, which also offer a set of responses to emerging and anticipated pressures arising from the global economic downturn:

- policy advice: the IMF has tailored its advice in support of country-specific responses to the crisis, and has encouraged countries to ensure that responses reflect the potential resources available, are time-limited, and are targeted at the most vulnerable;
- financing: the IMF has agreed four new Poverty Reduction and Growth Facility (PRGF) arrangements in light of the food and fuel price shocks. These arrangements provided $65 million in total to Burundi, Djibouti, Mali and Niger. The Fund has also provided additional finance totalling over $150 million to countries with existing PRGF arrangements; and
- improving instruments: the UK has successfully pushed for the IMF's Exogenous Shocks Facility to be reformed to provide larger sums of money more rapidly in cases where countries are hit by shocks beyond their control. Malawi, the Kyrgyz Republic, Comoros, Senegal, Ethiopia, Democratic Republic of Congo, St Vincent

and the Grenadines, Kenya and Tanzania have recently received support from the facility and we expect several further countries to do so in the coming months.

**Box 4.A: Commitments at the London Summit to support LICs in the global crisis**

At the London Summit in April, G20 Leaders agreed to support a doubling of the IMF's concessional lending capacity for LICs and a doubling of access limits, within the Debt Sustainability Framework. It was agreed that additional resources from agreed sales of IMF gold will be used, together with surplus income, to provide $6 billion additional concessional and flexible finance for the poorest countries over the next two to three years, consistent with the new income model of the IMF.

As set out in chapter 3, G20 Leaders also agreed to support a general SDR allocation to inject $250 billion into the world economy and increase global liquidity, of which $20 billion will go directly to Low-Income Countries.

Going forward, the G20 and IFIs will be working to ensure that these resources can be effectively and efficiently distributed to those countries that need them most.

## IMF instruments for Low-Income Countries

4.6 The IMF Board has maintained its view that the primary focus of the Fund's work in LICs should be to provide policy advice and technical support on the design of appropriate macroeconomic frameworks and critical structural reforms, and that Fund staff have a key role in helping countries manage the macroeconomic impact of aid inflows and avoid re-accumulating unsustainable debt. In addition to the recent doubling in access limits, the IMF's concessional financing facilities are being reformed to make them more flexible and address the diverse needs of Low-Income Countries as they face the global crisis. Reforms will include steps to provide more effective short-term and emergency financial assistance. To help the poorest countries manage through the crisis, at the 2009 Spring Meetings, the Chancellor of the Exchequer also called for the interest rates on all IMF concessional facilities to be reduced to zero for the next two to three years.

4.7 The following section highlights the different IMF instruments available to support LICs.

## Poverty reduction and growth facility

4.8 The Poverty Reduction and Growth Facility (PRGF) was established in 1999 and is the IMF's main concessional lending programme and prime vehicle for engagement in LICs. PRGF-supported programmes are framed around comprehensive country-owned Poverty Reduction Strategy Papers (PRSPs), prepared by governments with the active participation of civil society and other development partners.

4.9 Largely as a result of new programmes and augmentations resulting from the food and fuel crisis, disbursement under the PRGF rose from SDR 328 million in 2007 to SDR 522 million in 2008 up to end-October. In November 2008, 24 IMF members were benefiting from PRGF arrangements; four new programmes were approved during the 2007, eight in 2008.

4.10 The UK's approach at the Board when considering and reviewing PRGF loans is informed by in-country analysis from development experts at the Department for International Development. We monitor progress on the key targets that PRGF programmes are expected to meet in developing countries through reporting on pro-poor budgets and Poverty and Social Impact Assessments (PSIA). During discussions of PRGF countries, the UK typically focuses on issues related to programme design such as whether programmes support PRSPs with well-sequenced and realistic reforms, well-focused conditionality, whether eligible countries are progressing towards attaining debt relief, and whether necessary performance targets have been met and, where not, whether waivers are justified.

## Exogenous Shocks Facility

4.11 In November 2005, the Fund introduced the Exogenous Shocks Facility (ESF) to provide concessional financing to PRGF-eligible countries that are experiencing sudden shocks, such as oil and food price changes, natural disasters and conflicts, but which do not have a current PRGF programme in place. The UK has pressed for further reform of the facility to ensure it better meets the needs of Low-Income Countries and this was secured in September 2008. This has enabled nine countries (Malawi, the Kyrgyz Republic, Comoros, Senegal, Ethiopia, Democratic Republic of Congo, St Vincent and the Grenadines, Kenya and Tanzania) access to over $1 billion in additional resources.

4.12 The reformed ESF now has two key components: (i) a rapid-access component (RAC) under which a country can quickly access up to 50 per cent of its quota for each exogenous shock in a single disbursement; and (ii) a high-access component (which can be used following an RAC) with access up to 150 per cent of quota in normal circumstances with phased disbursements over one to two years.

4.13 In addition, the requirement for a member to have a Poverty Reduction Strategy has been dropped (although the ESF retains a focus on the impact on the poor of the shock and related policies) and conditionality has been streamlined and better tailored to members' needs and circumstances, so that for instance under the RAC members are only required to commit to appropriate policies to address the shock.

## Policy support instrument

4.14 For those LICs eligible for PRGF lending that do not want financial assistance from the IMF, but do want advice and endorsement of their policies, the Policy Support Instrument (PSI) was introduced in October 2005. 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. By the end of 2007, Nigeria had successfully completed its first two-year PSI, as a result of which Nigeria achieved impressive economic reforms and $18 billion in debt relief. PSIs have also been approved at the request of five other countries: Uganda, Cape Verde, Tanzania, Mozambique and Senegal.

## Debt relief

4.15 The Heavily Indebted Poor Countries (HIPC) initiative was launched in 1996 by the IMF and World Bank to ensure that no poor country faced an unmanageable debt burden. Under the initiative a country receives interim debt relief at 'Decision Point'. At 'Completion Point', a country's debts are irrevocably reduced to a sustainable level, and a number of countries, including the UK, give additional debt relief and cancel 100 per cent of their bilateral debts. In 2005, agreement was secured on the Multilateral Debt Relief Initiative (MDRI), which cancels 100 per cent of the debts owed by Completion Point HIPCs to the IMF, World Bank and African Development Bank. The UK remains fully committed to both initiatives.

4.16 Progress has continued to be made during the past two years. A total of 24 countries have now completed HIPC and received irrevocable debt cancellation, including under the MDRI. The IMF is also providing MDRI relief to two non-HIPCs with per capita income below the established threshold. A further eleven countries are receiving interim HIPC assistance. Five other countries will be eligible for HIPC debt relief when they have established a track record of macroeconomic stability and have shown a commitment to poverty reduction. They will also qualify for MDRI on reaching Completion Point. In total, the IMF is expected to deliver US $6.1 billion of debt relief under HIPC and US $4.2 billion under MDRI.

## Debt Sustainability Framework

4.17 The Joint World Bank and IMF Debt Sustainability Framework (DSF), introduced in 2005, was developed to better monitor the accumulation of debt and inform decision-making for new borrowing. The Framework puts responsibilities on both borrowers and creditors and provides guidance on financing strategies to help borrowing countries devote resources toward achieving the MDGs, while also considering their ability to repay their debts. The DSF is intended to avoid the build up of unsustainable debt in the future. Since then, the UK has continued to work closely with the Bank and Fund to promote the use of the Framework and strengthen it where necessary, and will continue to do so in 2009. At the London Summit in April it was agreed to review the flexibility of the DSF, and the leaders asked the IMF and World Bank to report to the IMFC and the Development Committee at the Annual Meetings.

**Box 4.B: The IMF's role in debt relief in Liberia**

Two decades of war and instability devastated Liberia, leaving 80 per cent of the population living on less than a dollar per day, and half living on less than 50 cents a day. Following a peace agreement in 2003, a new Government came to power and made progress in restoring stability and putting in place steps for growth, development and normalising relations with the international community. Addressing the amount of external debt was essential to support progress and to free up resources for health, education and infrastructure – clearing Liberia's $824 million arrears to the Fund was a vital first step.

After discussions in which the UK played a lead role, the IMF announced in 2007 that it had received sufficient financing assurances to cover the costs of Liberia's IMF arrears clearance and debt relief. The financing solution involved the use of IMF resources, as agreed by a number of Member Countries, and additional contributions from the G8. In total, over 80 countries contributed to the international effort, pledging $842 million.

The UK agreed to forego its refund of IMF resources, which amounted to £12.5 million, and contributed £3.9 million in new resources. In addition, the UK contributed £3.9m to the arrears clearance operation for Liberia at the African Development Bank. As a result, Liberia reached HIPC Decision Point and started to receive debt relief in March 2008.

## Collaboration between the IMF and World Bank

4.18 In March 2006, the Managing Director of the IMF and the President of the World Bank commissioned a review of the process of collaboration between the two institutions. An External Review Committee issued its report in March 2007, and in response, the Fund and Bank Boards agreed a Joint Management Action Plan in October 2007[1], which focused on improving staff cooperation, planning and information sharing. The UK welcomes the Plan and believes the IMF and the World Bank should take this opportunity to strengthen their culture of collaboration and work more effectively together and with other donors in supporting LICs. In support of strong collaboration, the UK has a joint office to ensure a consistent approach and effective representation across the institutions.

[1] The Action Plan is available on the IMF website at http://imf.org/external/np/pp/2007/eng/092007.pdf

# 5 An accountable and effective IMF

5.1 The reforms to the Fund's core functions of surveillance and lending are designed to ensure that it is an effective multilateral institution, able to promote sustainable global growth. However, if the Fund is to be equipped to play a full role in fostering greater cooperation in a world of large capital flows and much greater risks of capital account crises, and in providing objective and credible surveillance, its governance must be legitimate and effective. To reduce the risk and likelihood of future crises, its expertise and analysis must be heard and discussed by policy-makers at the highest level across the Fund's membership, and this must lead to effective and collaborative action. Ensuring the ongoing relevance of the IMF in supporting multilateral cooperation is dependant on maintaining its credibility, legitimacy and effectiveness in a changing world.

5.2 This requires a more transparent IMF with an inclusive governance and management structure, and clearer strategic direction. As G20 Leaders agreed at the London Summit in April, the UK believes it is imperative that reforms must cover quota and voice – to ensure that the decision-making structures reflect the economic weight of member countries; that Ministers' policy and strategic direction-setting role in the IMF is stronger; and that the Fund's Managing Director and senior leadership are appointed through an open, transparent and merits-based selection process.

**Box 5.A: Current governance structure of IMF**

The governance structure of the IMF resembles the structure established in 1944. Every member country appoints a Governor to the Fund, usually the Minister of Finance or the Governor of the Central Bank, who collectively make up the Board of Governors. The full Board of Governors typically comes together once a year at the Annual Meetings in the autumn where they vote on a number of high-level issues. The Fund's day-to-day business is overseen by the Executive Board, which consists of 24 Executive Directors sitting in continuous session at the IMF headquarters in Washington, DC. The UK, as one of the five largest quota holders of the Fund, appoints its own Executive Director. The other 19 Executive Directors represent constituencies, three of which (China, Russia and Saudi Arabia) are single seat constituencies. The UK's voting record is contained in Annex A.

The IMFC, established in 1999, acts as the principal advisory committee to the Board of Governors. They meet biennially at the Spring and Annual Meetings to discuss IMF policies and provide strategic direction for the work programme of the IMF. The Committee is currently Chaired by Youssef Boutros-Ghali, Egyptian Minister of Finance.

## Governance: quotas and voice reform

5.3 While the current crisis has provided a greater impetus for reform reflected in the new facilities and greater resources in particular, the need to modernise the Fund is something that has been widely identified for some time, and which the UK has long advocated. Some changes have taken place during the last two years.

5.4 Following a process, which started during 2006, a first round of quota reforms were agreed in Spring 2008. Quotas at the IMF serve three purposes: providing the basis for determining members' financial contributions to the Fund; access to financial resources from the Fund; and setting relative voting power in the institution. The sum of members' quotas also determines the size of the IMF's total lending capacity – annex B contains more information on the financial relationship between the UK and the Fund.

5.5 Changes to distribution of quotas have historically happened only slowly and at irregular intervals – in recent years they have not kept pace adequately with changes in the world economy. So the purpose of the 2008 quota reform was to address concerns that the recent rapid growth of certain emerging market, transition and advanced economies and the history of over-representation of other members, meant voting shares no longer reflected the relative positions of these countries in the world economy. In addition, the changes sought to address the low level of voice and representation of Low-Income Countries (LICs) in the Fund.

5.6 To deliver the on the objectives of the quota review, the Fund moved from a complex and somewhat opaque process for setting quota share, to a transparent, more straightforward approach. In the past, five different formulas were used to determine quota shares, which included complex variables some of questionable value. The new approach resulted in a single formula, with four variables (GDP, openness, variability and reserves) together a better reflection of the Fund's purpose, and the use to which the quota calculation is put.

5.7 A summary of the reform outcomes is in box 5.B below. The review did meet the objectives of increasing the shares of Emerging Markets and Low-Income Countries and was undoubtedly a move in the right direction. As a result, the UK's and other advanced countries' voting shares in the Fund will decline, but the UK actively encouraged other members of the Fund to work cooperatively to reach agreement.

5.8 The 2008 quota and voice reform marked an important first step and will provide for a dynamic process for future reviews. The UK strongly supports the commitment made by the G20 Leaders in April 2008 to significantly accelerate the timetable for the next quota review in order to complete the process by January 2011. The objectives of further reform are to ensure that quota better reflects modern economic reality, and relative weight of countries in the world, whilst ensuring a strong voice for the poorest countries is also achieved. Given the increase in demand for Fund resources, the next review will also need to address the total size of the quota to meet ongoing needs including in a post-crisis environment.

**Box 5.B: 2008 The quota and voice reform package – key facts**

- A total of 54 countries will receive increases in their quota; 135 countries, over 70 per cent of the membership, receive increases in their voting share.
- The largest gains in terms of quota share and voting share will go to the dynamic economies of China, South Korea, India and Brazil.
- Several advanced countries agreed to forgo some of the increases that they would otherwise have been entitled to.
- Application of the new formula is to be repeated at five-year intervals in the future, ensuring that the shifts become steadily greater as the cumulative effect of future reviews plays out.
- Low-income Countries benefit, largely through the tripling of basic votes. The UK was in full support of this initiative, which is the first of its kind since the Fund's inception in 1944.
- Through an amendment in the Articles of Agreement, the two African constituencies stand to each gain an additional Alternate Executive Director in appreciation of the extra workload faced by large constituencies.

## Governance: structures

5.9 However, as well as reforming quota shares, the UK believes that the Fund must adopt a more inclusive and effective governance structure which also encourages commitment and cooperation from its members. It is in the interests of all countries to be proactive in contributing to international efforts to maintain stability and countries must feel they are able to make an effective contribution to the Fund's work to achieve that.

5.10 One of the key UK priorities is ensuring that the Fund has enhanced political legitimacy, by ensuring a stronger Ministerial role in strategic oversight and decision-making. This was addressed in a report by the IMF's Independent Evaluation Officer's on Corporate Governance published in May 2008 (for a summary of its recommendations, see box 5.C below). This report concluded among other things, that whilst the IMFC has provided a useful forum for Ministers, the Fund's effectiveness had suffered from a lack of systematic Ministerial direction. A formally embedded Ministerial decision-making process would help the Fund be more effective in securing its members' commitment to action that not only benefits their domestic economies, but also strengthens the global economy.

5.11 In addition to strengthening political engagement in the Fund's work, there is also a need to improve the accountability structure against which policy-makers can set strategic goals for the Fund, exercise oversight and hold it to account for delivery against agreed objectives.

5.12 One mechanism for achieving these objectives could be the creation of a Ministerial Council with formal powers. This was a key recommendation of the group of Eminent Persons led by Trevor Manuel (then South African Finance Minister), which reported to the IMF Managing Director in March 2009, on corporate governance (see box 5.C below for a summary of its recommendations). Such a council could provide a channel through which Fund management could be called to explain to Ministers how the Fund's work meets its mandate. Political endorsement of the Fund's work and priorities would place a corresponding responsibility on members to explain the actions they will take to address risks highlighted by Fund surveillance, which the current crisis demonstrates, is extremely important.

5.13 As also recommended by these two reports, the UK believes it is necessary for there to be more clearly defined roles for the different governance bodies in the IMF, with each being held accountable for delivery against specific objectives which should follow from those set by the strategic decision-making body. If Ministers are to take a greater role in setting direction and holding the Fund to account for delivery against objectives, the role of the Executive Board and senior management must be recast to ensure that they fit into a well-defined structure with clear lines of accountability.

5.14 The IMFC in April 2009 called on the Executive Board to report on these issues by the time of the Annual Meetings in October 2009.

**Box 5.C: The Independent Evaluation Office's (IEO) Evaluation of Aspects of IMF Corporate Governance[1] and Eminent Persons Report[2]**

The IEO found that effectiveness is the strongest aspect of the current structure, allowing fast and consistent action in times of crisis. However, accountability and voice were identified as the weakest aspects. The report set out four broad conclusions and recommendations:

- greater clarity is needed on the respective roles of the different governance bodies within the Fund, particularly between the Executive Board and Management;
- the Fund needs more systematic and robust ministerial involvement in order to enhance political legitimacy and oversight. This could be achieved under current provisions in the Articles of Agreement, through activation of the IMF Council;
- the work of the Executive Board must be re-oriented away from its focus on the executive towards a more supervisory function; and

a clear accountability framework for the Managing Director should be established; and selection of the Managing Director should be based on the principles set out in the 2001 Draft Joint Report of the Bank and Fund Working Groups to Review the Process for Selection of the President and Managing Director.

The Committee of Eminent Persons chaired by Trevor Manuel reported to the Managing Director in March 2009 concluding the Fund requires a re-energized mandate, and a number of things need to be done to improve the Fund's legitimacy and effectiveness. It recommended a package of reforms to be implemented together:

- Acceleration of the quota review process to conclude by April 2010, amendments to the Articles to remove appointed chairs, and consolidation of Chairs including those of EU countries;
- Activation of a Council of Ministers and Governors to provide a forum for coordination and strategic decision making as provided for in the Articles of Agreement (troika to lead, with regular rotation);
- Expansion of Fund's surveillance mandate to provide coverage of macroeconomic policies, prudential issues and financial spillovers. To include the capital account;
- Most authority for conducting and completing member-specific surveillance to Fund management, with strengthened accountability;
- Elevation of Executive Board from operational decisions to provider of advice to the Council and supervising, oversight and review of surveillance. Retain

[1] Governance of the IMF: An evaluation, May 28 2008: http://www.ieo-imf.org/eval/complete/eval_05212008.html

[2] Committee on IMF Governance Reform, March 25 2009: http://www.imf.org/external/np/sec/pr/2009/pr0988.htm

responsibility for lending and financial decisions;

- Lowering of threshold on critical decisions from 85 per cent to 70-75 per cent, and consideration to greater use of double majorities;
- Introduction of an open, transparent, and merit-based system for selection and appointment of the Managing Director and the Fund's senior leadership.

5.15 Another aspect of reform is on the question of key appointments, where the UK has long advocated a transparent process of appointment for the Managing Director and senior staff. This was also a recommendation of the Manuel group. The current Managing Director, Dominique Strauss Khan, was appointed in late 2007 following an improved process with a clear job description, a public timetable, a round of nominations open to candidates from all members, and a formal interview stage. The UK believes that this process must be further strengthened over the coming years and welcomes the call made by the G20 Leaders in April, for an open, transparent and merit-based selection process for the IMF Managing Director, and other key international financial institutions.

5.16 Once actions to address the crisis and put the economy on a path to recovery have been firmly implemented, the UK believes that attention should turn more fully to modernising the Fund's governance as a matter of priority. This will be critical if the Fund is to be a highly effective multi-lateral, relevant and trusted institution, promoting growth and ensuring the global economy is more resilient in future.

## Finance reform

### Expenditure reform

5.17 Budgetary difficulties in 2007-08 meant that difficult decisions were required on the expenditure side. The UK had long been pressing for efforts to increase the efficiency of the Fund by modernising working practices, including through flattening the hierarchy, increased delegation of responsibility, streamlining the support services, and modernising HR processes. As a result of a series of budgetary reforms introduced in the course of 2007, the IMF was able to achieve medium-term spending cuts of about $100 million annually. Much of this was achieved through increased efficiency and refocusing on core activities. Throughout this process the UK stressed the importance of maintaining, and where necessary increasing, the resources available for priority tasks, including the work on financial sector surveillance, macro-financial linkages, anti-money laundering/counter-terrorist financing.

### A new income model

5.18 2007 and 2008 have also seen significant reform of the Fund's approach to income. The IMF has traditionally relied on income from its lending operations to finance its budget. This model came under increasing strain in the benign global climate that preceded the current crisis. At the Spring Meetings in April 2008 the IMF's Executive Board therefore agreed to revamp the Fund's income model, away from one that primarily relies on lending, towards one that generates funds from a variety of sources. The UK supported this decision, which should improve the sustainability and transparency of the IMF's finances. This new income model will include two core elements:

- expanding the IMF's investment authority to enhance the return on its investments; and
- creating an endowment from the profits of selling a limited portion (about one-eighth) of the IMF's gold.

5.19 The Board's decision on the income model broadly reflects the recommendations of a committee of eminent persons, headed by Andrew Crockett, who recommended in early 2007 that the IMF adopt a package of income-generating measures (see Box 5.D). IMF member countries are in the process of completing national ratification processes, as the adoption of the New Income Model required a change to the Fund's Articles of Agreement. The UK has also argued that an income model should not be developed in isolation from the expenditure side, and that the Board should consider the income consequences of any decision to change the Fund's level of expenditure. The Board's decision was an important step towards developing the new income-expenditure framework.

**Box 5.D: The Crockett Committee recommendations on sustainable long-term financing of the IMF**

On 31 January 2007, a Committee of Eminent Persons, chaired by Andrew Crockett, announced its recommendations for a new income model for the IMF "that would be more appropriate for the various activities undertaken by the Fund, and would be more responsive to evolving conditions in the world economy and in the role of the Fund itself". The Committee's report concluded that the IMF's current income model – which relies primarily on the income generated from lending to member countries – was not appropriate, and recommended a new set of revenue measures, including:

- expanding investment operations. The Fund should use its balance sheet to generate income by broadening its investment mandate, and investing part of the quota resources subscribed by members;
- creating an endowment from limited IMF gold sales. This would be restricted to around 400 metric tons, around one-eighth of the total stock, and would be ring-fenced to exclude further sales and subject to strong safeguards to limit any market impact; and
- charging for services to member countries. Without unduly discouraging the use of capacity-building services, the Committee supported charging for services, not so much for the revenue that would be generated, but to enhance transparency and accountability in the provision of such services.

# 6 Forward look: UK priorities for next 12 months

6.1 As this report makes clear a lot has happened at the IMF over the past two years, much of which has been given particular impetus by the global economic crisis. The UK has been a strong advocate for the reforms that have taken place on surveillance, resourcing, lending and quotas.

6.2 However, the period ahead will be one of further challenges. The Fund's top priority should continue to be supporting the crisis response, and helping ensure the global economy is set on a sustainable recovery path towards future growth. Central to this will be ensuring that the resources already committed to the IMF are delivered – through bilateral loans, a modernised, bigger NAB, and the $250 billion SDR issuance. Monitoring and reporting on the adequacy of the ongoing policy responses will be another important role the Fund must continue to play.

6.3 Looking forward, the UK believes other key priorities for the Fund include ensuring that the Fund's surveillance activity is well-focused and meets the needs of the modern global economy, including analysing and advising on appropriate exit strategies from current policies. Delivering on a further quota review, additional governance reforms and improving transparency will also be important steps to ensure the IMF's ongoing relevance and legitimacy.

6.4 These priorities will be taken forward in a number of ways. As Chair of the G20 in 2009, the UK will continue to ensure that the G20 drives forward delivery in these key areas, and on the London Summit commitments more generally. G20 Finance Ministers will review progress against these commitments and consider further actions to manage the crisis and promote a sustainable recovery when they meet in London on 4-5 September. In addition, at the London Summit, the UK as Chair was tasked, working with the G20 Finance Ministers, to consult widely in an inclusive process and report back to the next meeting with proposals for further reform to improve the responsiveness and adaptability of the international financial institutions.

6.5 The IMF's Executive Board also has a key role to play in taking forward strategy and developing and implementing appropriate policies – and enhancing the lending framework for Low-Income Countries is one of the issues currently at the top of their agenda. The forthcoming Annual Meetings taking place in Istanbul, Turkey in October 2009 will provide another opportunity to ensure that the Fund and its member countries are focused on learning lessons from the crisis, and applying those lessons in future.

# A UK's voting record

A.1 This annex provides information on the formal votes taken by the Board of Governors of the IMF in 2007, 2008 and early 2009, and an explanation of the UK position on each vote. Most decisions are taken in the IMF Executive Board, which usually works on the convention of consensus, without recourse to formal voting.

## 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 Meetings of the Board of Governors'. Governors voted on the following decisions in 2007-09:

**Table A.1: The UK's Voting Record**

| NO. | RESOLUTION | VOTING RESULT | UK POSITION | VOTE OUTCOME |
|---|---|---|---|---|
| 62-1 | 2007 | Direct Remuneration of Executive Directors and their Alternates | Opposed | Passed |
| 62-2 | 2007 | Financial Statements, Report on Audit, and Administrative and Capital Budgets | Passed at the Annual Meetings | Passed |
| 63-1 | 2008 | Thirteenth General Review of Quotas | In favour | Passed |
| 63-2 | 2008 | Reform of Quota and Voice in the International Monetary Fund | In favour | Passed |
| 63-3 | 2008 | Proposed Amendment of the Articles of Agreement of the International Monetary Fund to Expand the Investment Authority of the International Monetary Fund | In favour | Passed |
| 63-4 | 2008 | Direct Remuneration of Executive Directors and their Alternates | Opposed | Passed |
| 63-5 | 2008 | 2008 Regular Election of Executive Directors | In favour | Passed |
| 63-6 | 2008 | Reimbursement for Reasonable Expenses Incurred by Governors and Alternates in Attending Meetings of the Board of Governors—Amendment of Section 14(a) of the By-Laws | In favour | Passed |

| | | | | |
|---|---|---|---|---|
| 63-7 | 2008 | Financial Statements, Report on Audit, and Administrative and Capital Budgets | Passed at the Annual Meetings | Passed |
| 64-1 | 2009 | Amendments to the Statute of the Administrative Tribunal of the International Monetary Fund | In favour | Passed |
| 64-2 | 2009 | Membership for the Republic of Kosovo | In favour | Passed |

A.4 Consistent with the UK's approach to budget discipline and previous voting patterns on this issue, the UK opposed the votes (62-1 and 63-4) concerning the direct remuneration of Executive Directors and their Alternates. The UK believes that the remuneration of Executive Directors and their Alternates should reflect their primary role as appointed public officials and representatives.

A.5 Decisions 62-2 and 63-7 gave the 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.6 As outlined in chapter 5, Decisions 63-1 and 63-2 relate to the 2008 quota review. The UK supported the outcome which resulted in increased quota and voting shares for many the Emerging Markets and Low-Income Countries, and a smaller share for the UK and other advanced countries.

A.7 Decision 63-3 relates to reforms to the Fund's income model, including allowing for the sale of some of the IMF's gold, as outlined in chapter 5. The UK believed these reforms would strengthen the income model for the Fund.

A.8 Decision 64-1 relates to improvements to the Fund's Administrative Tribunal, which is deployed in certain employment disputes. The UK supported the reforms to improve its functioning including through staggered appointments to the tribunal and general improvements to its governance.

A.9 Decision 64-2 relates to Kosovo's request to join the IMF, which the UK supported. Gaining access to the range of technical, policy and financial support that Fund membership offers will be important for Kosovo as it works to strengthen and develop its economy.

# B The UK's financial relationship with the IMF

B.1 This annex considers the UK's financial relationship with the IMF in 2008-09 and assesses the 'cost' of Fund membership. The financial relationship of any member with the Fund is complex. Its main impact is felt via the impact on UK reserve holdings. This annex therefore calculates the net financial cost of holding official reserves in the form required by IMF membership. Separate to this, the Fund's involvement in Low-Income Countries means that resources of the Department for International Development are provided for specific IMF instruments.

## Impact of IMF membership on UK reserves

B.2 There are two components to the financial relationship of members to the Fund. As a member, the UK both finances lending operations through the quota system and holds an allocation of Special Drawing Rights from the Fund. To calculate the net cost of Fund membership to the UK therefore requires three calculations:

- the financial effect of the operation of the UK's quota;
- the financial effect of managing the UK's allocation of SDRs; and
- the opportunity cost of holding Fund assets.

B.3 Each component of this calculation is set out below.

## Quotas

### The context

B.4 Quotas form the main financial relationship of a member country with the IMF. Quotas determine both the amount that the member can be asked to lend to the Fund and the amount that they can borrow. They also determine voting rights within the Fund's governance structure. Each member of the IMF is assigned a quota allocation to broadly reflect the member's relative size in the global economy, based on a number of macroeconomic variables. For more information on the quota and voice agenda, see chapter 3.

B.5 Not all of a country's quota is paid into the IMF – instead, a proportion of the quota is paid in reserve assets (dollar, euro, sterling or yen) and the remainder in the member's own currency, or in non-interest bearing promissory notes, which can be exchanged for that currency. Quotas are denominated in SDRs, the IMF's unit of account. The SDR rate of exchange is determined by a basket of reserve asset currencies, with weightings reviewed every five years. The current weightings are: 44 per cent dollar, 34 per cent euro, 11 per cent yen and 11 per cent sterling.

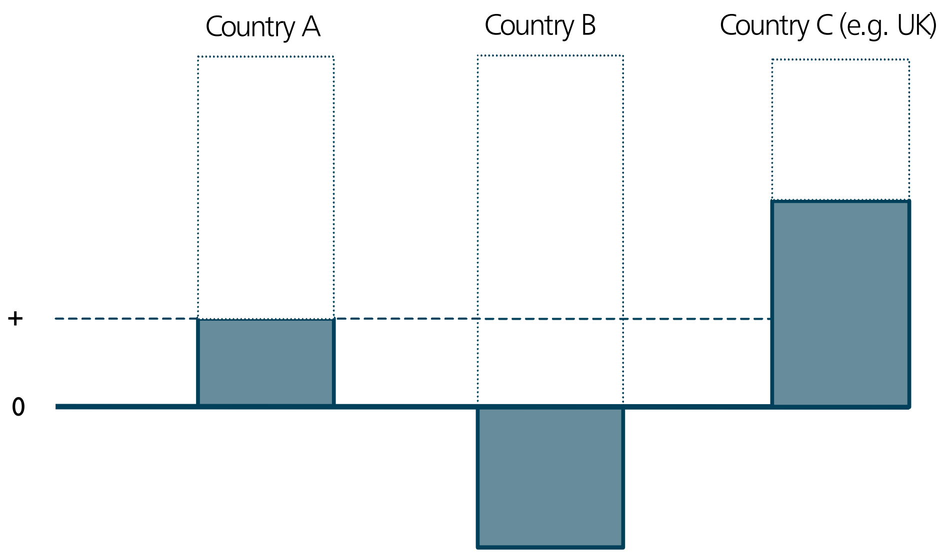
B.6 The Reserve Tranche Position (RTP) describes the amount of a members' quota that the IMF has drawn upon. It consists of the proportion of quota originally provided in reserve assets, plus the additional part of the quota that the IMF has drawn upon by exchanging non-interest bearing notes. As a result, when the IMF draws upon a member's quota, RTP rises, up to a maximum of 100 per cent of quota.

B.7 Conversely, when a country requires IMF resources, in the first instance, the borrowing country can call back from the Fund the proportion of its quota originally paid in reserve assets. However, the borrowing country can also request additional funds, financed by other member countries as set out above. The total amount that can be borrowed will be 100 per cent of quota in the first instance.

B.8 At any one point in time, members of the Fund will have different financial positions in respect to it – some illustrative possibilities are set out in Chart B1 below, for three countries with equally sized quota. The thick solid horizontal line shows a zero asset/liability position with the Fund; points above this show that the country has a net claim upon the fund (i.e. is a creditor); and points below this line show a country that the Fund has net claims on (i.e. is a debtor). The first dotted line shows the level of a country's original reserve asset subscription to the Fund.

B.9 In Chart B1, Country A has provided a reserve asset subscription to the IMF but has not been called upon to provide further funds for lending. Country B is in debt to the IMF, having drawn its own RTP and having been provided with additional monies. Country C represents the UK's current position in respect of the IMF – it has both paid its quota subscription and provided additional reserves, although not the full quota, to the Fund to finance borrowing.

**Chart B.1: Possible financial position in the IMF**




## The UK position

B.10 The UK's quota is SDR 10,739 million and has remained at this level in SDRs since 2000, when it was increased from SDR 10,461 million. This amounts to 4.86 per cent of the overall quota of all members, and equated to £ 11,193 million as at 31 March 2009, up from £8,881 million at the prevailing exchange rate at the end of March 2008. The UK's RTP at 31 March 2009 was SDR 1626 million (£1,695 million), up from SDR 678 million (£561 million) as at 31 March 2008 (basically reflecting a higher level of lending to the IMF). The RTP is an asset of the National Loans Fund (NLF).

B.11 When the UK joined the IMF, it provided a proportion of quota in reserve assets; the remainder is held by the Fund in non-interest bearing promissory notes, which do not themselves, feature in national reserves accounting. When the IMF calls upon the UK's quota to finance lending operations, however, these notes are exchanged with the NLF for sterling and provided to the Fund, with a subsequent impact on reserves.

B.12 As the UK reserves provided to the IMF can be called back by the UK at any point, the RTP forms part of the UK's official reserves. Changes in the RTP may be funded either from existing reserve assets or from additional sterling financing. If they are funded by additional sterling financing, then the official reserves will increase. If they are funded from sales of other FX assets held in the reserves, the reserves will fall, but official reserves will remain unchanged. If the change in the RTP is funded by additional sterling financing, then initially gross public sector debt will rise, but net public sector debt will not, because the increased level of sterling issuance is offset by increased reserves holdings (the RTP). If the change in the RTP is funded by sales of other FX assets, then gross and net public sector debt will remain unchanged.

## Costs and benefits of holding reserves at the IMF

B.13 As the UK's RTP forms part of the official reserves, any increases in its size are not regarded as public expenditure. There can, nonetheless, be costs and benefits associated with IMF membership, related to the remuneration paid on UK reserves held at the IMF and capital gains or losses on holdings. These depend on the level of the IMF's interest rate, the SDR rate - based upon a basket of high credit quality short-term interest rates in the four SDR currencies. The IMF remunerates the UK's RTP at slightly below this rate, in common with all other members.[1] 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.14 Table B1 summarises the cost and benefits of the RTP in 2008-09. The interest loss, which is 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 £13 million. This was offset by a capital gain of £226 million, due to sterling-SDR exchange rate movements. The total gain on the UK RTP was therefore £213 million.

**Table B.1: A summary of the Reserve Tranche Position**

| 2008-09 | Total Cost (£m) | Total Income (£m) | Gain from holding assets (£m) |
|---|---|---|---|
| Interest | -28 | +15 | -13 |
| Capital Gain | - | +226 | +226 |
| Total | -28 | +241 | +213 |

## SDR allocation

B.15 In addition to the UK quota, another element of the UK's financial relationship with the IMF is via one-off SDR allocations. SDR allocations first took place in 1969, as an attempt to give member governments of the Fund access to the reserve assets they needed to manage their currencies within the Bretton Woods fixed exchange rate system. The last allocation took place in 1981. The UK has received a total of SDR 1,913 million in SDR allocations since 1969; this was equivalent to £1995 million at the exchange rate for the end of March 2009. 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 the UK held its full allocation in SDRs, the interest paid on this allocation would cancel out the interest received, resulting in a net cost of zero.

B.16 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

[1] The rate is slightly below the SDR rate due to a burden sharing mechanism set in place to provide the IMF with specific monies to guard against the risk of protracted arrears from borrowers. The rate of charge for borrowers is adjusted upwards by the same amount. These adjustments are determined after the end of each financial quarter and on average the adjustment is of the order of 0.1 percentage points.

dollar, euro and yen assets for portfolio management reasons. In 2008-09, of its total SDR allocation, the UK chose to hold on average £259 million in SDRs and £1.5 billion in foreign currency. As a result, interest was paid to the IMF for the full UK allocation but interest received from the IMF on only the £0.3 billion UK SDR holdings. However, the UK received interest on £1.5 billion in foreign exchange holdings at market interest rates[2] in the respective currencies.

B.17 Under this arrangement, the UK would make a profit if the average interest rate on these foreign exchange holdings was higher than the SDR rate. In 2008-09, this was not the case; the SDR rate exceeded the average interest rate on foreign exchange holdings and the UK therefore made a net loss of £2 million attributable to interest rate differences. However, a capital gain[3] on the allocation led to a total gain of £50 million to the official reserves after the differential costs of funding.

## Net financial cost of membership

B.18 Taking together the financial effect of the UK holding official reserves at the Fund and the effect of the UK SDR allocation, it is possible to calculate the net financial impact of IMF membership on UK reserves. As the UK made a gain of £213 million by holding reserve assets in the RTP and a gain of £50 million on the SDR allocation, the total gain of IMF membership to UK reserves in 2007-08 was £263 million.

B.19 The third element in assessing the overall cost of Fund membership, however, is to compare this figure to the gain or loss that the UK would have made on the same level of reserves, had they been held in line with other UK reserves. If amounts equal to the RTP and SDR allocation had been held as reserve assets in the EEA[4], alongside the rest of the net foreign currency reserves, it is calculated that the UK would have made a net gain of £693 million.

B.20 Overall, therefore, IMF membership cost the UK £430 million in 2007-08, as set out in Table B1.

**Table B.2: A summary of the effect of holding SDRs**

| 2008-09 | Gain from membership (£m) | Gain from non-membership (£m) | Net Benefit of Membership (£m) |
|---|---|---|---|
| SDRs | +50 | +443 | -393 |
| RTP | +213 | +250 | -37 |
| Total | +263 | +693 | -430 |

B.21 Table B3 shows the impact of IMF membership on UK reserves may have a different impact from year to year. The estimated net financial cost to the UK of membership of the IMF is driven by sterling, SDR and foreign interest rate differentials and by exchange rate movements (dollar, euro, yen and SDR versus the pound). It is also worth noting that an additional cost of IMF membership is that reserves held by the IMF are less liquid than those held in the EEA. This analysis does not, however, include the non-financial benefits of IMF membership such as enhanced voting powers and greater access to IMF financing.

[2] The EEA holds foreign currency debt securities at a range of maturities. The assumption about the income the UK receives, for the purposes of calculating the cost of IMF membership, is based on a three-month repo (collateralised) market interest rates.

[3] A capital gain or loss will occur if the basket of foreign exchange investment (40:40:20 Dollar: Euro: Yen) changes against the SDR, leading to a change in the sterling value of foreign exchange reserves versus the SDR holdings. If the UK held the whole allocation in SDRs, then there would be no capital gains or losses, as both asset and liability would be denominated in SDRs and mo therefore move in line with each other.

[4] Existing holdings in the EEA are made in dollar, euro and yen at a ratio of 40:40:20, and it is assumed that they also earned interest at the three-month repo rates in the respective markets.

**Table B.3: A summary of the cost of UK membership of the IMF in recent years**

| Year | Gain/loss from membership (£m) | Gain/loss of non-membership (£m) | Net benefit/cost of membership (£m) |
|---|---|---|---|
| 2008-09 | +263 | +693 | -430 |
| 2007-08 | +29 | +143 | -114 |
| 2006-07 | -128 | -250 | 122 |
| 2005-06 | +39 | +85 | - 46 |
| 2004-05 | -124 | -181 | 57 |
| 2003-04 | -375 | -530 | +155 |

## UK financial contribution to IMF development initiatives

B.22 In addition to providing loans to countries experiencing balance of payments difficulties, financed by national reserves, the IMF provides concessional loans to Low-Income Countries aimed at poverty reduction, financed directly from contributions by members. Lending through the Poverty Reduction and Growth Facility is founded on the Poverty Reduction Strategy process and also provides the basis for debt relief under the Heavily Indebted Poor Countries Initiative. The Fund also provides assistance for countries experiencing external shocks through the Exogenous Shocks Facility, as set out in chapter 2.

B.23 The UK voluntarily contributes to these programmes to ensure concessional loans from the IMF are available for poor countries that seek such assistance through DFID as part of official overseas development aid (ODA). This therefore does not impact on UK reserves, or affect the overall financial position of the UK vis a vis the IMF. In addition, DFID finances a number of technical assistance programmes, which the IMF provide to build capacity in poor countries.

# C A new statement of surveillance priorities

## Surveillance priorities for the International Monetary Fund 2008-11 (the 'remit')

In pursuit of its mandate to promote international monetary and financial stability, IMF surveillance will be guided through 2011 by the following priorities:

### Economic priorities

The global economy faces a period of severe financial distress and slower growth alongside the challenges of sharp commodity price changes and global imbalances. The following interrelated policy objectives will be key to return to an international environment more conducive to sustainable non inflationary growth:

- Resolve financial market distress. Restore stability and minimize the adverse impact of the current crisis in financial markets on the real economy;
- Strengthen the global financial system by upgrading domestic and cross-border regulation and supervision, especially in major financial centers, and by avoiding the exposure of capital-importing countries, including Low-Income Countries, to excessive risks;
- Adjust to sharp changes in commodity prices. React to commodity price shifts in domestically appropriate and globally consistent ways, with emphasis on keeping inflationary pressures in check in boom phases and minimizing risks that could arise when prices fall;
- Promote the orderly reduction of global imbalances while minimizing adverse real and financial repercussions.

*In coordination with other International Financial Institutions, the IMF should* promote a common understanding *of the forces and linkages underlying these challenges;* draw key lessons *from different experiences to share across the membership;* provide clear advance warnings of risks *to global economic and financial stability; and* advise on how best to use policy *– in particular monetary, fiscal, exchange rate, and financial sector policies – in support of these objectives.*

### Operational priorities

- Risk assessment. Refine the tools necessary to provide clear early warnings to members. Thorough analysis of major risks to baseline projections (including, where appropriate, high-cost tail risks) and their policy implications should become more systematic;
- Financial sector surveillance and real-financial linkages. Improve analysis of financial stability, including diagnostic tools; deepen understanding of linkages, including

between markets and institutions; and ensure adequate discussion in surveillance reports;

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

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

The Executive Board has set the above priorities to foster multilateral collaboration and guide IMF management and staff in the conduct of surveillance. These priorities look ahead three years, but may be revised if circumstances warrant. They will guide the Fund's work within the framework for surveillance provided by the Articles of Agreement and the relevant Board decisions, including the 2007 Decision on Bilateral Surveillance. Moreover, traditional areas of strength (such as fiscal and debt sustainability analysis) and relevant country-specific issues should not be overlooked.

The Executive Board is responsible for conducting, guiding and evaluating surveillance in order to ensure the achievement of these priorities. Management and staff are responsible for delivering on the operational priorities, subject to members' cooperation in line with commitments under the Articles of Agreement. To foster progress toward economic priorities, management and staff are responsible for providing candid high-quality analysis and effective communication. The Managing Director will report: (i) regularly on actions toward priorities and readily visible results; and (ii) at the time of the next Triennial Surveillance Review on progress in attaining these priorities; management's and staff's contributions; and factors that impeded progress.

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