RESPONDING TO THE CHALLENGES OF GLOBALISATION: THE UK AND THE IMF 2001

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FOREWORD BY THE CHANCELLOR OF THE EXCHEQUER

The tragic events of September 11th and their aftermath confirm what we have all known for years: that in the new global economy we are, all of us – the richest and the poorest countries – inextricably and inescapably linked one to another. What happens to the poorest citizen in the poorest country can directly affect the richest citizen in the richest country; and talk of an international community living in peace and grounded in justice will only be real if the developed world acts decisively, not just to root out terrorism but to tackle injustice and poverty and make globalisation work for all.

Macroeconomic stability and sustainable economic growth remain prerequisites, requiring sound macroeconomic policies and these are at the centre of the IMF's mandate. The IMF must play its part in demonstrating that the work of the international community will go on, and that, working together, we are both willing and able to take strong action to maintain the conditions for stability and growth, and further strengthen the international financial system; to crack down on terrorist financing; and to ensure that this exceptional shock does not undermine the progress made in reducing poverty and achieving debt sustainability in the poorest countries.

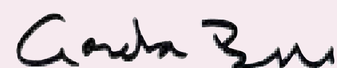
Given the exceptional circumstances following the events of September 11th the Annual Meetings of the IMF and the World Bank, to be held in Washington on September 29th-30th, were cancelled. However, recognising the need for a determined and cooperative policy response to the challenges facing the world economy, the International Monetary and Financial Committee met in Ottawa on November 17th 2001. I would like to express my thanks to the Canadian Government for hosting this meeting.

Much has been achieved to strengthen the international financial system and the IMF is now itself stronger, more effective, transparent and accountable. Now the work must continue. We must:

- continue to build on our approach to the introduction and operation of transparent codes and standards, with proper sequencing of capital liberalisation, as a better guarantee of both an investment friendly environment and long-term stability. In a world of greater international capital flows codes and standards have become a precondition of economic success;
- tackle, where identified, financial sector problems that carry potential international repercussions, and enhance the IMF's role in its bilateral and multilateral country surveillance, including proposals to make the IMF's surveillance and monitoring functions more independent of decisions about crisis resolution;
- involve the private sector in the resolution of financial crises to ensure an equitable distribution of the adjustment burden between debtor countries and their creditors. We need to resolve the obstacles that stand in the way of effective debt rescheduling, including the steps that would create an effective international bankruptcy procedure;
- ensure coherent international action to tackle abuse of the international financial system, countering money laundering and financial crime and acting quickly and decisively to combat the financing of terrorism;
- manage the process of globalisation to further our shared goals of social justice. International co-operation must be used to ensure globalisation works for the world's poor.

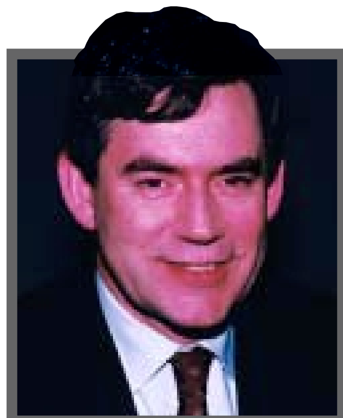
It is a measure of the agreement of the objectives that now exist that all major countries and all international organisations, including the IMF, have signed up to meeting the Millennium Development Goals. The scale of the challenge needed to meet these targets is immense, and will require action on many fronts: on trade, debt relief and aid. Globalisation will not be fair unless the poorest countries and communities have the capacity to enjoy the benefits of global prosperity. The international community must work together to strengthen and modernise our global economic system to meet all the challenges we presently face.

I am pleased to be able to welcome this third annual report to Parliament and to the public on the UK and the IMF. This report demonstrates our continued commitment to improve the transparency of our dealings with the IMF and outlines, for the first time, the position that the UK has taken in votes by the Board of Governors, and in Executive Board discussions of surveillance, programmes and major policy issues.

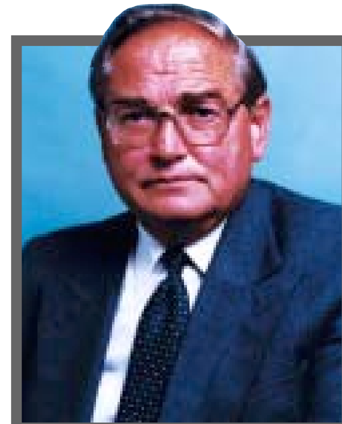


REPRESENTING THE UK IN THE IMF

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

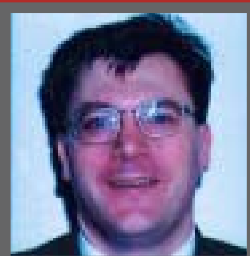


Rt. Hon. Gordon Brown,
Chancellor of the Exchequer.
UK Governor of the IMF, Chairman of the IMFC



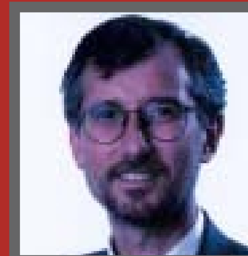
Sir Edward George,
Governor of the Bank of England.
Alternate UK Governor, UK representative on the IMFC

Gus O'Donnell,
Managing Director Macroeconomic Policy and International Finance, HM Treasury.
Chairman IMFC Deputies and G7 Finance Ministry Deputy

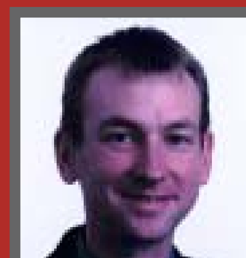


Ed Balls,
Chief Economic Adviser to the Treasury.
UK representative IMFC Deputies and G20 Finance Ministry Deputy

Mervyn King,
Deputy Governor of the Bank of England
UK representative IMFC Deputies and G7 Central Bank Deputy



Stephen Pickford,
UK Executive Director,
1998-2001



Tom Scholar,
Current Executive Director

The day-to-day work of the IMF is the responsibility of the UK Executive Director. HM 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 HM Treasury the Macroeconomic and International Finance Directorate is specifically responsible for preparing advice on the policy issues and specific country programmes that are brought before the Executive Board.

1 MANAGING THE ECONOMIC CHALLENGES OF GLOBALISATION

Globalisation has brought significant benefits to those countries that have become more integrated into the world economy. But increased cross-border financial flows and integration of financial markets have also brought new risks. The most important and difficult challenges that now face the IMF are, to encourage economic growth, to strengthen the global financial system – so that it becomes less prone to financial crises – and to advance the fight against poverty in the poorest countries. This chapter provides an overview of globalisation and the Government's policy response to the challenges it creates, and of the UK's priorities for the IMF, covered in greater detail in later chapters.

BUILDING THE FOUNDATIONS FOR THE NEW GLOBAL ECONOMY

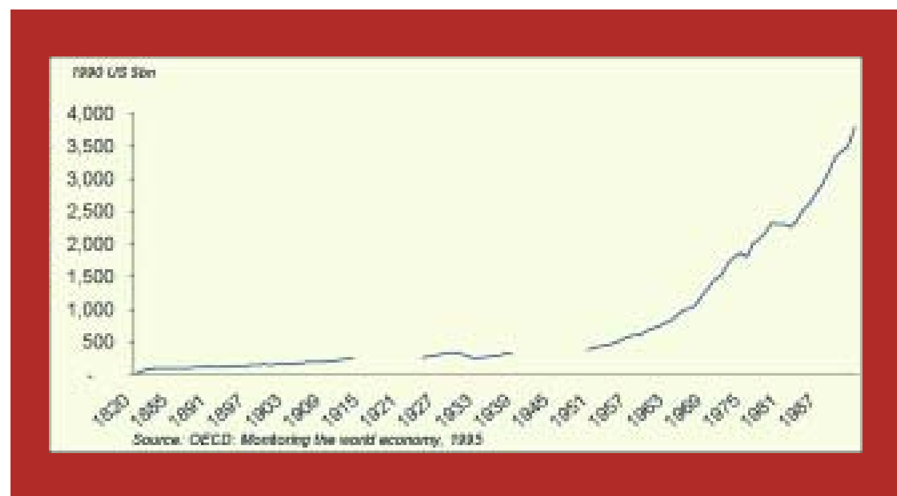
1.1 Globalisation has created new challenges for the international community, including the IMF. Greater integration has brought the benefits of higher investment, faster growth and more effective poverty reduction to those countries that have become more integrated into the global economy; but increased cross-border financial flows and integration of financial markets have also brought risks. Integration of economies has increased the risk of contagion, so that a financial crisis in one country has implications in other, seemingly unrelated economies, and has created new opportunities for the abuse of markets (through new opportunities to launder money, evade taxes, and to finance terrorism). It also creates change – which labour markets, tax and social security systems, and fiscal and monetary policy frameworks must respond to. There is a danger that the poorest countries, which have not yet benefited from globalisation, will fall further behind as living standards rise elsewhere. Therefore two of the most important, and difficult challenges that the IMF now faces are; how to strengthen the global financial system so that it becomes less susceptible to financial crises and more able to cope when crises do occur; and how to advance the fight against poverty in low-income countries.

1.2 Globalisation can be defined as the growing integration of national economic systems, including greater trade in goods and services; movements in capital and integration of financial markets; and movements of labour. Economic integration is not a new phenomenon – the last great "wave" of economic integration began in the mid-1800s and ended with World War I. That period was characterised, not only by strong growth in trade and capital flows, but also by considerable migration. The outbreak of war and the onset of the Great Depression however, led countries to raise trade barriers and institute extensive capital controls in an attempt to protect their own economies.

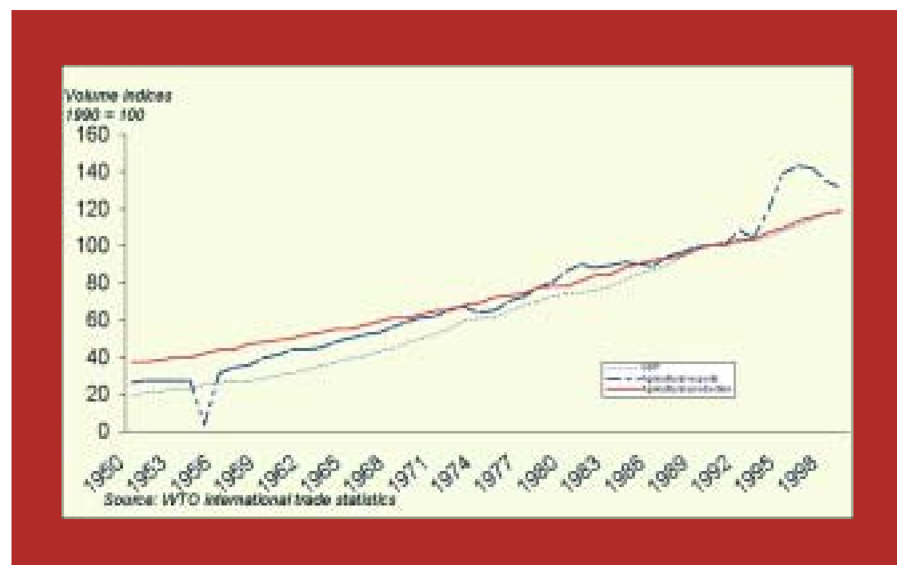
Post-War Globalisation

1.3 After World War II, successive rounds of trade agreements began to reduce tariff barriers and the eventual collapse of the gold standard led to a shift to floating exchange rates and brought about the removal of capital controls in most industrialised countries. Advances in transport and communications also encouraged foreign investment, largely driven by multinational companies. These influences have led to large increases in trade and investment, and increased capital flows as the charts below illustrate.

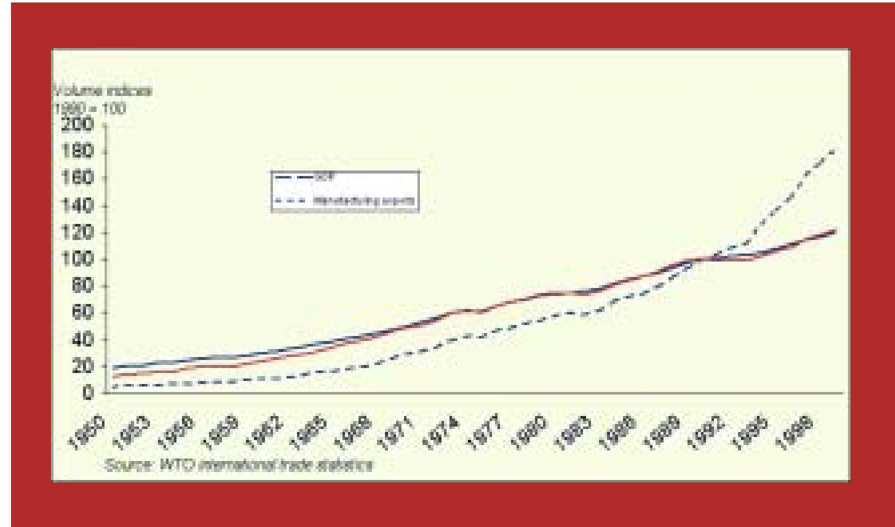
World value exports 1820 - 1992 at constant 1990 prices



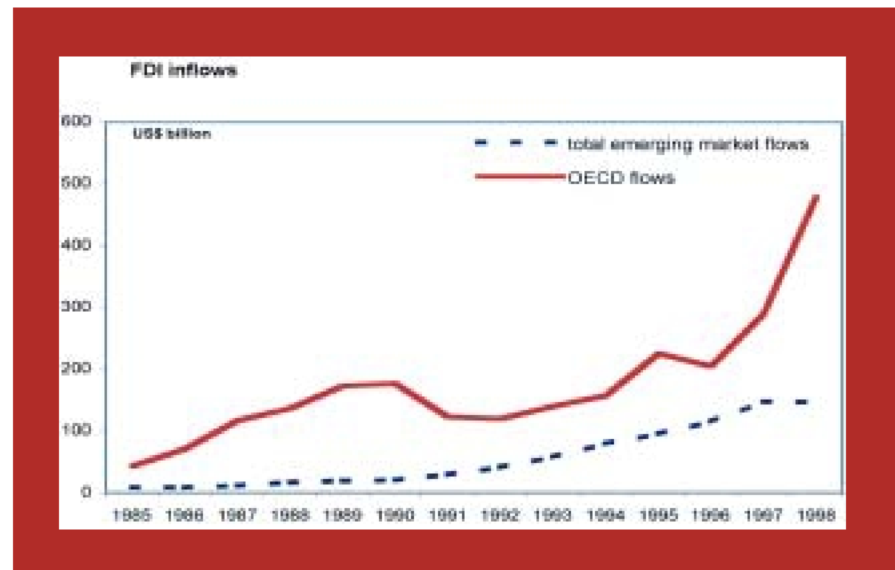
World Agricultural Export Volumes and GDP 1950 - 1999



World Manufacturing Export Volumes and GDP 1950 - 1999



Foreign direct investment inflows



1.4 Greater economic integration has the potential to bring substantial benefits to domestic economies; for example:

- global markets give people access to more capital, better technology, greater choice of goods, and the benefits of larger markets and economies of scale;
- free flows of goods and capital lead to a more efficient allocation of resources and higher growth and incomes; and
- increased competition and exposure to world-best practice lead to more efficient, responsive and innovative domestic economies.

1.5 The integration of the global economy has delivered substantial benefits in many countries. While openness to the global economy does not guarantee growth, it is necessary to achieving and sustaining growth and poverty reduction. Greater integration has enhanced the community of nations, and promoted democracy and internationalism. It has brought higher investment, growth and living standards. Those countries that have integrated into the global economy have seen the benefits of faster growth and poverty reduction. For example, outward-orientated policies have transformed countries in East Asia, reducing poverty by one-third in 10 years.

Building a stronger global economic system

1.6 But while the process of globalisation has benefited countries that have opened up to the international economy, the process also brings risks, and places new obligations on governments and the international institutions. Financial crises, especially in emerging markets in recent years have highlighted both policy weaknesses in the countries themselves, and also flaws in the international financial system. Experience has shown that once foreign and domestic investors lose confidence, capital inflows can dry up, and large capital outflows can spark a financial crisis. A crisis in one country can rapidly spill over into other economies. Therefore the IMF must continue to focus on the steps required to promote international macroeconomic and financial stability as the foundation for the new global economy – through strengthened approaches to both crisis prevention and crisis resolution.

1.7 In a world of ever-larger cross-border private capital flows, developing countries, which need finance most, can become vulnerable to changes in the judgements of global financial markets. Macroeconomic stability is a precondition of economic success and the fight against poverty, in both developed and developing countries. In order to promote stability, and prevent crises in developing and emerging market countries, the UK Government advocates a new more rules-based system, and an increase in the capacity of developing countries to participate in the global economy.

Macroeconomic frameworks for the 21st century

1.8 As economies become more open and more integrated credibility has increased in importance, and international capital markets have been more ready to channel private flows to developing countries. But, conversely, dents to credibility have become more quickly and severely punished when investors have lost

confidence in domestic economic policies. To answer this challenge all countries, both developed and developing, should seek to establish macroeconomic frameworks that will act to strengthen their stability and promote investor confidence.

1.9 The UK Government believes that the most appropriate response is to create a more rules-based framework which constrains macroeconomic policy to achieve clear long-term goals, but which gives the ability to respond flexibly in the short-term to a variety of shocks, without damaging credibility. The underlying principles for such a framework are:

- clear and sound long term policy objectives;
- pre-commitment, through strong institutional arrangements and procedural rules; and
- maximum openness and transparency, and clear accountability.

1.10 These principles imply that:

- price stability should be the goal of monetary policy. Inflation targeting, supported by central bank independence and transparency in decision making, provides scope for policy flexibility;
- while fixed exchange rate regimes may still be appropriate under certain circumstances, the increasing integration and openess of economies makes it more difficult to maintain credibility under such a regime the institutional framework - including such areas as wage setting and labour mobility - has to have developed adequately to enable sufficient flexibility to respond to shocks. Thus the policy requirements for their successful operation have become increasingly onerous;
- fiscal policy should focus on long-run sustainability, backed by institutional procedures to support a stronger commitment to fiscal responsibility. There should be effective mechanisms for public expenditure management and control; able to direct resources in line with public priorities, and to meet the needs of the poorest citizens while maintaining value for money.

1.11 These principles, whilst universally applicable, need to be applied in a manner, which depends on the nature of the economy in question. Recent crises have also shown that prudent public debt and reserves management, a comprehensive financial sector supervisory and regulatory regime, and effective corporate governance are an important complement to macro-economic policy in contributing to stable economic outcomes.

Complementary structural reforms

1.12 Sound macroeconomic frameworks must also be accompanied by structural reforms to create a more dynamic, efficient and innovative economy. Capital market reforms should aim to create a dynamic financial sector, which is sufficiently flexible and innovative to respond to the changing global environment but at the same time provides the stability necessary to attract long-term investment by consumers and businesses. Regulatory and supervisory reforms should focus on key areas of vulnerability, supported by prudential reforms to ensure that liberalisation does not create new areas of vulnerability. In the UK, for example, the Financial Services Authority (FSA) has been established as a single integrated financial services regulator with statutory objectives, to maintain confidence in the financial markets, provide appropriate consumer protection, increase public awareness of financial issues, and to fight financial crime. In fulfilling these objectives the FSA must have regard to the need for the UK to have a competitive, dynamic and innovative financial sector.

1.13 Labour market reforms should also be used to promote flexibility with minimum standards and equality of opportunity in the economy. Well-functioning labour markets, coupled with dynamic product and capital markets, equate to strong job creation, which best safeguards against social exclusion. Tackling unemployment and raising employment is therefore one of the most important routes to delivering both prosperity and social justice to all citizens[9].

1.14 One benefit of looking at policies this way is that it encourages a comprehensive approach to policy design. Policies need to fit together in a coherent framework, and be consistent with each other, in order to be successful on a lasting basis. A systematic consideration of policy objectives, of the incentives for achieving those objectives, and of the means by which policy makers will be held accountable should therefore be an integral part of IMF surveillance and a useful reference point to guide the orientation of programmes.

Codes and Standards

1.15 The framework of internationally agreed codes and standards is consistent with these principles. The adoption of clear, transparent policies, in monetary and fiscal decisions – by both developed and developing countries - improves macroeconomic stability, boosts investor confidence and limit contagion. Their implementation in poor countries has contributed to, for example, improvements in public expenditure management and accountability. The UK Government is committed to working with the IMF, the World Bank regional development banks, and other developed countries to offer technical assistance and transitional help encouraging the early implementation of such codes.

1.16 Where countries do operate transparent and effective policies the IMF's Contingent Credit Line facility should play a stronger role in helping them to strengthen their financial position and guard against contagion.

1.17 The Government also welcomes the IMF's ongoing review of conditionality as part of their efforts to enhance country ownership of their programmes. It is important that conditionality focuses on the macro and micro economic reforms that are key to the success of the programme.

[9]More information on the UK's structural reform priorities is set out in HM Treasury's February 2002 White Paper, "Realising Europe's Potential: Economic Reform in Europe", available at www.hm-tresury.go.uk

Combating terrorist financing

1.18 The importance of defending the international financial system against abuse of all kinds has become more apparent since September 11th. The UK has led calls for concerted international action to tackle financial crime and the Government welcomes the work of the IMF and the World Bank to expand technical assistance to improve compliance with international anti-money laundering standards. Money laundering, corruption and financial fraud are frequently tied up with the financing of terrorism, therefore effective international action can play an important role in disrupting terrorist networks.

Independence of the IMF surveillance process

1.19 The IMF's reviews of countries' economies and policies – surveillance – are an invaluable tool in crisis prevention. To be fully effective, the surveillance process must be transparent, authoritative and independent. We welcome the steps taken by the Fund to increase transparency, in particular the establishment of the Independent Evaluation Office. But there is a case for further institutional change to ensure the independence of the IMF's surveillance process from decisions on medium-term lending and crisis intervention, to strengthen the credibility of surveillance (and of lending decisions), and thereby enhancing its role.

Private Sector Involvement

1.20 By far the greater part of international financial flows are private flows, therefore the private sector must also play an important role in crisis prevention and resolution. The IMF must continue its efforts to strengthen its dialogue with market participants and to develop an effective framework to promote private sector involvement.

1.21 As part of this framework, the IMF needs to establish clearer presumptions for the respective roles of official and private finance, including through clearer limits on the scale of official flows, and greater clarity about the role of official finance when a country's debt position becomes unsustainable. We also need to resolve the obstacles that stand in the way of effective debt rescheduling and containment of financial crises, when more voluntary approaches are unlikely to deliver sustainable outcomes, and consider steps towards a more effective international bankruptcy procedure.

Improved trade regime

1.22 The experience of the last half-century has also shown that countries, which have been able to integrate into the world economy, have seen faster growth rates than closed ones. Economic growth, on average, raises incomes for both the rich and the poor, helping lift the poor out of poverty. We must move forward the progress made by the World Trade Organisation at its meetings in Doha in 2001 by the swift adoption of an improved trade regime that will deliver greater participation by developing countries in the world economy on fair terms. At their meeting in November, the IMFC strongly welcomed the outcome of Doha. They recommended that all countries stand firm against protectionist pressures, and that advanced economies, in particular, should improve access to their markets and reduce trade-distorting subsidies, both for their own benefit, and to provide support for developing countries. They agreed that the IMF should strengthen its surveillance of these issues and help promote international efforts to open markets. The Government also proposes backing up a code of corporate standards with financial support for the creation, in developing countries, of investment forums between

Integrating poor countries into the world economy

public and private sectors, to promote domestic and foreign investment and address any obstacles to investment, increasing employment and growth.

I.23 However, integration of poor countries into the world economy is also dependent on the policies pursued by their governments. To advance this goal, the IMF and the World Bank support country-driven poverty reduction strategy processes whereby countries clearly identify their own long-term policy goals. Fund and Bank programmes are now being designed to promote financial and technical support to these country-led strategies.

I.24 This process will contribute significantly towards the achievement of the international community's Millennium Development Goals, set for 2015. The main focus of these goals are: halving the proportion of the world's population living on less than a dollar a day, reducing child mortality by two-thirds, and ensuring that every child has the chance to start and complete a primary education. The challenges are immense, and will require an extraordinary effort by the international community. The Government's policies to respond to these challenges are set out fully in the 2000 International Development White Paper, "Eliminating World Poverty: Making Globalisation Work for the Poor" available at www.dfid.gov.uk.

Financing for development

I.25 A substantial transfer of additional resources from the richest to the poorest countries, in the form of investment for development will be needed if all countries are to benefit. The focus must be on aid that will foster investment and which addresses the long term causes of poverty. We must meet the urgent need to provide for education, health and access to clean water, to ensure that globalisation also delivers social justice for people across the world.

Development assistance and debt relief

I.26 Debt relief also has an important role. Implementation of the Heavily Indebted Poor Countries (HIPC) initiative by the IMF and the World Bank has already lifted the burden of unpayable debt from twenty-four of the most highly indebted countries, cancelling $56 billion in debt and helping to build a new and virtuous circle of debt relief, poverty reduction and sustainable development.

International Development Trust Fund

I.28 But debt relief alone cannot be the answer. There have been proposals for new and innovative ways to meet the funding gap, which need to be evaluated with an open mind. The Government has also proposed that the international community establishes a new "International Development Trust Fund" – which would focus on meeting the Millennium Development Goals, with pooled and untied aid, and supporting good policies in poor countries. This proposal will involve the richest countries making a substantial additional commitment of resources to 2015 and beyond.

I.29 In answer to the challenges of making globalisation work to the benefit of all, the IMF must continue to work to strengthen the international financial system and to accelerate progress towards reducing poverty, as well as promoting sound economic policies among its members. There must be a greater shift in emphasis away from tackling recurrent crises when they hit, to one of crisis prevention, to the benefit of the poorest. The UK will continue to push for IMF policies that advance these objectives.

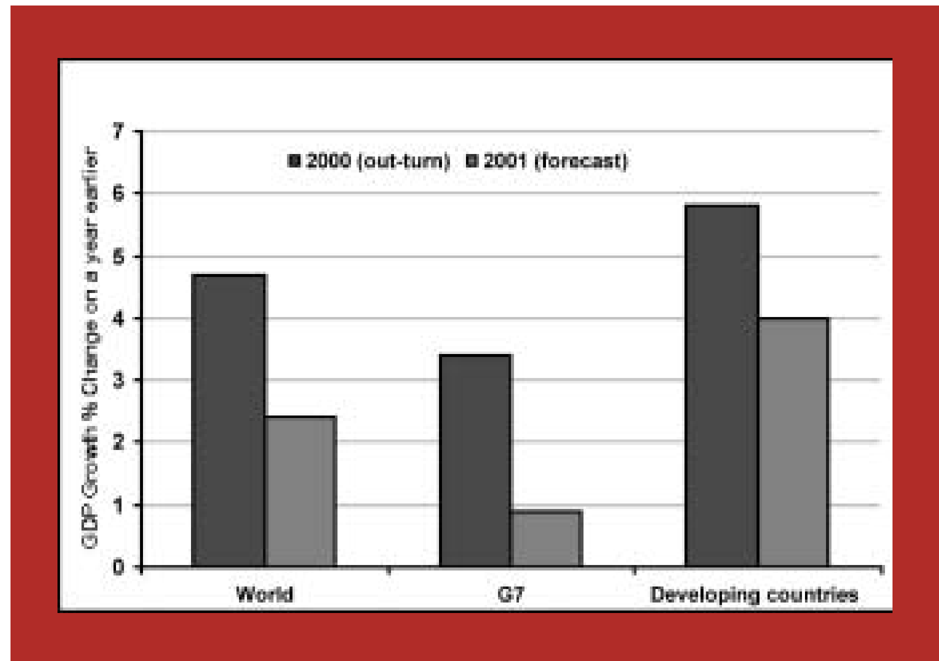
2 THE WORLD ECONOMY IN 2001

Over the last year the world economy has slowed significantly. In this chapter we review the IMF's surveillance over the past year, looking at the US, the Euro-area, Japan, the UK, emerging market economies and developing countries. It identifies the main vulnerabilities and risks, and describes the international response to financial crises in Turkey and Argentina.

WORLD ECONOMY OVERVIEW

2.1 Over the last year, the IMF's operations were carried out against the background of a world economy that has slowed significantly, with sharp declines in world trade growth, investment, industrial production and stock markets. For the first time since 1974, there has been a significant and simultaneous slowdown of growth in the US, Europe and Japan. To a considerable extent, this synchronicity is the result of common shocks, including the bursting of the information technology bubble and the increase in oil prices, both of which had a worldwide impact. Increased international linkages, particularly in the financial and corporate sectors, have played a role – a trend that is likely to continue. Following the terrorist attacks of 11 September, heightened uncertainty and declining confidence have further weakened demand and delayed the recovery in the major economies.

IMF World Economic Outlook: December 2001



US Article IV

2.2 In the US, falling stock prices and rising unemployment were already beginning to weigh on consumer confidence prior to 11 September and the economy contracted during the third quarter. The National Bureau of Economic Research has officially declared that the economy has been in recession since March. Output is likely to have declined again in the fourth quarter, but towards the end of the year, following a rapid policy response, there were tentative signs that a recovery is beginning to emerge. At the US Article IV Board discussion in July, staff pointed out that there were significant downside risks on investment, consumer demand and productivity growth. Tax cuts were expected to provide a welcome short-term stimulus, but there were considerable doubts over long-term budget forecasts. The IMF recognised that there was considerable uncertainty over when the downturn would end and questioned the sustainability of the high exchange rate and current account deficit.

Euro-Area Article IV

2.3 Economic activity in the Euro-area was much weaker than expected in 2001. The impact of weaker external demand has been only partly offset by recent interest rate cuts. Germany has been particularly affected by the world slowdown and, amongst other factors, continued weakness in the construction sector. The IMF encouraged further structural reform in product and labour markets, while welcoming some recent progress.

Japan's Article IV

2.4 Renewed weakness in Japan is largely attributable to the deterioration in the external economic environment. The new government's commitment to a much-needed programme of structural reform is likely to exert further downward pressure on growth and inflation in the short-term, but should yield significant long-term benefits. However, the situation in the banking system is of increasing concern. The IMF recognised that the deteriorating economic outlook presented significant policy challenges. Further easing of monetary policy was urged, though Japan was entering uncharted territory and there was considerable uncertainty over whether this could be achieved. On fiscal policy, it was important to send a clear signal that Japan was committed to reducing the deficit, whilst avoiding exacerbating the current downturn. It was recognised that a supplementary budget could be needed this year.

2.5 Further information on the general themes and priorities behind UK interventions in these, and other Article IV discussions in the Executive Board is available in Annex I of this report, as part of the Government's continued efforts to improve the transparency of its dealings with the IMF.

Article IV country surveillance

Country surveillance takes the form of regular, comprehensive consultations with individual member countries about their economic policies. The consultations are referred to as "Article IV consultations" as they are mandated by Article IV of the IMF's Articles of Agreement. The consultations focus on the member's exchange rate, fiscal and monetary policies; its balance of payments and external debt developments; the influence of its policies on the country's external accounts; the international and regional implications of those policies; and on the identification of potential vulnerabilities. They are not limited to macroeconomic policies, but touch on all policies that significantly affect the macroeconomic performance of a country, which, depending on circumstances, may include labour and environmental policies and the economic aspects of governance.

A staff team visits the country, and collects economic and financial information, and discusses the country's economic developments and policies with officials. On return the staff prepares a report, which forms the basis for discussion by the Executive Board. The views expressed in the Article IV staff report itself are those of the staff team. The views of the Executive Board are summarised in Public Information Notices (PINs) attached to the staff report. Comments by the country authorities are also attached, if any were submitted at the time of the Board discussion

In August 2000, following a successful pilot project, the Executive Board adopted a policy of voluntary publication of Article IV staff reports, The Uk participated in te pilot project by authorising the publication of our 1999 Article IV report, and have continued to do so in 2000 and 2001

Surveillance of the UK economy

The IMF mission for the UK's 2001 Article IV consultation was conducted in November 2000. We published the Concluding Statement of the IMF mission shortly after the mission team had completed their work.

The mission concluded, that, "the overall performance of the UK economy remains impressive", labour market policies "continue to be exemplary", and "the UK fiscal position is very healthy". This was due largely to, "in no small measure, sound macroeconomic policies underpinned by strong fiscal and monetary frameworks that emphasise transparency and accountability".

However the Fund pointed to the UK's comparatively weak labour productivity over the past decade as a potential "Achilles' heel". They also recommended a prudent course of action for the March 2001 Budget, managing public finances to avoid over-stimulating the economy.

The Executive Board considered the Staff Report in February 2001. Executive Directors "commended" the UK Government "for the strong performance of the UK economy." The Directors agreed that "sound fiscal and monetary policies, underpinned by transparent medium-term policy frameworks as well as sustained implementation of structural reforms" have contributed to the strength of the economy in recent years. They also "expected output growth would remain robust" while "prospects for inflation remain benign". The full report was published on 28 February 2001 and is available at the IMF web site.

The IMF mission for the UK's 2002 Article IV consultation was conducted in December 2001. The concluding statement is available at the IMF web site. The full Article IV report will be discussed by the Executive Board, probably in late February 2002, and will then be published.

EMERGING MARKET ECONOMIES

2.6 Despite the rapid global slowdown, and a number of crises for individual countries, there were no wider contagion effects within the international financial system over the past year. However, many Asian emerging markets have been particularly affected because of the openness of their economies and their heavy dependence on trade in Information and Communications Technology related goods. Excluding the crisis year of 1998, the IMF expects economic activity in emerging Asia during 2001 to have been weaker than at any time over the past 20 years. Elsewhere in the world, Latin American economies have been affected by the slowdown in the US and reduced access to international capital markets, while emerging European economies have seen their growth prospects curtailed by weaker economic developments in the Euro-area.

2.7 There have also been a number of shocks to the wider global economy. In particular the terrorist attacks in the US on 11 September led to widespread and significant declines in equity prices as well as heightened uncertainty. The absence of inflationary pressure in industrialised countries enabled a decisive response by policy-makers in the US and Europe, which helped to underpin confidence.

Vulnerabilities

2.8 Many countries also remained vulnerable due to large external financing requirements, whilst private capital flows to emerging markets were significantly below their levels before the crises in 1997. Table 4a shows the extent to which private flows to emerging markets outweigh official flows from the International Financial Institutions and bilateral sources. The Institute of International Finance expect total net private capital flows to emerging markets to have fallen sharply in 2001. The main factor behind lower net flows is a reversal of private credit, with Foreign Direct Investment (FDI) flows holding up reasonably well.

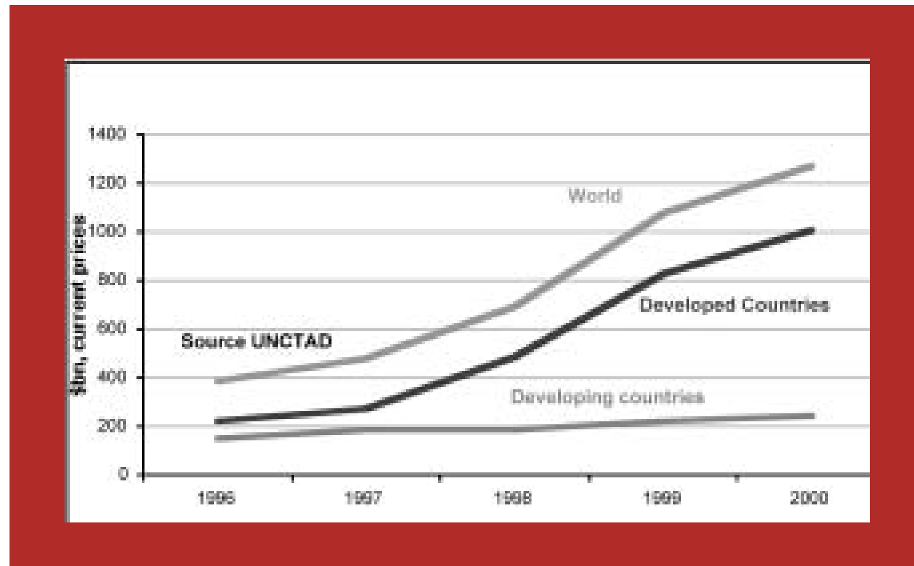
Chart 4a: Emerging Market External Financing[1], Source IIF, *IIF forecast

$ bn current prices	Private Flows (1)	Official Flows (2)	Resident net Lending (3)	Current Account Deficit (4)	Increase in Reserves (5)
1998	141.5	51.2	143.2	7.9	41.6
1999	143.2	10.2	121.7	-23.1	54.7
2000	169.0	-1.9	146.1	-49.3	70.3
2001*	115.1	20.0	87.7	-19.2	66.6
2002*	144.2	17.8	105.0	22.2	33.2

[1] External Financing (1) + (2) = (3) + (4) + (5)

2.9 Flows of FDI around the world have grown slowly and consistently over the past decade. FDI flows have more than doubled in the last four years, to almost $1300 billion in 2000, with the rise almost entirely accounted for by increased flows to developed countries. FDI flows to emerging markets have grown, but relatively slowly.

FDI Inflows



Emerging market programmes

2.10 Those countries involved in IMF supported programmes[2] have had varying degrees of success in implementing reform. Some countries such as Brazil have faced a particularly challenging environment due to external factors. And serious economic and financial problems have continued to affect a number of countries, most notably Turkey and Argentina. However, these crises have also been notable for the absence of international contagion.

Turkey – Stand-by Arrangement

2.11 Following a financial crisis in November 2000, Turkey received SDR 5.8 billion (approx $7.3 billion) in additional IMF lending to alleviate balance of payments difficulties. However, a further financial crisis in February 2001, sparked by political disputes in Turkey's ruling coalition, forced the authorities to abandon its exchange rate peg, and float the lira. A new economics team had to address the effects of the devaluation (which included major losses in the banking sector) and past losses in the state banks. Tackling this put further strain on Turkey's already worrying domestic debt dynamics.

[2] During 2001 the Executive Board discussed requests for Stand-by Arrangments (SBS) from the Republic of Latvia, Federal Republic of Yugoslavia, Republic of Lithuania, Brazil and Romania; augmentated Argentina's existing SBA; and reviewed SBAs in Turkey, Pakistan, Papua New Guinea Argentina, Ecuador, Gabon, Federal Republic of Yugoslavia, Republic of Croatia, and Uruguay. The principles underlying the UK's interventions in these discussions are set out in annex I.

To help Turkey overcome this, and to underpin macroeconomic stability more generally, Turkey's programme was redesigned for a floating exchange rate environment, and backed with a further SDR 6.4 billion (approx $8 billion) of IMF money. However, the programme's early progress was hampered by further domestic political disputes (July 2001) and significantly affected by the effects of 11 September.. In response the IMF has provisionally agreed to fill Turkey's 2002 financing gap, subject to Board approval. This has brought a substantial rebound in market sentiment, although confidence remains very fragile.

Argentina – Stand-by Arrangement

2.12 Adverse domestic and external events meant Argentina remained in recession during 2000 and led to Argentina's first augmentation of their existing stand-by arrangement (see box on the background to the crisis in Argentina). This was approved in January 2001 to SDR 10.6 billion (approx $13.3 billion, equivalent to 500 per cent of quota). However, doubts about the sustainability of Argentina's public debt resurfaced following the authorities' failure to sustain the fiscal policies underlying the program. A Ministerial crisis in March led to new policies, which failed to restore confidence, and the country was brought to the edge of a sovereign debt default in July. A second augmentation of the arrangement to SDR 16.9 billion (approx $21.3 billion, equivalent to 800 percent of quota) was approved in September. The UK and the IMF identified significant risks to the success of the programme, which depended upon a number of factors. The UK and the IMF recognised that the augmentation should be seen as an exception as it was not in itself sufficient to put Argentina back on a medium-term sustainable path. It was questionable whether the plan would buy enough time for the restoration of confidence, necessary for the continued private sector involvement vital for the programme's success. There were also considerable risks to the macroeconomic assumptions underlying the programme. The UK asked the IMF to be prepared if the programme were to fail. These concerns were realised at the end of the year when the Argentinean government announced a debt standstill on all its obligations to private creditors and the Government resigned amid protests over the banking curbs introduced to prevent the collapse of the financial system. Following further political turmoil, the Duhalde Government ended the Convertibility regime (which pegged the peso one-to-one to the US dollar) and devalued the peso, and the IMF programme was suspended. As of February 2002, the IMF is currently engaged with Argentina over a plan to restore the country to a sustainable economic path.

IMF liquidity

2.13 The IMF's financial position remained strong despite the fall in the liquidity reation during the year, placing the Fund in a good position to respond to the increased borrowing needs of emerging markets. The Fund's liquidity ratio, the ratio of the Fund's net uncommitted usable resources to its liquid liabilities, is used to assess the adequacy of resources available to meet potential demands from members. On April 30 2001, the liquidity ratio was 168.4 per cent. Although it fell, during the year, due to augmentation of the Argentina programme and Brazil's recent programme, the liquidity ratio remained around 115 per cent at the beginning of September 2001. Following the 11 September attacks on the United States the ratio fell further, to 105.6 per cent. However this remains significantly higher than the figure of just over 40 per cent seen in 1998.

Financial Crisis in Argentina

After suffering from years of hyperinflation, Argentina adopted a Currency Board Arrangement in 1991, whereby the peso was fixed by legislations at a one-to-one rate with the US dollar also known as Convertibility). This measure was accompanied by structural reforms that led to high growth combined with low inflation. However, in the second half of the decade, the pace of reform slowed and the fiscal position deteriorated. Argentina then suffered a combination of external shocks: the Asian Crisis in 1998, the Brazilian devaluation in January 1999, falling world commodity prices, a strengthening dollar and tighter emerging market conditions. With monetary and fiscal policy unable to respond, Argentina became trapped in a vicious circle whereby rising interest rates increased debt service costs, stifled growth and led to a deteriorating fiscal position. The risk premium began to increase rapidly, putting further upward pressure on interest rates.

In January 2001, as the environment deteriorated, the IMF agreed to augment Argentina's precautionary SBA by a further $6.1 billion. This was part of a $40 billion package agreed with private creditors to boost confidence and to support a return to economic growth. The IMF augmented the SBA by a further $8 billion in September 2001 (see text for details), but an unsustainable mix of falling tax revenues and a contracting economy made the IMF fiscal deficit target for 2001 unattainable and negotiations with the Fund stalled.

With default looming, Argentina embarked on a massive restructuring of debt. The successful completion of the domestic portion of the debt swap was not sufficient to prevent nervous depositors withdrawing funds from their banks at an accelerating rate. On 1st December, Economy Minister Cavallo imposed banking restrictions and capital controls to prevent the collapse of the banking system. Shortly afterwards the IMF announced that they would suspend further payments under Argentina's programme.

Strikes and mounting social unrest followed, culminating in looting and violence on December 19th. The Cabinet resigned en masse that day and President De la Rua resigned the following evening amid further rioting. On December 23rd Rodriguez Saa was named interim President and immediately announced that Argentina would suspend its external debt payments. A week later he resigned amid fresh protests and a lack of political support. On January 1st, the Congress voted Eduardo Duhalde in as President. He announced the end to Convertibility and devalued the peso. At the time of writing Argentina is working closely with the IMF to develop a sustainable economic plan. The key areas of focus will be the monetary and fiscal policy framework, the banking system and the exchange rate regime.

DEVELOPING COUNTRIES

2.14 Prior to September 11th, weaker external demand, low commodity prices, increasing risk aversion and deteriorating conditions in international financial markets were already affecting the world's developing economies.

2.15 Economic growth is the key to tackling the range of problems faced by the world's poorest countries. The global slowdown is likely to have a significant impact on many of these economies. The World Bank estimates that growth in the developing world will slow from 5.5 per cent in 2000 to 2.9 per cent in 2001, and that the events of September 11th will further reduce developing country growth by between ½ and ¾ percentage points in 2002 as economic recovery is delayed around the world.

2.16 Developing countries have been particularly affected by the fall in commodity prices associated with weaker world demand during 2001. Non-oil commodity prices have fallen by 5 per cent since 11 September. In addition, greater risk aversion on the part of international investors has raised the cost of emerging and developing country borrowing, while foreign direct investment in emerging markets fell by 5 per cent in the first half of 2001 and is expected to have declined further in the second half of the year. A slump in tourism has also affected many regions.

2.17 In low-income countries, the IMF has worked with governments to factor these impacts into growth projections and into programme design. The IMF's Poverty Reduction and Growth Facility (PRGF), the Fund's concessional lending facility, is able to provide increased resources where necessary to support balance of payments difficulties. The World Bank is providing increased International Development Association (IDA) concessional flows into affected countries, conditional on appropriate social and structural adjustment policies. During 2001 the Executive Board discussed requests for, or reviews of PRGF arrangements for 27 countries.[3] The UK's approach to the IMF in poor countries is set out in chapter 6. The points made by the UK in relation to Board discussions on the PRGF are summarised in annex I.

[3] Albania, Azerbaijan Republic, Benin, Burkina Faso, Cambodia, Central African Repubic, Chad, Croatia, Ethiopia, Gambis, Guina, Honduras Lesotho, Madagascar, Mail, Mauritania, Mongolia, Mozambique, Pakistan, Rwanda, Senegal, Sierra Leone, Tajikistan, Tanzania, Vietnam, Yemen and Zambia

3 INTERNATIONAL FINANCIAL ARCHITECTURE AND REFORM OF THE IMF

As globalisation and increasing integration of the world economy brings new challenges, the IMF must evolve and adapt in order to fulfil its statutory purposes – to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment.

The IMF has, and must continue to, respond by introducing reforms aimed at strengthening the international financial architecture and by enhancing its own contribution to the prevention and resolution of financial crises. It has also given new emphasis to enhancing growth, and reducing poverty in the world's poorest countries.

This chapter sets out the UK position in all of the major policy areas that have been discussed by the Executive Board, and at Ministerial level in the IMFC, during 2001.

BACKGROUND AND OVERVIEW

3.1 As economies and financial markets become more open and integrated, transparent, credible and accountable macroeconomic frameworks become ever more important to promote stability and growth. The IMF, with its near universal membership (183 countries), is the cornerstone for promoting global growth and stability.

3.2 In response to the Asian Crisis in 1998, the members of the IMF agreed a far-reaching programme of reform to strengthen the International Financial System. This included establishing a framework of internationally agreed standards and codes, a stronger emphasis on crisis prevention through enhanced surveillance, and reforms to improve the transparency and accountability of the IMF. The process of reform is not complete – although much progress has been made and the IMF is now stronger, more effective, transparent and accountable. There remain major challenges of implementation, and a need to build wider support.

3.3 This chapter sets out details of the reforms underway in the IMF, and the Government's views on the appropriate priorities, in the following areas:

- enhancing the credibility, scope and independence of IMF surveillance;
- improving the effectiveness of the codes and standards framework to strengthen countries' defences against destabilising capital flows and promote growth;

- tackling abuse of the international financial system;
- developing a new framework of clearer presumptions about private sector involvement (PSI) crisis resolution;
- enhancing transparency, and in particular the role of the Independent Evaluation Office;
- delivering more sustained reforms through streamlining conditionality and enabling greater ownership among emerging markets and developing countries; and
- ensuring, while supporting stability that countries put in place strong social systems and mechanisms to help the most vulnerable and, at a time of crisis minimise the impact on the poor and most vulnerable.

New appointments to IMF management

There have been significant changes to key staff at the IMF over the last year. First Deputy Managing Director Stanley Fischer announced his intention to leave his position shortly after the spring meetings. Michael Mussa, Economic Counsellor and Director of the Research Department, and Jack Boorman, Counsellor and Director of the Policy Development and Review Department, also retired from the Fund later in the year.

The Managing Director appointed Anne Krueger as Mr. Fisher's successor, effective from 1 September 2001. Chief economist at the World Bank from 1982 to 1986, Krueger is widely considered to be an expert on financial institutions and international issues. She came to the Fund from her then professional post at Stanford University. He also announced appointment of Gerd Häusler to be Counsellor and Director of the new International Capital Markets Department; Kenneth Rogoff as Economic Counsellor and Director of the Research Department; and Timothy Geithner as Director of the Policy Development and Review Department.

CRISIS PREVENTION

The current economic climate again highlights the importance of on-going reforms to strengthen crisis prevention, identify vulnerabilities at an early stage and reduce the frequency and magnitude of financial crises. These include the enhanced role and credibility of IMF surveillance; encouraging the adoption of internationally agreed codes and standards; use of the IMF's Contingent Credit Line facility; and the work of the Financial Stability Forum.

ENHANCING THE ROLE OF IMF SURVEILLANCE

3.4 One of the key functions of the IMF is the surveillance of the international monetary system. Over the past few years substantial progress has been made in reforms to the international financial architecture, including measures to promote greater transparency and accountability; improve financial systems; and minimise vulnerabilities to volatile capital flows. The IMF's role in surveillance, and the need to address any potential shortcomings, is crucial to the success of the reforms.

3.5 Concerns over surveillance are not new. The need, for example, to improve surveillance of countries' financial policies was noted by the Interim Committee (now the IMFC) in 1995, following the Mexican crisis, but surfaced again in the aftermath of the East Asian crisis. We need to ensure that the current reform process delivers a step change in the role of surveillance as an instrument of crisis prevention. In order to do so, it may be necessary to look not only at how best to deliver specific reforms, but also to consider the overall structure of surveillance, and whether the right incentives are in place to ensure its effectiveness.

Multilateral surveillance

3.6 The IMF's surveillance is conducted at global, regional and country levels. The Fund's multilateral surveillance consists of regular reviews of global economic and financial developments by the Executive Board. The IMF's World Economic Outlook is published twice yearly (in May and October). The Board also hold an annual discussion of developments, prospects and policy issues in international capital markets, the staff reports on which are also published. From February 2002 these reports will be replaced by a quarterly Global Financial Report. This is supplemented by regular discussions and examination of policies pursued by regional economic institutions, including the European Central Bank.

Country surveillance

3.7 The IMF's country surveillance takes the form of regular comprehensive consultations with member countries about their economic policies and circumstances. The experience of the past few years has shown that if it is to provide an effective early warning mechanism of potential financial crises, this surveillance must extend beyond the traditional macroeconomic indicators, such as the levels of

deficits and debt, to take into account balance sheet indicators and institutional factors, such as the quality of banking supervision and corporate governance. It is in these areas that the Codes and Standards framework is crucial.

To be fully effective, surveillance must be:

- **transparent.** Openness provides stronger incentives for countries to undertake policy reforms. A transparent surveillance process enhances its credibility and accountability, by making clear when macroeconomic positions are unsustainable, and holding the Fund accountable for its policy advice;

- **authoritative.** Surveillance should be based on an up-to-date and widely accepted model of economic policy making, and the underlying basis for economic judgements should be clear and challengeable; and

- **independent**. Given the inevitable degree of judgement that must enter in to the assessment process, the integrity of the institutions involved must be beyond question. Surveillance institutions need to be focussed on the task at hand and not influenced by their involvement in other activities.

Publication of Article IV reports

3.9 The IMF has taken considerable steps to increase transparency in recent years. The summing up of Board discussions for many Article IV consultations, together with summaries of the staff's analysis, are published in Public Information Notices (see annex I). In many cases the full staff reports are also being released and are available on the IMF's website. The Government believes that the publication of Article IV staff reports is an important element in enhancing the transparency and credibility of IMF surveillance, and as a result the UK authorised publication of our Article IV report at the earliest opportunity in 1999, and have continued to do so in 2000 and 2001. In Article IV discussions in the Executive Board the UK also encourages other member countries to authorise publication of their Article IV reports.

3.10 There is also a case for further institutional change to ensure – and to be seen to ensure – the independence of the IMF's surveillance process from decisions on medium term lending and crisis intervention. At the November 2001 meeting of the IMFC, the Chancellor proposed further examination of this. One possible option would be to separate these functions, and to adapt the internal structure of the IMF to resolve the potential conflict of interest. The surveillance arm of the IMF would be specifically dedicated to the production of transparent authoritative and independent surveillance of countries and markets. Reports would provide the information framework necessary for the international community to take effective and timely decisions in a financial crisis. The surveillance arm would also be charged with providing impartial advice to all countries, on the measures required to enhance growth and stability.

Strengthening surveillance of financial markets

3.11 The Government welcomes the steps taken by the Fund to strengthen their surveillance of financial sectors. In particular the Financial Sector Assessment Programme (FSAP) framework has moved out of its pilot phase and in December 2000 the Fund and World Bank Boards agreed that it should carry out up to 24 country assessments per year. By end September 2001, 22 countries had undertaken financial sector assessments, which provide a comprehensive analysis of member countries' financial sectors, and a further 40 had committed to participate in the programme. The UK is actively encouraging this by undergoing a financial sector assessment under the FSAP this year.

International Capital Markets Department

3.12 Effective surveillance will also be facilitated by developing expertise within the IMF capable of assessing problems arising in international financial markets. This includes through the IMF participation in the Financial Stability Forum [see box], which brings together the expertise of the IMF and other key regulatory authorities. Another important step was the establishment of a new International Capital Markets Department in the Fund. The new department's objective is to help deepen the IMF's understanding of capital market operations, strengthen their capacity to address systemic issues related to capital market developments and enable the Fund to conduct more effective surveillance at both national and international levels. It will also improve the Fund's capability to provide early warnings of potential stress in financial markets and its ability to help all member countries gain access to, and participate in international capital markets.

Financial Stability Forum

The Financial Stability Forum was established in 1999 and is developing to fulfil its role as an early warning system for financial crises. It consists of high-level officials from Finance Ministries, Central Banks and financial supervisory authorities of the major financial centre economies, including the UK, together with representatives from relevant international financial institutions and regulatory bodies. Developing countries are drawn in to the Forum's work on issues of relevance to them. The Forum meets twice a year in the spring and in the autumn.

The objective of the Financial Stability Forum is to ensure that participants can more effectively foster and coordinate their respective responsibilities to promote international financial stability, improve the functioning of markets and reduce systemic risk. In order to achieve this, the FSF assesses vulnerabilities in the global financial system, identifies and oversees actions necessary to address these vulnerabilities, and improves co-ordination and information exchange between other authorities.

The IMF is a member of the Forum and much of the Forum's work relates directly to that of the IMF. More information is available at http://www.fsforum.org.

PROMOTING STABILITY - CODES AND STANDARDS

3.13 The codes and standards framework has been established as an important part of the work of the IMF to strengthen the architecture of the international financial system. The UK strongly believes that the adoption of clear, transparent standards of good practice in fiscal and monetary policies and for developing robust financial systems by all countries, will improve macroeconomic stability, boost investor confidence and help to limit the threat of contagion. The adoption of internationally agreed codes and standards is designed to improve transparency and good governance, and increase the accountability of policy.

Promoting the development and improvement of standards

3.14 Continued progress has been made in promoting the development and improvement of internationally recognised standards. The IMF has made a significant contribution to this process, taking the lead in the development of standards governing the transparency of macroeconomic and financial policies and data dissemination. The Executive Board's endorsement of the Data Quality Assessment Framework and its integration into the Report on the Observance of Standards and Codes (ROSC) module, this year, has been an important improvement to the Fund's data standards. G20 members should also continue to play a leadership role in developing and reinforcing a broader political consensus and gaining commitment to the codes and standards agenda.

3.15 The Fund also collaborates with a number of other bodies to revise and develop standards. Among others, the IMF has worked closely with the Financial Action Task Force (FATF) and the World Bank to develop global standards for combating the financing of terrorism and countering money laundering (see section 5.4), and with the Basel Committee on the new Basel Capital Accord, the internationally recognised standard for banking supervision

Assessing the observance of codes and standards

3.16 In addition to participating in the development of codes and standards, the IMF coordinates the assessment of countries' observance of a range of standards relevant to macroeconomic and financial stability. The ROSC framework has been established as a permanent and principal tool for assessing standards and codes and plays a key role in highlighting where reforms are needed, in areas of direct operational relevance to the Fund – including fiscal, monetary and financial policy transparency, banking supervision, and data dissemination. The ROSC framework allows the IMF to produce assessments of observance of individual codes and standards for member countries. Over time, the ROSC "modules" build up to a comprehensive picture of a country's progress in implementing the range of codes and standards, while allowing prioritisation according to the specific needs and circumstances of individual countries. Building on this approach, the IMF and the World Bank have together established the Financial Sector Assessment programme (FSAP) through which assessments of domestic financial sector codes and standards are carried out. The FSAP feeds into the ROSC exercise, resulting in ROSC modules assessing the codes for monetary and fiscal policy transparency, the Core principles of banking supervision, and occassionally other supervisory standards.

3.17 For codes and standards to work effectively there must also be transparency about countries' implementation. The UK has consistently argued that countries should aim to fully disclose their record on implementing codes and standards. An increasing number of member countries have undergone ROSC modules - as of December 2001 201 ROSC modules, for 67 countries, had been completed, and 145 of those, for 45 countries, had been published.

Technical assistance to support implementation

3.18 Countries must have the freedom to implement codes and standards in a manner, and at a pace that reflects their capacity and domestic reform priorities. The implementation of codes and standards is the responsibility of individual countries, but the Fund and other international bodies can help by providing technical assistance (see box). The UK is continuing to promote the need for technical assistance in order to ensure that developing countries are more effectively involved in both the design and the implementation of codes and standards.

3.19 The UK's proposal to establish a multi-donor technical assistance for standards and codes facility will be an important means of encouraging this, by delivering rapid and targeted technical assistance to support developing countries implementing codes and standards for financial services regulation and market integrity.

The Contingent Credit Line

3.20 Where countries do operate transparent, sound and effective policies the IMF's Contingent Credit Line (CCL) facility should play a stronger role in helping them to strengthen their financial position and guard against contagion. Approval of financing under the CCL should signal the IMF's confidence in a country's economic policies. But, despite reforms to increase its attractiveness (see box), the facility has not yet been used.

3.21 The CCL is a potentially valuable instrument with which to signal the adoption of strong policies and guard against contagion. Therefore, at the November IMFC, the UK called upon the IMF to take a more pro-active approach to the CCL. The UK is proposing that a number of options are considered, including;

- establishing a central Fund policy, to help countries through the CCL process. Recent experience with the HIPC Initiative highlighted the effectiveness of a policy and the role of targets for the number of countries to be brought through the initiative. Such a policy for the CCL could help to overcome the constraints attached to individual country cases. It would focus both countries and the institutions on the CCL, and help to promote the CCL as a signal of good quality for emerging markets. Technical assistance would be required to support this initiative;

- promoting the CCL by introducing a standard section in each member's Article IV consultation that considers whether that member is potentially eligible for a CCL, and the specific steps needed to achieve potential eligibility. In addition to improving the transparency of the eligibility criteria, this option should help to demonstrate that achievement of eligibility is a positive target.

Including all members (including developed countries) in the process could help to allay fears that a CCL assessment is a sign of weakness rather than of success; and

- that advanced economies lead by example, building support for the CCL much as they have done in building support for the ROSC and FSAP processes. This would strengthen the international system, as well as benefiting individual members by ensuring the strength of their individual policies.

Assessing implemtation of Codes and Standards - illustrative examples

Areas where the Fund has developed standards, and some illustrative examples of countries who have undertaken and published ROSCs in these areas include:

- Data Dissemination: The Special Data Dissemination Standard was established in 1996 to guide countries that have, or that might see, access to international capital markets in the dissemination of economic and financial data to the public. The General data Dissemination Standards was then established in 1997 to guide countries in the provision of comprehensive, timely, and accessible economic, financial and socio-demographic data. For example Cameroon was assessed against the Fund's General Data Dissemination System. The report examined transparency and accountability in government and public sector operations under their current economic programme. This included presenting detailed information on Cameroon's statistical system and plans for improvements.

- Fiscal Transparency: The ROSC on fiscal transparency addresses issues such as clarity of roles and responsibilities, and legal frameworks for fiscal management; public availability of information; open budget preparation, execution and reporting; and accountability. In Mozambique for instance, the February 2001 ROSC noted that the authorities had made progress in a number of areas, including through the creation of an independent audit office. It highlighted priority areas for further attention, including the need to disclose extra-budgetary activities in the budget, and the need to ensure that year-end audited accounts are produced within 12 months, instead of more than 20 months currently.

- Monetary and Financial Policy Transparency: The Code of Good Practice in the Transparency of Monetary and Financial Policies sets out broad principles that central banks and financial agencies should seek to achieve and addresses areas such as public awareness of the goals and instruments of policy and the credibility of the authorities' commitment to meet those goals, and the accountability of central banks and other financial agencies.

- This is among the ROSCs undertaken by Argentina over the past few years. The Fund examined the Central Bank, assessing the degree of transparency in the formation and conduct of monetary policy and the factors influencing this. The report also looked at a range of autonomous financial regulatory agencies, in particular the impact of their degree of independence on their transparency and accountability.

- Financial sectors: Standards covering a number of financial sectors have been developed by other institutions, but are assessed under the joint Fund-Bank Financial Sector Assessment Programme. As part of their FSAP, Poland, for example, has undertaken ROSC modules covering banking supervision, payment and settlement systems, securities markets, insurance regulation and transparency in monetary and financial policies. The report examined the impact of recent developments in their financial sector on stability - including increased diversification, the role of foreign investors, particularly in banking and insurance, and their privatisation agenda – and assessed their implementation of international standards in these areas. The FSAP itself provided more detailed institutional information and analysis.

In addition to these, the World Bank leads on undertaking assessment of some sets of standards, including corporate governance, accounting, auditing and insolvency and creditor rights, although these may also be examined under the FSAP.

More information and a complete list of published ROSCs are available at http://www.imf.org.

Supporting best practice – Technical Assitance

The codes and standards framework plays a central role in promoting macroeconomic stability and strengthening the international financial system. The IMF, in co-operation with other organisations, must improve their provision of technical assistance to member countries to support implementation of codes and standards and effective economic management, encouraging broader participation of developing countries within the process.

The IMF currently provides technical assistance and training in four principal areas;

- strengthening monetary and financial sectors through advice on banking system regulation, supervision and restructuring, foreign exchange management and operations, clearing and settlement systems for payments, and the structure and development of Central Banks;
- supporting strong fiscal policies and management through advice on tax and customs policies and administration, budget formation, expenditure management, design of social safety nets and management of domestic and external debt;
- compiling, managing and disseminating statistical data and improving data quality; and
- drafting and reviewing economic and financial legislation.

Much of the IMF's technical assistance is aimed at strengthening members' human resource and institutional capacity to formulate and implement sustainable, growth-oriented, poverty-reducing macroeconomic, financial and structural policies. The Fund also assists countries in the design of appropriate policies and reforms, drawing lessons from other countries and helping to strengthen country ownership. However more could be done to harmonise technical assistance among the International Financial Institutions and donors to ensure that efficient and appropriate technical assistance and capacity building is provided.

The UK is working with the IMF and the World Bank to establish a trust fund to facilitate donor contributions to providing this sort of technical assistance.

The Contingent Credit Line

The Contigent Credit Line (CCL) was established in 1999 to provide precautionary lines of defence against future balance of payments problems for countries following strong economic policies.

It provides the option of pre-committed short-term financing to help members overcome exceptional balance of payments difficulties that can arise from circumstances that are largely beyond the member's control. It is only Fund facility that operates on the principle of pre-qualification. Approval of financing under a CCL is based on meeting strong criteria that reflect the strength of a country's economic policies and progress towards meeting international requirements. Encouraging countries to move towards eligibility therefore creates incentives for the adoption of strong policies (notably debt management and sustainable exchange rate policies), adherence to intentionally recognized standards, and fostering constructive involvement of the private sector.

In September 2000 the IMF endorsed reforms to improve the attractiveness and the effectiveness of the CCL. These included reducing the rate of the charge (so that the CCL is now notably cheaper than the Supplemental Reserve Facility (SRF), and reducing the commitment fee. However, positive action is needed to promote the benefits of the CCL and encourage emerging markets to apply.

CAPITAL ACCOUNT LIBERALISATION

3.22 Greater capital mobility has the potential to raise welfare by improving the global allocation of saving and investment; by creating opportunities for portfolio diversification, risk sharing and facilitate trade; and by promoting competition, specialisation, and efficiency in domestic financial systems. However, undertaking liberalisation too quickly, before the necessary conditions are in place, can jeopardise stability. We should be prepared - where other reasonable options have been exhausted - to suport a country that must impose temporary capital controls, as part of an orderly process of crisis resolution.

3.23 Thus proper sequencing of capital account liberalisation is critical to maximising the benefits and minimising the risks associated with greater openess. And this involves not only the proper sequencing when removing controls, but also the transformation of a country's regime for managing the risks associated with external capital flows from a regime based on direct but distortionary restrictions on the flows themselves to a regime based on making the domestic macro-economy more resilient to shocks. To effect this transition without creating new areas of vulnerability, the removal of capital account restrictions needs to be carefully sequenced and linked to the adoption of supporting reforms that augment the country's capacity to manage capital account volatility.

Key reforms necessary

3.24 This implies that to be successful, capital account liberalisation needs to be accompanied by a number of key macroeconomic, structural, regulatory, and supervisory reforms including:

- a stable macroeconomic framework,
- a relatively open current account,
- an effective financial regulatory and supervisory framework,
- a sound banking sector,
- open and transparent corporate governance arrangements,
- provisions for protection of creditors and shareholders, and
- the need to monitor and manage the foreign exchange liquidity position of the public and banking sectos

The role of the IMF and the World Bank

3.25 The International Financial Institutions (IFIs) have an important role to play in providing policy advice and technical assistance to countries seeking greater access to international capital markets, and the IMF and the World Bank should stand ready to advise countries on the proper sequencing of liberalisation and supporting macro-prudential reforms. Given the range of country starting points and economic priorities, there can be no "one-size-fits-all" plan for sequencing capital account liberalisation that is both sufficiently detailed and universally applicable. At the same time, there is value in providing countries with a flexible methodology for guiding the process of liberalisation which acknowledges the short-term risks associated with sub-optimal sequencing while recognising the medium and long-term welfare costs that result from undue delay in liberalising capital account restrictions.

3.26 In July 2001, the IMF Board had a preliminary discussion of some general principles, which could help countries in sequencing and coordinating capital account liberalisation. These principles emphasise:

- the importance of a credible and sustainable macroeconomic framework, which is the foundation of a stable open economy;
- giving priority to financial sector reforms that support macroeconomic stability;
- coordinating different financial sector policies to ensure mutually reinforcing reforms;

- taking into account the initial condition of financial and non-financial entities, and the effectiveness of existing capital controls;
- implementing early, key measures that may have a long lead time;
- considering the sustainability of the reform process; and
- ensuring the transparency of the liberalization process.

3.27 Over time the Government hopes that these principles will provide the framework for country-specific route maps for capital account liberalisation, developed in partnership between countries and the IFIs, and which would highlight the linkages between liberalisation of restrictions and supporting structural and regulatory reforms, but without specifying a rigid sequencing of reforms.

3.28 Any route-map for sequencing of capital account liberalisation and supporting reforms should be based upon a comprehensive assessment of a country's vulnerability to the various risks associated with a more open capital account. This assessment should also look at the interaction between macroeconomic, prudential, and structural vulnerabilities.

3.29 In relation to capital account liberalisation, internationally-agreed codes and standards have an important role to play both as reference points in the initial assessment of potential areas of vulnerability and as transparent benchmarks against which countries could assess their progress along their sequencing plan. The Government will continue topush for the integration of codes and standards into any country-specific plan for capital accoutn liberalisation. Both the Reports on the Observance of Standards and Codes (ROSC) and the Financial Sector Assessment Programme (FSAP) processes can also provide useful platforms for:

- identifying areas of vulnerability to changes in external capital flows:
- prioritising regulatory and supervision reforms needed to support liberalisation; and
- organising technical assistance and coordinating with other donors.

TACKLING ABUSE OF THE INTERNATIONAL FINANCIAL SYSTEM

The impotance of defending the international financial system against abuse of all kinds has become more apparent since the events of 11 September. Money laundering, corruption and financial fraud are frequently bound up with the financing of terrorist groups. Effective international action to prevent financial crime can play a vital role in helping to disrupt terrorist networks.

IMFC, 17 November 2001

3.30 The UK has played a central role in international efforts to combat the financing of terrorism, through the UN Counter Terrorism Committee, the Financial Action Task Force (FATF), the G7, the G20 and the IMF. At the IMFC meeting on 17 November 2001, under the Chancellor's chairmanship, the IMFC reiterated its concerns at the use of the financial system to launder criminal funds and to fund terrorist acts. It therefore;

- called on all member countries to ratify and implement fully the United Nations instruments to counter terrorism. Particularly UN Security Council Resolution 1373, which requires Member States to freeze the funds, financial assets and economic resources of terrorists. The UK was one of the first countries to implement this on 10 October 2001:
- welcomed and supported the FATF's eight Special Recommendations on combating terrorist financing (see box below);
- called on all member countries to freeze the assets of terrorists and their associates, close their access to the international financial system and to make public the lists of those terrorists whose assets are subject to freezing and the amounts frozen, in monthly reports.

IMF Action Plan

3.31 The IMFC endorsed the IMF's action plan to intensify its contribution to the global effort in combating terrorism by:

- extending the IMF's involvement in combating financial abuse to efforts aimed at countering terrorism financing;
- expanding its anti-money laundering work, including through FSAPs, to cover legal and institutional frameworks;
- accelerating its program of Offshore Financial Centre assessments, and undertaking onshore assessments in the context of the FSAP;

- helping countries identify gaps in their anti-money laundering and anti-terrorist financing regimes in the context of Article IV voluntary questionnaires;

- enhancing its collaboration with the FATF on developing a global standard covering the FATF recommendations, and working to apply the standard on a uniform, cooperative, and voluntary basis; and

- increasing technical assistance to enable members to implement effectively the agreed international standards,

3.32 The IMFC also urged further international action to combat the financing of terrorism and called for:

- all countries to establish financial intelligence units to receive and process reports of suspicious transactions from the country's financial sector, and to monitor and analyse suspected terrorist funds;

- provisions to ensure the sharing of information and cooperation between national financial intelligence units (FIU), building on the work of the Egmont Group (a group of FIUs which co-operates in sharing information and good practice); and

- the deployment of technical assistance to ensure that every country can play its part, based on support either bilaterally or through an international trust fund.

3.33 The UK has led calls for concerted international action to tackle financial crime and will continue to play a central role as the IMF helps to monitor the progress of action over the next year.

3.34 It is important that the World Bank and Fund work closely together on this work. The Government welcomes the Bank's efforts to expand its technical assistance programme to improve compliance with international anti money laundering standards, and its collaboration with the Fund on the ROSC and FSAP processes. The UK will continue to work on the boards of both Bank and Fund, and with G7 and other stakeholders, to enhance the coordination and effectiveness of both institutions.

Financial Action Task Force (FATF)

The Financial Action Task Force (FATF) on Money Laundering is an inter-governmental body whose purpose is the development and promotion of policies to combat money laundering globally. It works to generate the political will to bring about national legislative and regulatory reforms to combat money laundering. In performing these activities FATF has collaborated with other international bodies involved in this work.

The FATF currently consists of 26 countries plus the European Commission and the Gulf Cooperation Council. Its membership includes the major financial centre countries of Europe, North America and Asia.

A number of regional sister-organisations to the FATF have also developed, with a commitment to implement the FATF recommendations, and to provide support to their members. These groups include the Council of Europe Anti-Money Laundering Group (covering Eastern Europe and a number of former Soviet Union countries, including Russia), the Asia-Pacific Group, the Offshore Group of Banking Supervisors, and the Caribbean Financial Action Task Force. More recently the UK and the Commonwealth have supported the new Eastern and Southern African Anti-Money Laundering Group, which focuses on the reduction of crime and corruption in Africa.

The FATF has published a set of 40 Recommendations, now widely seen as the global anti-money laundering standard, which it encourages all countries to adopt in order to establish systems to prevent their financial sector from being used to launder the proceeds of crime. They are comprehensive, covering the criminal justice system and law enforcement, the financial system and regulation, and international cooperation. The measures set out principles for action and allow flexibility in implementing the principles according to circumstances and constitutional frameworks.

The FATF periodically reviews its membership, through self-assessment and mutual evaluation, and publishes a list of countries and territories that it considers to be non-cooperative in the international fight against money laundering. This list identifies jurisdictions that have not adopted adequate anti-money laundering systems.

In response to the events of 11 September, the FATF also produced 8 Special Recommendations on Terrorist Financing, which commits members to take immediate steps to ratify and implement the relevant UN instruments, criminalize terrorist financing, terrorist acts and terrorist organisations, freeze and confiscate terrorist assets, report suspicious transactions related to terrorism, co-operate with other bodies internationally, regulate alternative remittance systems, strengthen customer identification in wire transfer services and ensure that non-profit organisations cannot be misused to finance terrorism. Further information is available from http://www.fatf-gafi.org. terrorism. Further information is available from http://www.fatf--gafi.org.

3.4 RESOLVING FINANCIAL CRISES

The IMF has an important role resolving financial crises, but the availability of official resources is limited in relation to private capital flows. This increases the importance of securing the involvement of private sector creditors in crisis resolution. The way crises are resolved today may have important implications for the behaviour of the public and private sectors in the future.

3.35 While the rapid growth in private capital flows to developing countries has opened up new opportunities for investment, growth, and poverty-reduction in recipient countries, it has also posed new challenges for the way countries and the international community respond to financial crises in emerging market countries. If a country enjoys a significant level of international capital flows there is always the danger that these flows could dry up or reverse if investors become uneasy abut some aspects of the country's economy. In the absence of capital flows it takes time before macroeconomic imbalances exhanust reserves and precipitate a balance of payments crisis. Capital markets can anticipate balance of payments difficulties and by acting now, dramatically bring forward the timing of a crisis. This fundamental change in the nature and origins of emerging market crises has prompted the international community to re-evaluate its approach to crisis resolution and, in particular, underlined the importance of involving the private sector in their resolution.

Private Sector Involvement

3.36 The IMF will continue to play a central, coordinating role in the management of financial crises management. However, the dominant role of private capital flows in the capital accounts of many emerging market countries coupled with the relative scarcity of official resources available for crisis lending makes private sector involvement essential, both:

- to resolve payments imbalances and restore medium-term sustainability in countries experiencing financial crises; and
- to provide the incentives to creditors and debtors needed to minimise the incidence and intensity of such crises in the future.

3.37 Over the past several years, the international community has endeavoured to adapt its approach to crisis management to the challenges of wider and deeper financial integration. At its 2000 Spring and Annual Meetings, the IMFC endorsed a framework of principles that should guide and underpin the new official approach to crisis resolution.

Framework for PSI

3.38 With this broad framework of principles in place, the UK authorities continues to work with international partners to consider what reforms to our crisis management procedures may be necessary to translate these agreed principles into practice in individual cases[4]. Over the past year, the international community's efforts to develop an operational framework for private sector involvement in crisis resolution have targetted a wide range of issues, including:

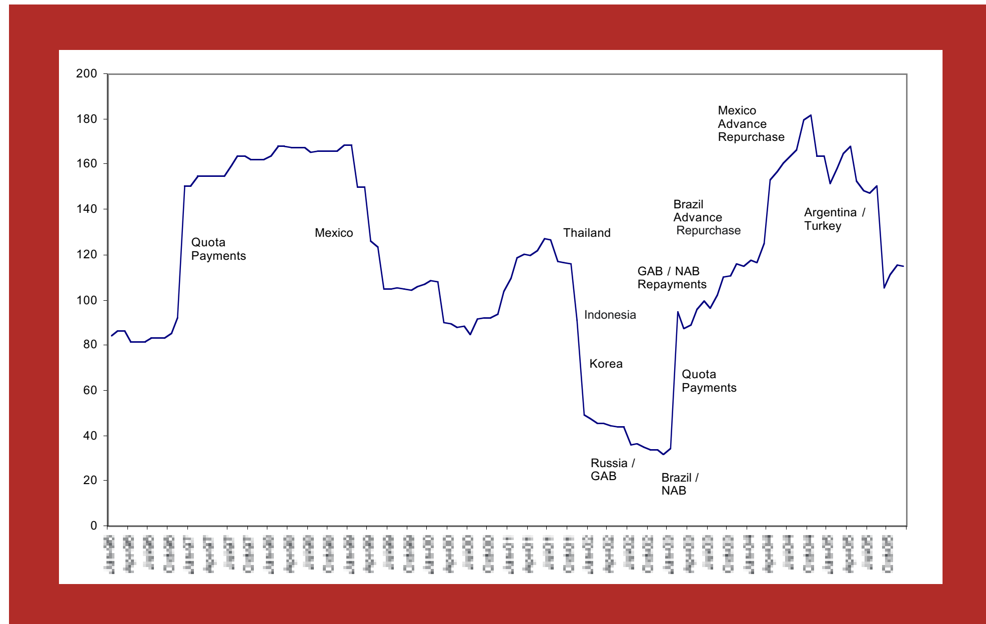
- the requirements and procedures used to determine access to IMF resources;
- the analytical content of IMF programme documentation;
- the institutional and contractual mechanisms for encouraging creditors and debtors to find cooperative solutions to their payments problems;
- the relations between the IMF and the Paris Club; and
- the legal and practical obstacles that prevent timely and orderly debt rescheduling of debt owed to the private sector in countries with unsustainable private debt burdens.

ACCESS POLICY

3.39 Capital account crises place extraordinary demands on official resources. Between 1990 and 1994, annual access to IMF resources under normal stand-by or extended arrangements averaged between 32 and 56 per cent of quota. In contrast, annual access to IMF resources during the capital account crises of the 1990s averaged 330 per cent of quota (ranging from 118% of quota for Argentina in 1995, to 1,757 per cent of quota for Korea in 1998). The coincidence of such crises in the late 1990s fed a rapid increase in IMF credit outstanding from SDR 25 billion in 1994 to SDR 60 billion in 1999 and in the number of IMF programmes that exceed the IMF's normal access limits of 300 per cent of quota. This increase in exceptional lending has, at times, placed a significant strain on the financial position of the Fund.

[4] See for example the article on "The resolution of international financial crises: private finance and public funds" in the Bank of England's Financial Stability Review, December 2001. This is available at http://www.bankofengland.co.uk

IMF Liquidity ratio 1990-2000



3.40 Access to official resources beyond normal access limits can play an important role in preserving market confidence in some cases. However, as the growth in private capital flows to emerging markets continues to outstrip the growth in official resources it is critical that such exceptional access is reserved for those circumstances where it is most needed and most likely to be effective. The official sector must do more to shape expectations about the scale of and limits on official resources to:

- encourage countries and their private creditors to find lasting solutions to their payments problems without repeated recourse to official financing;
- ensure that future investor behaviour does not become based on near-sighted assumptions about the official sector's capacity to act an international lender of last resort; and
- safeguard official resources and the global public goods they provide

Review of access policy

3.41 In August 2001, the Executive Board reviewed IMF access policy for current account crises. However, further work is needed to establish clearer presumptions about the prospective scale of and limits on access to official resources in the full range of crisis cases. In the coming year, the Board will conduct a review of the Fund's policy on high access to Fund resources in capital account crises. In this discussion and in other fora, the Government will work with international partners to consider what changes to IMF access policy may be needed:

- ensure that IMF access limits are properly calibrated to the financing requirements of the full range of crisis cases;

- establish clearer presumptions about the prospective scale of official support in normal access cases; and

- explore the range of procedures for reinforcing the exceptional nature of financing beyond those access limits.

INFORMATION

3.42 Making private sector involvement a standard element of crisis resolution requires a step change in the quantity and quality of information about a country's capital account. Based on recent experience with involving the private sector in the resolution of crises, the IMF has identified a range of factors that influence the likely effectiveness and potential risks of different approaches to involving the private sector in crisis resolution, including:

- a country's underlying payment capacity;

- a country's prospects for regaining market access;

- the sustainability of a country's debt profile; and

- the nature of a country's creditors and outstanding instruments.

3.43 The documentation accompanying financing requests presented to the IMF Board now routinely includes a range of relevant indicators. However, further work is needed to enhance the analytical basis for the Fund's assessment of the above factors. Over the past year, the Executive Board has considered some of the analytical issues including:

- In August, the Board considered different approaches to assessing a countries' external vulnerability-

- In September, Directors considered some of the key factors that influence a country's prospects for regaining market access when emerging from crises.

3.44 In the coming year, the Board will consider the balance sheet approach to assessing vulnerability to crises as well as a new methodology for assessing balance of payments sustainability. In these discussions and in other fora, the Government will encourage the Fund to further improve the analytical basis for decision making on private sector involvement and to integrate those assessments into programme documentation and design.

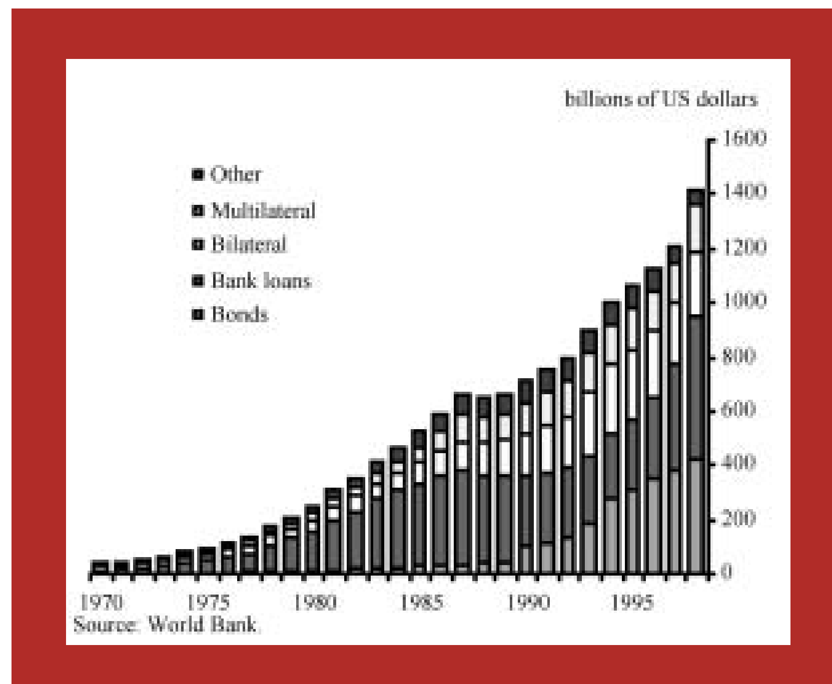
Mechanisms for creditor-debtor coordination

Composition of private flows

3.45 While the increase in private capital flows relative to the scale of official resources has underlined the need for greater private sector involvement in crisis resolution, changes to the composition of those private flows has made the task of securing the necessary private sector contribution more complex. The previous surge in private lending to emerging market countries in the later 1970s and early 1980s was predominantly in the form of bank loans extended to sovereign debtors. However, the more recent surge in private lending has seen:

- a compositional shift away from direct bank lending towards bond issues held by a large number of dispersed creditors;
- a diversification of debtors away from public sector borrowing by emerging market governments toward private sector borrowing by a diffuse and heterogeneous group of private banks and non-bank corporates; and
- deeper integration of the emerging market financial sectors with international capital markets.

External debt stocks of 20 developing countries



Risks

3.46 Taken together, these parallel trends in the pattern of emerging market finance over the past decade have exacerbated the problems and risks associated with involving the private sector in the resolution of crises as:

- the proliferation of creditors and debtors undermines the existing institutional apparatus (such as lending syndicates and the London Club) for creditor coordination, making the task of negotiating a cooperative agreement much more difficult;
- the growing securitisation and secondary market trading of emerging market debt has weakened incentives for cooperation as creditors no longer have ongoing business relationships with borrowers; and
- financial integration has increased the risks to emerging market financial sectors and highlighted the linkages between the balance sheets of the sovereign and those of the domestic financial institutions.

3.47 To address some of the information and coordination problems that can prevent debtors and creditors from finding cooperative solutions to their payments problems, the official sector has explored a range of mechanisms available to encourage and facilitate greater dialogue between debtors and their increasingly diverse private creditors.

Investor fora

3.48 In 2001 the Fund, through its Capital Markets Consultative Group, engaged market participants to review recent experience with the establishment of investor relations programmes in emerging market countries. The Government will continue to explore the range of tools available to encourage countries to adopt well-run investor fora.

3.49 The Group also discussed the contractual mechanisms such as collective action clauses that can help overcome creditor coordination problems, especially in circumstances where some form of debt restructuring may be needed The UK Government has been one of the strongest advocates of collective action clauses and is pushing hard to get them accepted internationally. Many eurobonds issued under English law now feature collective representation and majority action clauses, and the Government has taken a lead here by including majority action clauses in its own foreign currency borrowing.

Obstacles to sovereign debt restructuring

3.50 The aim of above mechanisms is to facilitate voluntary approaches and cooperative solutions to any payments problems that may arise between debtors and their private creditors. At the same time, there will be cases where such approaches fail to deliver a sustainable outcome, and a country may have little choice but to resort to a payment suspension or comprehensive debt restructuring. In such cases, the official sector should be prepared to support a country that must impose temporary capital controls, or a standstill on its debts, as part of an orderly process of crisis resolution.

PARIS CLUB AND THE IMF

3.51 One way in which creditor countries can support countries with unsustainable debt burdens is through the restructuring of their official bilateral debt through the Paris Club[5]. However, in order to ensure appropriate burden sharing between the country's official bilateral and private creditors, agreements between Paris Club creditors and debtor countries include a clause under which the debtor agrees to seek at least comparable terms obtained in the Paris Club rescheduling from other non-multilateral creditors, and not to grant such creditors a treatment more favourable than given to Paris Club creditors.

Comparability

3.52 In August 2001, the Executive Board discussed a range of issues relating to the application of the comparability of treatment principle to individual cases. Directors discussed the need for greater cooperation and information-sharing between the Fund, the Paris Club, and the private sector to ensure that issues of private sector involvement, comparability, and medium-term sustainability are effectively addressed in the design of Fund programmes and in Paris Club rescheduling agreements. By providing greater clarity regarding the application of the principles of comparability of treatment, such cooperation should help to improve market confidence and reduce uncertainty in debt restructuring cases.

3.53 However, under the current framework, the legal and procedural uncertainties associated with this approach can preclude countries from undertaking a restructuring of their obligations to private creditors in a timely and orderly manner. The lack of a clear and credible procedure for sovereign debt restructuring entails significant costs for the debtor country, its private creditors and the official sector.

[5] See also page 68 on the Paris Club and debt relief

A NEW MECHANISM FOR SOVEREIGN DEBT RESTRUCTURING

3.54 In her speech to the National Economist's Club (http://www.imf.org/external/np/speeches/2001/122001.htm), the Fund's Deputy Managing Director Anne Krueger set out some of the key features of a new sovereign debt workout procedure designed to address some of the legal obstacles that can stand in the way of orderly debt restructuring:

- To prevent disruptive litigation and creditor coordination problems from undermining agreement, it may be necessary for the official sector to grant debtors that have suspended payments temporary protection from creditor litigation until a fair and sustainable resolution has been achieved.

- To prevent the suspension of these provisions being abused by the debtor, it may be necessary to establish a mechanism to facilitate debtor-creditor negotiations to ensure that the debtor acts fairly and in good faith.

- To facilitate the provision of new money, it may be necessary to grant seniority to financing extended during the restructuring period.

- To prevent holdout creditors from undermining any restructuring agreement negotiated between creditors and debtors, it may be necessary to establish a mechanism that would bind minority creditors to an agreement that has been approved by the requisite majority.

3.55 The Executive Board will hold a series of discussions on this issue in the coming year. There is clearly a range of institutional, operational, and legal issues to consider in the design of an effective sovereign debt restructuring mechanism. Both in the Board and in other fora, the Government will encourage our international partners to consider the full range of feasible options for establishing such a mechanism.

TRANSPARENCY, ACCOUNTABILITY AND THE INDEPENDENT EVALUATION OFFICE

The UK has consistently argued strongly for actions to further improve IMF transparency and accountability to strengthen the effectiveness of its operations and procedures, and will continue to do so. We welcome the significant steps that the Fund has already taken. The establishment of the IMF's Independent Evaluation Office (IEO) is a fundamentally important development.

Publication of Article IV reports

3.56 There has been a significant increase in the publication of Public Information Notices summarising Article IV discussions in the Board, of Article IV staff reports themselves, and of Chairman's statements, news briefs and press releases following Board discussions on the use of Fund resources and on policy issues. There is now a presumption that documents setting out the authorities' intentions under Fund-supported programmes will be available to the public. This increase in the transparency of members' policies has been matched by greater transparency of the Fund's own policies and assessments.

Establishment of IEO

3.57 The UK has been one of the key drivers for creating the Independent Evaluation office (IEO) to complement the review and evaluation work of the IMF. The Government strongly believes that the creation of this office will help the Fund to learn from past successes and weaknesses in order to improve its future operations, and will enhance its accountability.

3.58 Terms of reference for the IEO were endorsed by the IMFC in September 2000. Subsequently the Executive Board appointed Mr. Montek Singh Ahluwahlia, a member of the Indian Planning Commission and the Economic Advisory Council of the Prime Minister of India, as Director of the IEO. He took up his appointment in mid-July.

Independence and accountability

3.59 In order to ensure its independence, and its accountability, the office will;

- be independent of Fund management and staff and will work at arms length from the Executive Board. The majority of its full time staff will come from outside the Fund;

- be responsible for its own work programme, which will be determined by the Director, "in light of consultation with Executive Directors and management, as well as with informed and interested parties outside the Fund";

- provide regular reports on its activities to the IMFC, as well as reporting regularly to the IMF Board;

- publish its work programme. There is also a strong presumption that their reports will be published promptly.

Early work programme

3.60 Accordingly Mr. Ahluwahlia has proposed a work programme following extensive consultation with the Executive Board and other interested groups, including NGOs and civil society, narrowing down a large menu of potential topics. The UK has stressed the importance of establishing a balanced work programme, including both individual country cases and cross cutting issues, reflecting the priorities of Fund members, as early as possible. The Government welcomes the IEO's work programme for its first year (2002-03). The office has initiated work on its first three projects;

- **fiscal adjustment in IMF supported programmes** – fiscal adjustment, especially in low-income countries, has long been the subject of criticism in large part because it involves severe trade-offs between stability and growth, or stability and social expenditures, which involve distributional issues and are highly politically sensitive. This study will be based on a sample of (mainly low-income) countries that have limited access to private international capital markets, and will examine the major features of fiscal programme design, the nature of dialogue between Fund staff and the country authorities and other groups, the extent of country ownership, and the results in terms of efficiency, sustainability, and social impact of the fiscal adjustment;

- **a group of three capital account crisis cases - Indonesia, Korea and Brazil** – an evaluation of the role of the Fund in recent capital account crises is a high priority because of the systemic importance of these cases, and because there is considerable public controversy about key elements of the strategy pursued. This study will focus on three country cases to evaluate the effectiveness of the Fund's role in spotting vulnerabilities before the crisis, and the effectiveness of Fund supported programmes in resolving the crisis. The proposed countries are contrasting examples of the factors underlying the crisis and of the outcomes;

- **repeat use of Fund resources** – 25 countries have been indebted to the IMF for more than 30 years of the last 50, and 16 countries have been under Fund supported programmes for 12 or more of the last 18 years. Such prolonged use risks turning the Fund into a source of long-term financing, in contradiction with its mandate. This report will draw on a number of case studies examining the causes of repeat use, such as weaknesses in programme design and assessments of debt sustainability, the costs for the borrower and for the Fund and the possible remedies.

3.61 The IEO intends to publish their first report by the Annual Meetings next year, and their ultimate aim is to undertake 5 projects each year. The full outline of the work programme is available on the IMF's website at www.imf.org/external/np/ieo/index.htm, together with an invitation to the public to comment on this work.

STREAMLINING CONDITIONALITY AND ENHANCING OWNERSHIP

> Recent experience has shown that country-ownership is a vital ensure sustained implementation of agreed programmes. As part of their efforts to enhance country-ownership the Fund is conducting a review of conditionality with the aim of agreeing revised guidelines around the middle of the year.
>
> The IMF and the World Bank must work together to ensure that overall conditonality is focussed, without leaving gaps in coverage.

3.62 IMF lending is conditional on policies designed to ensure that by borrowing from the IMF, a country does not just postpone hard choices and accumulate more debt, but is able to strengthen its economy and repay the loan. Experience across a broad section of Fund members has shown a strong relationship between country ownership of the goals of policy, and the success of Fund programmes. The Government welcomes the steps that the Fund has taken, along with the Bank, to promote this, and to strengthen their commitment to transparency by encouraging publication of Letters of Intent, explaining programmes and conditionality.

3.63 During 2000-2001 the IMF has been reviewing its 1979 Conditionality Guidelines with the aim of increasing ownership, and focusing on those elements, which are critical to the success of the programmes, while leaving room for national decision-making on the broader policy agenda and on the specific ways to achieve national objectives. The review of Fund conditionality will continue over the coming months, with a view to agreeing revised guidelines 2002. The objective is to ensure that the IMF's guidelines on conditionality reflect the new realities and give emphasis to the need for streamlining.

Streamlining conditionality

3.64 At their April meeting the IMFC agreed to shift the presumption of coverage from one of comprehensiveness to one of parsimony, ensuring that conditionality would continue to cover all elements necessary to the success of the programme without going back to the narrow, short-term financial conditionality of the past. This involves examining what policies are to be covered by the Fund's conditionality, in particular in structural areas; how these policies are to be monitored; and clarifying the boundaries between what is covered and what is not, as well as between the IMF's conditionality and that of other institutions.

3.65 The Government has been encouraged by the IMF's review of conditionality, in particular the focus on the need for country ownership. This mirrors the change in the way the UK's aid is delivered, and our aim of getting the best use of savings from debt relief. All focus on the importance of country-owned strategies, notably the PRSPs in the poorest countries.

Low-income countries

3.66 Experience has shown that ownership is vital for sustainable implementation of an agreed reform programme. The IMF and the World Bank have adopted a new approach, based on country-driven and developed Poverty Reduction Strategy Papers (PRSPs). Country ownership of the goals, strategy and direction of development and poverty reduction is a vital part of this approach. Fund and Bank programmes are now being designed the support these country-led strategies.

3.67 All Fund programme reports now contain a box giving details on how conditionality has been streamlined, including identifying those areas of conditionality which are within the World Bank's domain.

3.68 The IMF and the World Bank need to work together to ensure the overall streamlining of conditionality and to ensure that these identified areas are recognised in the design of future World Bank programmes. The IMF have made sure that all the documents considered by the Executive Board in this area have been published on their website, and they have invited consultation. The Government has been encouraged by response to these consultations, and will continue trying to increase the number of responses from developing country governments.

QUOTA REFORM AND SPECIAL DRAWING RIGHTS (SDRs)

During the year the Executive Board have also discussed staff proposals for alternative quota formulas and various issues surrounding SDR allocations.

In particular the UK would wish to see early implementation of the Special SDR Allocation, which would result in a more equitable distribution of SDRs between members.

3.69 IMF quotas determine members' capital subscription to the Fund, determine their drawing rights/access to Fund resources, and their voting power. Quotas are intended broadly to reflect members' economic size in the world economy; the larger a country's economy in terms of output, based on the size of GDP, current account transactions and official reserves. However the quota shares of many member countries have become increasingly out of line with their importance in the world economy.

Alternative Quota Formulae

3.70 Therefore, in 1999 the IMF established an external panel of independent experts, the Quota Formula Review Group, (QFRG) to assess the adequacy of the formulas used as an input to calculating members' quotas and to make recommendations for reforms that take account of changes in the world economy and the international financial system, and the increasing globalisation of markets. The QFRG reported in August 2000. The Executive Board discussion revealed a wide range of views on the issues raised, but there was general agreement on the need to simplify the current formulas and to update them to take account of the growing role of capital flows in the world economy. Work on quota formulas is set to continue over the coming year.

Ad-hoc quota increase for China

3.71 Related to this issue, the IMF, supported by the UK, approved a special ad hoc quota increase for China. The Chinese authorities requested a special increase in 1997 to better reflect China's position in the world economy following the resumption of Chinese sovereignty over Hong Kong.. The Board of Governors approved the proposal in February 2001, and the increase became effective when China consented to and paid the increased subscription on 28 February.

3.72 Each member's assigned quota is expressed in Special Drawing Rights (SDRs). SDRs are an international reserve asset introduced by the IMF in 1969 out of concern amongst members that the current stock and prospective growth of international reserves might not be sufficient to support the expansion in world trade. The IMF allocates SDRs to member countries as a percentage of their quotas. The last allocation took place in 1981, when there were only 141 member countries. Since 1981 however the membership has not seen the need for another general allocation of SDRs partly because it has not seen a global need to supplement existing reserve assets. The Executive Board last discussed a general allocation of SDRs in December 2001. The UK remains open-minded about the possibility of an SDR allocation. A decision on whether this is necessary should be made on the basis of avoiding "economic stagnation and deflation as well as excess demand and inflation in the world"—as set out in Article XVIII of the Articles of Agreement.

Fourth Amendment to the Articles of Agreement

3.73 However, the Board of Governors proposed a special one-off Amendment to the Articles of Agreement in September 1997, to correct for the fact that one-fifth of the IMF's expanded membership had not received an SDR allocation (since they had joined after 1981). The special allocation, known as the Fourth Amendment, would allow all members of the IMF to participate in the SDR system on an equitable basis. The proposal would become effective when three-fifths of the IMF membership (110 members), having 85% of the voting power have ratified the proposal. 112 members, including the UK and all of the G7 (except the U.S.), have already done so. The Government supports an early implementation of this allocation, as called for in the communiqué of the IMFC.

COOPERATION IN THE INTERNATIONAL COMMUNITY

A key element of the IMF's role in the global economy is its relationship with other international organisations. In particular, the IMF and the World Bank play important, complementary roles in ensuring the world's economic growth and stability; in cooperation with the United Nations and its agencies, and with the World Trade Organisation.

Working through the European Union, G7, the G20 and the Commonwealth, as well as in our own right also enhances the UK's influence within the IMF.

THE IMF AND THE WORLD BANK

Statement of enhanced partnership

3.74 The UK welcomes the steps that the IMF and World Bank have taken to improve their collaboration over recent years. In September 2000 Managing Director of the Fund, Horst Köhler, and President of the World Bank, Jim Wolfensohn, issued a joint statement, which promised an enhanced partnership between the institutions. This recognised that the two institutions shared the same broad objective: "helping to improve the quality of life and reduce poverty through sustainable and equitable growth."[5]

3.75 A close partnership through the Joint Implementation Committee has resulted in significant progress in delivering HIPC debt relief and Poverty Reduction Strategy Papers. A first-time joint visit to Africa, by Köhler and Wolfensohn, also signalled the close cooperation between the two institutions. However there remain significant challenges. In particular the UK has highlighted Public Expenditure Management, conditionality and Poverty and Social Impact Analysis as areas in need of more intensive collaboration.

3.76 The Fund and Bank have also sought to strengthen their co-operation in several other areas, including: cooperation on financial sector reform through their joint Financial Sector Liaison Committee and the establishment of the Financial Sector Assessment Programme (FSAP), which identifies vulnerabilities in member country financial sectors; the preparation of Reports on the Observance of Standards and Codes (ROSCs); and an expansion of their work on anti-money laundering and combating the financing of terrorism.

[5] "The IMF and the World Bank Group: An Enhanced Partnership for Sustainable Growth and Poverty Reduction", Joint Statement by Horst Kohler and Jim Wolfensohn, September 5th 2000

3.77 Consistent with the division of labour between the IMF and the Bank, each institution concentrates on its primary areas of responsibility and competence. The IMF leads on macroeconomic issues and the Bank on social and structural issues. However, the recognition of the link between macroeconomic stability and structural policies, particularly in the world of open capital markets, has increased the need for the staff and management of the two institutions to consult and work ever more closely together. The UK has a joint Executive Director who represents us on the Boards of both the Fund and the Bank. The UK government will continue to work on the boards of both Bank and Fund, and with G7 and other stakeholders, to enhance the coordination and effectiveness of both institutions.

The IMF and the World Trade Organisation

3.78 The IMF and the World Bank have also played an important role in the Integrated Framework, which aims to mainstream trade into developing countries' overall development strategies and to provide for a more coherent approach to trade-related technical assistance between developing countries, the International Financial Institutions, the World Trade Organisation (WTO) and other multilateral organisations. The UK has played a leading role in this initiative, drafting the original terms of reference.

The IMF and the United Nations

3.79 The United Nations system is a fundamental pillar for the promotion of international cooperation for development, and through its agencies – the UNDP (United Nations Development Programme) in particular – plays a central role in delivering development programmes. The IMF and World Bank work closely with the UN and its agencies, both at country level to coordinate activities and programmes, and through the annual meeting between the Economic and Social Council of the UN (ECOSOC) and the Bretton Woods Institutions. Coordination and coherence in the activities of the institutions concerned with development is essential to their long-term success. The UN's conference on Financing for Development (see also chapter 4.5) will consider further ways of enhancing the coherence of the international system – for example through including the WTO in the ECOSOC – Bretton Woods Institutions meetings. The UK supports improved coordination between all relevant actors at the policy and operational level, and will continue to explore opportunities for closer cooperation and dialogue.

EUROPE AND THE IMF

3.80 Under the Articles of Agreement, member states of the European Union are represented individually at the Board of the IMF. European countries have an important voice, in line with Europe's role in the world economy, and with EU member states accounting for around 30 per cent of total voting power. Three EU states – Germany, France and the UK – are represented by their own seat on the IMF Board and, at ministerial level, in the IMFC. The others are linked through their IMF constituencies with other non-member countries.

3.81 Although EU member states are represented individually at the IMF, all recognise the value of sharing perspectives and developing an EU consensus on strategic policy issues. The introduction of the euro has no direct implication for the role of the EU at the IMF; although clearly – on monetary policy issues – the members of the Euro-zone have a common approach to IMF business which impacts on their monetary policy. The IMF has, for example, supplemented its country surveillance programme, under Article IV, with a surveillance report on the Euro area (see paragraph 4.3).

3.82 There is also scope for the Union as a whole to build our common interests, and become a more powerful voice for reform in the IMF. The UK Government is encouraging an outward looking approach to economic issues in the EU, which recognises the role the EU can play in promoting economic reform, financial stability and poverty reduction world-wide. The UK Government has also made the point that economic reform in Europe itself will strengthen our role in the world economy, and that reform of the EU development budget will increase the contribution we make to global poverty reduction. The Chancellor has played a leading role amongst EU Finance Ministers to galvanise support for debt relief, development assistance, reform of the financial architecture and reform of the IMF itself. These discussions have been supported by the work of the EU's Economic and Financial Committee, made up of senior Finance Ministry and Central Bank officials, which provides a forum to discuss international economic policy issues. By working through the European Union, as well as in our own right, the UK is able to exert a more important influence on the international debate.

THE G7 AND THE G20

G7

3.83 G7 finance ministers and central bank governors meet at least twice a year to monitor developments in the world economy and assess economic policies. The Managing Director of the IMF usually, by invitation, participates in their surveillance discussions. These discussions have played a key part in shaping the ongoing reform of the international financial architecture. G7 members are Canada, France, Germany, Italy, Japan, the UK and the US. Reports from G7 finance ministers to Heads of State on "Strengthening the International Financial System and the Multilateral Development Banks", and "Fighting Abuses of the Global Financial System" are available at www.g7.utoronto.ca/g7summit/2001genoa.

G20

3.84 In their report to the 1999 Cologne Economic Summit, G7 Finance Ministers agreed to establish "a new mechanism for informal dialogue in the framework of the Bretton Woods institutional system, to broaden the dialogue on key economic and financial policy issues among systematically significant economies and promote cooperation to achieve stable and sustainable world economic growth that benefits all."

3.85 Discussions in the G20 are intended to complement and reinforce the role of the governing bodies of the Bretton Woods institutions, including the IMF, by providing an opportunity for informal sharing of experience and the development of

common views on key economic issues. In its meetings to date, the G20 has addressed issues such as the opportunities and challenges of globalisation and measures to reduce vulnerability to financial crisis, including private sector involvement and the implementation of codes and standards. At their November 2001 meeting in Ottawa G20 members agreed an action plan to combat the financing of terrorism. The November G20 communiqué is available at www.g20.org/news, along with further information and press releases.

3.86 Membership of the G20 comprises Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey and the United Kingdom, the United States of America and the EU Presidency. In addition, meetings of the G20 are attended by the Chairs of the IMF's International Monetary and Financial Committee and the Development Committee of the World Bank and the IMF, as well as by the Managing Director of the IMF and the President of the World Bank.

THE COMMONWEALTH

Commonwealth Finance Ministers Meeting

3.87 The Commonwealth is a voluntary association of 54 countries that spans the length of the economic and geographic spectrum. In their 1999 Fancourt Declaration, Commonwealth Heads of Government agreed that the "greatest challenge…facing us today is how to channel the forces of globalisation for the elimination of poverty and the empowerment of human beings to lead fulfilling lives." Commonwealth Finance Ministers meet once a year to prepare for the Annual Meetings of the IMF and the World Bank and to discuss financial issues that are of particular interest to Commonwealth countries. The Commonwealth meeting usually takes place immediately prior to the Annual Meetings. In September 2002 the UK will host the next Commonwealth Finance Ministers Meeting in London. Further details on the Commonwealth, its functions and its members can be found at www.thecommonwealth.org.

4 THE IMF AND THE POOREST COUNTRIES

The IMF is a monetary institution, but it has a vital role to play, alongside development institutions and donors in supporting poverty reduction in its member countries. Macroeconomic stability and sustainable economic growth are vital for reducing poverty, but they are not sufficient. That is why the IMF's Poverty Reduction and Growth Facility (PRGF) was designed to address both poverty reduction and growth, and to provide support for country-led poverty reduction strategies.

Making globalisation work for the poorest countries

4.1 At a global level and with member countries, the IMF promotes international financial stability to increase prosperity for all. At the same time it supports member countries in times of crisis. One of the greatest challenges the IMF faces, as does the international community, is the fight against poverty in the poorest countries. The majority of these countries are not yet seeing the benefits of globalisation and are struggling to integrate into the international economic system. The UK is concerned to see globalisation work for the poor, and the IMF has a key role to play in this regard, through its support to low-income countries with balance of payments difficulties, and reform programmes to reduce poverty, protect the vulnerable, and to increase growth. At the same time the IMF, working closely with the World Bank, must play a central part in ensuring that exceptional shocks do not undermine international efforts to lift the burden of unsustainable debt and channel additional resources into poverty reduction.

4.2 Stability, investment and trade are the main long-term drivers of prosperity. The IMF has a role to play in supporting conditions for increased investment, and is working with the World Bank in promoting investment forums in some countries in order to improve public-private efforts. The Fund must also help to promote trade, consistently urging rich countries to open up their markets to products from the poorest. The EU has taken the decision to grant duty and quota-free access to all exports, except arms, from developing countries. Estimates suggest that if the US, Japan and Canada do likewise developing country exports will increase by around 11 per cent. The Fund will have a role to play in building on progress made at the World Trade Organisation's meeting in Doha in 2001. In addition to progress on investment and trade, there will also need to be a significant transfer of resources from the richest to the poorest countries in the form of investment for development, through increased aid, if the international community is to meet the Millennium Development Goals set for 2015. The focus must be on building capacity to engage positively in the global economy and address the long-term causes of poverty.

Millennium Development Goals

4.3 The international community, including the IMF, have committed themselves to meeting the Millennium Development Goals – including halving the proportion of the world's population living on less than a dollar a day, reducing child mortality by two-thirds, and ensuring that every child has the chance to start and complete a primary education. Achieving these goals relies primarily on the efforts of developing countries themselves. However, the goals will not be achieved in all countries without more effort from the international community. The High level Panel on Financing for Development, chaired by former Mexican President Ernest Zedillo, concluded that if we are to succeed in achieving these goals an extra $50 billion in aid will be required each year until 2015. Other estimates from the World Bank and the World Health Organisation put this figure even higher.

A new approach to reducing poverty

4.4 The IMF and the World Bank both have important and complementary roles in supporting their new approach to reducing poverty in low-income countries. This new approach is based on the principles that;

- a comprehensive approach to development and a broad view of poverty are essential;
- faster economic growth is critical for sustained poverty reduction, and greater participation by the poor can increase a country's growth potential;
- country "ownership", through increased participation, of the goals, strategy and direction of development and poverty reduction is vital;
- the development community must work together closely; and
- the focus should be clearly on results.

4.5 The country-driven poverty reduction strategy process underlies this new approach, whereby countries seek IMF and World Bank support for their strategy through a Poverty Reduction Strategy Paper (PRSP). PRSPs are prepared by developing countries, in consultation with civil society, and are supported by the Fund and the World Bank. They ensure countries are in control of their own development plans, and that these plans meet balanced development needs across society, with a focus on development goals similar in nature to the Millennium Development Goals, and costed medium term expenditure frameworks. PRSPs also ensure a long-term, strategic view of development, and are an essential tool in ensuring that the many partners involved (the IMF, the World Bank, Regional Development Banks, the United Nations, and bilateral donors) are able to coordinate their activities effectively.

Enhancing the voice of the poorest Countries

The Government's 2000 International Development White Paper, "Eliminating World Poverty: Making Globalisation Work for the Poor", included a commitment to work towards a "stronger and more effective" voice for developing countries in the International Institutions. There have been increasing calls to give developing countries a stronger voice in the international system, particularly given the increased focus of the IMF on the Poverty Reduction Growth Facility (PRGF) and the Poverty Reduction Strategy Paper (PRSP) process. Some of the larger developing countries already play a very effective role in international institutions. But some of the smaller and least developed countries need further support to strengthen their representation and negotiating capacity.

Currently two Executive Directors represent 44 of the 45 sub-Saharan African members of the IMF. Executive Directors therefore need extra capacity to effectively represent their constituencies especially given the numbers of active programme African countries.

The UK government and others would support proposals which, in addition to improving the technical assistance provided by the IMF, could act to improve the capacity of the poorest countries and improve the effectiveness of their voice in the IMF. These could include proposals to expand the staff and other resources available to the African delegation offices, and to improve the capacity of their Executive Directors to represent countries' interests more effectively. These will have to be considered in parallel with measures to increase the effectiveness of technical assistance, aimed at building capacity in capitals and improving developing countries' ability to communicate and coordinate with their representative in Washington.

The IMF and global child poverty

In February 2001, the UK hosted an International Conference on Child Poverty. Participants were drawn from developed and developing countries, government and business, NGOs and civil society, the UN and the international financial institutions. The conference was addressed by Kofi Annan, Secretary General of the United Nations, Nelson Mandela, Horst Köhler, Managing Director of the IMF and James Wolfensohn, President of the World Bank.

The Chancellor said, "Over 10 million children will die before the age of 5. 120 million children are not in primary school. Each of us, as partners, must be prepared to make radical changes in the way we act so that the goals of 2015 can be achieved"

Participants reaffirmed their joint commitment to making every possible effort to reach the Millennium Development Goals. The IMF and the World Bank pledged to:

- continue actively to use the International Development Targets as a common framework to guide policies and programmes and to assess their policies' and programmes' effectiveness;
- help governments to broaden participation and develop greater ownership of macroeconomic, structural and social policy issues;
- support governments in developing programmes, policies and budgets that are in line with comprehensive poverty reduction strategies and which are pro-poor and pro-growth, shifting support towards activities that demonstrably benefit poor people and promote both equity and efficiency;
- ensure that appropriate social impact analysis is undertaken of structural reform measures, so that countervailing measures can be put in place to support groups adversely affected by reforms;
- ensure appropriate flexibility in fiscal targets for IMF programmes (such as in post-conflict situations, in response to unexpected external shocks; and to ensure that development assistance is genuinely additional to a country's own resources);
- assist governments to improve accountability of public resource management (including by providing regular assessment in their IMF Review);
- assist governments to cost and regularly assess what needs to be done in order to achieve their poverty reduction targets and the International Development Targets;
- strengthen support to countries by further decentralisation of World Bank functions and expertise.

POVERTY REDUCTION AND GROWTH FACILITY

At the Annual Meetings in 1999, the IMF and World Bank set out an improved approach to development, whereby low-income countries develop a Poverty Reduction Strategy Paper (PRSP) as a framework for IFI concessional support, and increasingly for that of other donors. This approach is strongly supported by the UK, and is implemented in practice through the work of the Department for International Development.

In support of this approach, the IMF created a new facility, the Poverty Reduction and Growth Facility (PRGF).

4.6 The PRGF is intended to be different from the previous Enhanced Structural Adjustment Facility (ESAF), through being more consistent with supporting government ownership, more consistent with a broad approach to poverty reduction, and providing an increased focus on the Fund's area of expertise. Overall, the PRGF is the core instrument for Fund support to poverty reduction and growth in low-income countries - some 80 countries in all.

4.7 In August 2000, the IMF set out the key features that would make the PRGF different from the ESAF[7], in particular expanding on how the PRGF would focus on poverty reduction and country ownership (see Box below). This commitment has been strongly welcomed and supported by the UK, and the Government is keen to see this approach implemented in low-income countries. To establish how well these new approaches are working, experience with both PRSPs and PRGF is being reviewed by the IMF and the World Bank, involving regional consultation exercises, analysis of submissions, and a major international meeting in Washington, January 2002. These reviews will be made publicly available during the spring of 2002.

4.8 There has been progress in implementing the new approach, as set out in the "key features" statement. For instance, there have been improvements made in Public Expenditure Management (PEM), making sure that public resources, including HIPC benefits, and donor flows are effectively and efficiently used, and that public accountability systems are robust. Early work on the HIPC tracking exercise[8] which traces the use of resources freed-up by debt relief, helped assess PEM systems in 25 HIPC countries. This has been followed by further work by the IMF, including Reports on Standards and Codes for Fiscal Transparency (ROSCs), and efforts to build capacity within governments on PEM. The World Bank is complementing these efforts. These are all mechanisms and processes that should help to ensure that public resources go to where they are intended, maximising the impact on poverty reduction.

[7] Key Features of IMF Poverty Reduction and Growth (PRGF) Supported Programmes, Policy Development and Review Department, IMF August 16th, 2000

[8] Tracking of Poverty-Reducing Public Spending in Heavily Indebted Poor Countries (HIPCs), IMF/World Bank, March 27th 2001

4.9 The IMF has also provided details of public spending in pro-poor areas such as health and education, in a number of PRGFs. In some cases, the IMF has highlighted the need for protection of social spending, where possible, in times of economic difficulty. These efforts are helping to provide an improved picture of pro-poor spending, including protection of the poor and vulnerable, and are helping countries and donors to understand more clearly the investments being made in, for example, primary education and primary health care, as countries seek to achieve progress towards meeting the Millennium Development Goals.

Poverty and Social Impact Analysis

4.10 The Joint Implementation Committee of the IMF and World Bank took up the issue of Social Impact Assessments in early 2001, undertaking a stock-take of current approaches. During the year an increasing number of PRGFs have started to provide some detail of Poverty and Social Impact Analysis (PSIA) of key reforms. Further work is being undertaken in this area, and the UK is directly supporting pilot PSIA work in 6 countries.

4.11 The Government believes that reforms at times of crisis or shock should focus strongly on bringing about stability and addressing any root causes of instability. The IMF should make every effort to ensure that the impact, of the reforms it supports, on the poor is addressed. Where time is available the IMF should work with governments, multilateral development banks and others to ensure PSIA is undertaken. Where time does not allow, the IMF should make first case analysis on potential impacts and possible actions by the authorities explicit in Fund documents.

4.12 Around 36 interim PRSPs have been completed and 8 full PRSPs. As more full PRSPs are developed, the PRGF will become more derived from the PRSP than it is at the moment. Progress has also been made in supporting more flexible fiscal targets in PRGF programmes. The UK will be engaging with the results of the PRSP and PRGF reviews, and is keen to ensure that the lessons feed into IMF policy design and practice.

PRGF Review

4.13 While substantial progress has been made with the development of the PRGF, more can still be done. The UK submission to the PRGF Review highlighted a number of areas, for instance:

- on country participation and ownership – this could further be enhanced by helping to build the capacity of PRGF countries to undertake improved macroeconomic analysis, and to debate options;

- progress on Poverty and Social Impact Assessments of key reforms is a vital part of this, and the UK would wish to see a timetable for all PRGFs to contain such analysis and discussion of options and choices, for 2002 and 2003;

- the staff reports on the PRGF could do more to show how the PRGF supports the overall poverty reduction strategy;

- more could be done on pro-poor budgets to report on levels of primary spending, for instance in health and education;

- the IMF is increasingly more flexible on the fiscal side, but it would help if all PRGFs recorded discussion of choices and compared two or three feasible fiscal scenarios;

- progress has been made in some PRGFs on reporting on public expenditure management, which is vital in ensuring that public and donor resources are efficiently and effectively used. The UK would be keen to see all PRGFs contain such reporting. However, there are many initiatives in this area between the Fund and the World Bank, and the UK would wish to see these efforts harmonised better to reduce the burden on PRGF countries; and

- finally, PRGFs have made good progress to streamline conditionality. However the UK has stressed the importance of ensuring any shift in conditionality from one institution to another is carefully implemented.

A Pro-Poor IMF: Key Features of the Poverty Reduction and Growth Facility (PRGF)

The IMF paper sets out 7 key features for the PRGF:

1. Broad Participation and Greater Ownership

The PRGF is to be derived from a country-owned and led Poverty Reduction Strategy Paper (PRSP), and produced in a transparent process with broad participation.

2. Embedding the PRGF in the Overall Strategy for Growth and Poverty Reduction

The PRGF will demonstrate how macroeconomic and other policies have been influenced by the growth and poverty objectives in the PRSP.

3. Budgets that are more Pro-poor and Pro-growth

The PRGF will support governments in their efforts to focus spending to benefit the poor; will assist to improve efficiency and targeting in areas relevant to growth and poverty reduction; in tax reforms to promote efficiency and equity; and to improve data and monitoring of expenditures.

4. Ensuring Appropriate Flexibility in Fiscal Targets

Present more normative macro-projections to signal financing needs; where warranted seek higher aid flows and build into the programme; identify contingent expenditures that could be added if more aid available; indicate how fiscal targets could be modified in event of key shocks.

5. More Selective Structural Conditionality

Limit conditionality to measures central to success of strategy, and confine to areas in the IMF's domain, with exceptions to be justified.

6. Emphasis on Measures to Improve Public Resource Management/ Accountability

The PRGF will support transparent monitoring systems to improve efficient delivery, and for HIPCs to include mechanisms to monitor use of debt relief. Fiscal policies and measures should be open to public debate. The IMF will consider selective conditionality on fiscal governance measures

7. Social Impact Analysis of Major Macro-adjustments and Structural Reforms

The PRGF should demonstrate that the distributional effects of key reforms have been considered, including evaluating policy choices and highlighting countervailing measures to offset temporary adverse effects where necessary. While the World Bank leads, the PRGF should indicate what assessment work was done and how it influenced policies.

INVESTMENT IN POVERTY REDUCTION

The Government remains focused on its long-term goal of helping to tackle poverty and achieve the internationally agreed Millennium Development Goals (MDGs). These goals include halving the proportion of people living in extreme poverty, providing universal access to primary education, reducing child and maternal mortality and reversing the spread of HIV/AIDS, malaria and other killer diseases.

4.14 To advance these goals, the Government is working in partnership with developing and developed countries, the international financial institutions, the private sector and civil society to relieve the burden of debt on poor countries, strengthen social systems in developing countries and ensure that they can participate in, and benefit from, the global financial system.

4.15 In order to achieve the MDGs, the focus of the international community must be on building capacity to allow developing countries to prosper from positive engagement in the world economy, and to address the long-term causes of poverty and social injustice. This must include meeting the urgent need to provide for basic education and primary health care for all in the poorest countries, and working to encourage direct investment flows into developing countries, which can boost employment, incomes and development.

Improving Health and Education Initiatives

Since 1997 the UK Government through the Department for International Development has committed £600 million to achieving universal primary education, and over £1 billion to support strengthening of health systems in developing countries. At the Child Poverty Conference, the Chancellor and the Secretary of State for International Development set out a range of new initiatives to strengthen achievement of the MDGs in education and health. Substantial progress has been made:

- The Global Fund to fight HIV/AIDS, tuberculosis and malaria – which are responsible for 5 million deaths each year – was launched at the beginning of 2002. Financial Commitments to the Fund already total over $1.8 billion, of which the UK has pledged $200 million;
- New tax incentives are being introduced in 2002 to encourage the pharmaceutical industry to invest in research and development into new medicines to fight diseases in developing countries;

- The Government has established a High Level Working Group on Access to Medicines, with membership from all key stakeholders, to find ways to increase the access of the poorest to affordable and effective medicines. It has also established an independent Commission on Intellectual Property Rights to look at the impact of these rights on poverty. Both will report in mid 2002;
- A new fund is being established during the Queen's Jubilee Year (2002) to strengthen Education for All in Commonwealth developing countries, with support from business, NGOs and government.

INCREASING PRIVATE SECTOR INVESTMENT IN THE POOREST COUNTRIES

4.16 Evidence shows that foreign direct investment (FDI) can be an important driver for both growth and development, as it generates higher productivity, employment opportunities and wealth, whilst transferring knowledge, skills and technology to the host country.

4.17 However, direct investment flows to the developing world are currently low. Only 20 per cent of FDI goes to developing countries with a combined population of 5 billion. The situation in low-income countries is particularly bad: less than 1 per cent of FDI goes to these countries, where the need for poverty reduction is greatest.

Increasing open dialogue

4.18 Developing countries need to implement policies which create a favourable business environment, and which ensure that the benefits from FDI inflows are maximised. Macroeconomic stability is one key determinant of the attractiveness of a country to investors. The adoption of codes and standards to strengthen policy making frameworks and national financial systems can make an important contribution to achieving greater stability and thus securing higher investment flows[8].

[8]For example De Mello Jr. L.R. 91997) Foreign Direct Investment in Developing Countries and Growth: A Selective Survey, *Journal of Development Studies*, 34, pp. 1-34; Borenszein E., De Gregorio J. & Lee J. (1988) How Does Foreign Direct Investment Affect Economic Growth?, *Journal of International Economics*, 45, pp. 115-135; Balassubramanyam V.N., Salisu M. and Sapsford D. (1996) Foreign Direct Investment and Growth in EP and IS Countries, *Economic Journal*, 106, pp. 92-105; Bromstorm M. & Persson H. (1983) Foreign Investment and Spillover Efficiency in an Underdeveloped Economy: Evidence from the Mexican Manufacturing Industry, *World Development*, 11, pp. 493-501

Creating a favourable business environment

4.19 The UK has fully supported efforts by the IMF and the World Bank to increase open dialogue between developing country governments and potential investors, for example through the development of investment advisory forums in sub-Saharan Africa. These will allow public and private sectors to work together at the highest level to investigate, and recommend specific action to remove barriers to a positive investment climate in a developing country. The level of education and skills of the local workforce will also influence the amount of investment in a developing country and the scope for it to generate beneficial spillovers. The UK is committed to extending access to education in poor countries, for example through the Department of International Development's investment £600 million has been spent on education since 1997.

4.20 Developing country governments should also be encouraged to put in place effective competition policy to reduce the risk of anti-competitive business practices by multi-national corporations, which might adversely affect local consumers and businesses.

Stakeholder awareness

4.21 The UK Governmen urges businesses to prove themselves reliable and long-term partners in the process of economic development. Stakeholder awareness in host countries and cross-border corporate accountability must also be enhanced to ensure that the appropriate labour, environmental and regulatory standards in the host country are not compromised through competition for foreign investment. Here the international standards of best practice in corporate governance drawn up by the Organisation for Economic Cooperation and Development (OECD), as part of the codes and standards initiative, have an important role to play, alongside the United Nations Global Compact, the Global Reporting Initiative, an the OECD's Guidelines for Multinational Enterprises. Building on this, the UK Government would encourage multinational companies to assess their economic and social impact in developing countries, and provide information on this to all the communities in which they operate.

HIPC AND DEBT RELIEF

Following significant progress in 2000, 2001 has been a year of continued achievement. Attention has been focussed on the need to ensure that HIPC leaves countries with a sustainable debt level upon exiting the initiative. The UK has continued to press major creditors and multilateral institutions to find solutions to this challenge. As a result the IMFC and the Development Committee of the World Bank, agreed, in November, to reassess HIPC at Completion Point and consider additional assistance, taking into account declining terms of trade and the global slowdown.

Most of the remaining countries are either involved in, or emerging from conflict or civil unrest, which makes progress towards HIPC debt relief very difficult. However the IMF and the World Bank, working closely with UN agencies and the international community, are providing technical and financial assistance to help countries get on the route towards economic security and post conflict reconstruction.

4.22 The UK was instrumental in securing international agreement for the joint IMF/ World Bank original (1996) and enhanced (1999) Heavily Indebted Poor Countries (HIPC) initiatives, and is continuing to push the debt relief agenda in all international fora. Progress through 2000 was more than satisfactory. The target, set at the 2000 Annual Meetings in Prague, to bring 20 HIPCs to decision point by the end of 2000, was met and exceeded. 22 countries reached decision point and began to benefit from $50 billion in debt relief, by the end of 2000.

4.23 The HIPC process is two-stage. At decision point a country begins to receive relief on its debt repaymetns, on the basis of an interim poverty reduction strategy. When that strategy is completed, and has begun to be implemented a country passes t its completion point, where debt reduction becomes irrevocable. Most eligible countries, having reached decision point by the end of 2000, benefited from debt relief throughout 2001. The IMF are tracking allocations of savings from debt relief to assess whether HIPCs would leave the process with sustainable debt levels. Three countries, Bolivia, Mozambique and Tanzania also reached completion point, and two further countries, Chad and Ethiopia, reached decision point. This brought the total debt relief to be written off to $56 billion, a significant step towards the total of $100 billion, and debt service payments reduced by an average of 30 per cent per year.

Debt Sustainability

4.24 Early assessment in April 2001 showed that there was a possibility that some HIPCs would leave the HIPC process with unsustainable levels of debt. This issue was discussed at an international conference, held in Lancaster House, London, in March 2001 involving governments, non-governmental organisations, international institutions and other experts. The conference considered the steps that developed country governments should take to prevent the re-emergence of unsustainable debts, in particular by banning the use of export credit support for unproductive expenditure. It also highlighted the need to ensure that the HIPC initiative marked a genuine exit from unpayable debt. The UK acknowledged this to be a major concern

that could seriously undermine the success of HIPC to date. As a result we have pressed the Fund and the Bank, and other major creditors, to recognise the implications and try to find an acceptable solution.

4.25 At the November meetings of the IMFC and the Development Committee, both recognised the need to take account of the worsening of global growth prospects and declining terms of trade when updating the HIPC debt sustainability analysis at completion point, before HIPC countries leave the process. Bolivia and Tanzania were two of the countries expected to leave the process with unsustainable debt levels. However reassessment at Completion Point placed both countries' debt levels below their debt sustainability thresholds relative to exports (114 per cent and 133 per cent respectively). The UK will continue to look at each case as they come up and will work to ensure that all HIPCs achieve sustainable debt levels.

Post-Conflict Countries

4.26 Progress in bringing countries towards decision point has been slower in 2001. Many of the countries that are yet to reach decision point are either involved in, or emerging from conflict. The UK has focussed on how to help these countries get on the route towards peace, so that they can also start to benefit from debt relief.

4.27 At the G7 Okinawa Summit in 2000, Heads of State called on conflict countries to end their involvement in conflict as a necessary first step towards tackling poverty and qualifying for debt relief. At the 2001 spring and autumn meetings of the IMFC and the Development Committee, this theme was re-emphasised. The IMF has now agreed, for the first time, to offer emergency post conflict assistance on concessional terms through the Post Conflict Assistance Account. The aim is to allow early, and concessional, support for post conflict countries. So far Albania, the Republic of Congo, Guinea Bissau, Rwanda, Sierra Leone and Tajikistan have benefited. The UK has made a pledge of £2.5 million and was the first country to make a contribution. The Fund is in dialogue with other potential donors.

4.28 While more work is underway in dealing with issues, such as the build up of arrears due to conflict, the IMF and the World Bank have been actively involved at an early stage in countries that demonstrate a commitment towards peace, such as DR Congo. DR Congo agreed a staff monitored programme in July 2001 and has been on track since then. If this continues, DR Congo may reach decision point as early as October 2002.

4.29 As a further incentive for HIPCs to reach decision point the Chancellor announced on 2nd December 2000 that the UK would no longer benefit from debt service payments from poor countries, and that for those countries that were yet to secure debt relief due to civil war, external conflict or the absence of a poverty reduction programme, all debt service payments would be held in trust until those countries can demonstrate that debt relief would go towards poverty reduction. The UK has also brought together its development, political and military efforts on conflict prevention in sub-Saharan Africa, including HIPCs, and funding for conflict prevention has been increased by 42 per cent in real terms.

Impact of debt reduction on social expenditures

4.30 Those countries that have reached Decision Point continue to demonstrate their commitment to poverty reduction by allocating savings from debt relief towards programmes that have an impact on the lives of the poor. In their interim and full PRSPs countries set out their strategy towards poverty reduction, setting out the basis for their sustainable development and their road map towards achieving the Millennium Development Goals. On average 65 per cent of assistance from debt relief is spent in the social sector.

4.31 The Enhanced HIPC initiative has reduced average debt service costs by 30 per cent. This reduction brings the ratio of debt service payments for HIPCs well below the average for non-HIPC developing countries. Countries have directed a significant proportion of their debt savings towards poverty reduction programmes. On average, these countries are expected to spend more than three times more on social sectors than on debt service after HIPC.

24 HIPCs that Have Reached Decision Point*

Country	Social Expenditure/ (per cent of GDP)		Debt Service/ (per cent of GDP)	
	1999	2002	1999	2002
Benin	31	39	18	8
Bolivia	10	12	13	12
Burkina Faso	36	40	14	7
Cameroon	16	22	24	12
Chad	50	56	31	16
Ethiopia	23	43	8	7
Gambia, The	29	35	20	15
Guinea	26	29	2	18
Guinea-Bissau	66	87	15	12
Guyana	35	42	32	13
Honduras	42	55	23	14
Madagascar	37	45	25	9
Malawi	34	32	30	11
Mali	18	23	18	12
Mauritania	30	38	35	14
Mozambique	32	30	17	7
Nicaragua	47	83	19	26
Niger	58	64	16	24
Rwanda	40	47	11	6
Sao Tome and Principe	93	86	44	10
Senegal	33	28	28	14
Tanzania	30	30	20	11
Uganda	40	36	13	5
Zambia	30	38	4	4

*Ghana was the 25th HIPC to reach decision point but at time of writing data on soical expenditure and debt service was not available

4.32 With Comoros now added to the HIPC list, there are 42 HIPCs, 25 of those through Decision Point. Sierra Leone is expected to reach Decision Point in March 2002. Most of the remaining countries are involved in conflict or civil unrest.

4.33 Of the remaining 18 countries – one has opted out (Laos), four will have sustainable debt levels without the need for additional relief through the HIPC initiative (Angola, Kenya, Vietnam and Yemen), and two have no relationship with the international community (Liberia and Somalia). This leaves 11 countries that are eligible for HIPC debt relief, most of which are involved in, or emerging from conflict. It is expected that progress through 2002 will continue to be difficult in these countries.

4.34 The total cost of assistance under the HIPC Initiative is now estimated at $31.3 billion (for 34 countries, excluding Angola, Kenya, Yemen, Laos, Vietnam, Liberia, Somalia and Sudan), in 1999 net present value terms. This is an increase from the previous estimate of $29.3 billion as Ghana has now opted for debt relief and Comoros has been added to the HIPC list.

THE PARIS CLUB AND DEBT RELIEF

4.35 The IMF and the Paris Club The IMF also works closely with the Paris Club of official bilateral creditors. This relationship is mutually dependent. For the IMF, rescheduling by Paris Club creditors can provide an important source of exceptional financing for Fund programmes. For the Paris Club, an IMF programme provides evidence of the pressing need of the financing problems a country is experiencing as well as comfort that those problems are being addressed in a coherent way. As a result, cooperation between the Paris Club and IMF is necessarily close in the design of the financing assumptions underpinning any programme where this form of finance is needed. This relationship is long established and during 2001 fifteen IMF programmes were supported with Paris Club agreements. Amongst these, nine agreements have concerned countries at various stages of the HIPC process.[10] More information is available at http://www.clubdeparis.org/en/index.php.

[10] For a full description of the involvement of the Paris Club in the HIP process see HM Treasury's last report to Parliament on Uk operations at the IMF, "The Uk and the IMF 1999-200", page 26

FINANCING FOR DEVELOPMENT

The UN Conference on Financing for Development (FfD) in Monterrey, Mexico, (March 2002). The UK Government is committed to making the conference a success, and the IMF and World Bank continue to play an important role in delivering progress at FfD.

UN Conference on Financing for Development

4.36 With its multifaceted approach, covering domestic resource mobilisation, Foreign Direct Investment (FDI), trade, aid, debt relief and the international financial system, the Financing for Development Conference is a major opportunity to deliver real progress for developing countries, and to strengthen the international response to the global economic slowdown and its impact on the poorest countries. It is important that all major stakeholders are actively involved, and that the focus is on realistic objectives that will make concrete contributions to achieving the Millennium Development Goals. The Development Committee, the joint ministerial committee of the World Bank and the IMF, had a full discussion on FfD at its meeting in Ottawa in November 2001. Similarly, the World Bank and the IMF will report to the Conference on the early outcomes from the review of the Poverty Reduction Strategy Paper approach.

4.37 The Chancellor underlined the UK's commitment to making progress towards the Millennium Development Goals and contributing to the success of Financing for Development in his speech to the New York Federal Reserve in Novembe 2001 He set out an ambitious agenda for a new global deal for developing countries: developing country governments should build strong domestic enabling environments for poverty reduction with good governance, policies for pro-poor economic growth, and investment in health and education. The EU should continue to press for progress on a broad trade agenda, building on the Doha outcome and the Everything but Arms initiative for the least developed countries. Donor countries should improve aid effectiveness, by supporting country-owned poverty reduction strategies, improving aid co-ordination and harmonisation of procedures, and by untying aid from the award of contracts.

Proposals for meeting the Millennium Development Goals

4.38 The Chancellor's speech highlighted the Zedillo Report, which argues that an extra $50 billion a year is needed to reach the Millennium Development Goals. To meet this challenge, he proposed a broad increase in development assistance from donors, and an International Development Trust Fund as a mechanism to harness additional aid and leverage in private sector resources. He also argued for commitment from all countries to work to strengthen the international financial architecture, through the implementation of codes and standards, private sector involvement in crisis prevention and resolution, and an enhanced role for IMF surveillance (details of which are set out in chapter 3 of this report).

International Development Trust Fund

The Government remains focussed on its long-term goal of helping to tackle global poverty and achieve the internationally agreed Millennium Development Goals (MDGs).The Zedillo Report concludes that achieving these goals requires, each year until 2015, an additional $50 billion in aid. Clearly some uncertainty surrounds such estimates but the scale of the challenge is clear: it requires unprecedented action by the developed world.

The Government is promoting a significant increase in development aid from all donor countries and international institutions to build capacity and address the long-term causes of poverty in the poorest countries. The UK is committed to the UN target of raising development assistance to 0.7 per cent of national income, and the Government has increased the Budget for the Department for International Development (DfID) to £3.6 billion – a 45 per cent increase in real terms between 1997/98 and 2003/04. Moreover, the Government will significantly raise the amount of our development aid, and also raise its share in national income, in our next spending round covering the years up to 2005/06.

To raise investment in developing countries by $50 billion a year to 2015 would require a step change in aid flows from the developed world. Recent proposals for new and innovative ways to meet this funding include global taxes and Special Drawing Rights (SDRs) from the IMF. The European Commission is examining the Tobin Tax and the Government approaches further evaluation of all these options with an open mind. However, such international initiatives rely, ultimately, on consensus and approval from all national governments. But there is a clear, immediate and pressing need for finance. In order to proceed with the urgency that the scale of the challenge demands, and recognising the duties of the richest countries to the least developed nations, the Government has proposed an International Development Trust Fund to build on the work of the World Bank, the IMF and the regional development banks.

The fund requires donor countries to commit substantial additional resources to 2015 and beyond. By pooling these funds with national governments offering a guarantee, backed by callable reserves or appropriate collateral as security, they could be leveraged through borrowing from international capital markets to meet the demand for large-scale assistance now. A new joint implementation committee of the IMF, World Bank and possible other donors might oversee the fund. To minimise bureaucracy and avoid the costly duplication of existing structures its resources should be distributed through tried and tested institutions.

But such resources must also be distributed taking account of the debt position of developing countries. To that end the poorest and most vulnerable countries should receive aid primarily in the form of grants alongside concessional loans from the World Bank, and all other low-income countries should receive interest-free loans. Hence the trust fund would continuously review the debt position of developing countries, both when disbursing funds and also as repayment falls due.

1 IMF DECISION MAKING - UK POSITIONS

Votes by the Board of Governors

The Government is committed to reporting to Parliament regularly on the position the UK takes on major policy issues discussed at the IMF. This year's report demonstrates the Government's continued commitment in this regard, by including, for the first time, the UK position on each vote made by the IMF's Board of Governors during the reporting period.

There have only been a few votes by the Board of Governors in recent years. Governors vote on specific issues, as defined in the Fund's Articles of Agreement and by-laws. These include subjects such as: changes in member's quotas; the remuneration of Executive Directors; the salary of 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.

The resolutions that are passed as a result of successful Governors' votes are currently published by the IMF, with a two-year delay, in the 'Summary Proceeding of the Annual Meeting of the Board of Governors'. This information is made available on the IMF website.

RESOLUTION	VOTING RESULT	EFFECTIVE DATE	UK POSITION
China – increase in quota	Passed	05.02.2001	Approve
Direct Remuneration of Executive Directors and their Alternates	Passed	15.08.2001	Oppose
2001 Annual Meetings Cancellation[1]	Passed	27.11.2001	Approve

The decision to increase China's quota is described in paragraph [3.7].

The UK has generally taken a tough stance on the issue of enhancing the remuneration of IMF Executive Directors. The Government believes that their remuneration should primarily reflect their primary role as appointed public officials and representatives, rather than being driven by comparability with either the private sector, or the salary required to attract high-quality individuals to other senior management positions in the IMF.

The Annual Meetings scheduled to be held in Washington DC on September 29-30 were cancelled, following the tragic events of 11 September. The IMFC and the Development Committee meetings, which were also due to be held in Washington, were rescheduled for November 17-18 in Ottawa.

Decisions by Executive Directors

The Government is also committed to taking further steps to promote the transparency of the Executive Board. In most instances decisions are taken in the Executive Board through a process of consensus building, without recourse to formal voting. There have been no formal votes by Executive Directors for several years. However, This report sets out the key policy, surveillance and programme discussions that were conducted in the Board during the year.

This annex sets out further details of the key features that the UK expects the IMF to cover in individual surveillance, programme and budget and administration discussions. These key features have helped the UK delegation to the Fund to ensure consistency in their approach to individual Board discussions.

Discussions of surveillance

In our interventions during individual countries' Article IV discussions, the UK emphasises the importance of vulnerability indicators and early warning systems. There are several elements to this;

- Fiscal Policy Frameworks – the Article IV should demonstrate sustainability, with sufficient flexibility to respond to temporary shocks. Specifically interventions on this point focus on the sustainability of deficit financing; in domestic debt and external debt terms, with an eye on domestic resource mobilisation and aid dependency. Linked to this is an appropriate balance between fiscal and monetary measures for maintaining stability given real interest rates, the tax effort and expenditure pressures;

- Vulnerabilities – the Article IV should identify vulnerabilities in the financial sector. We would consider whether the country undertaken a ROSC, or an FSAP, and if not, whether it would be a suitable candidate;

- Exchange Rate Regime – the Article IV must be sufficiently tough on unsustainable exchange rate regimes.

In addition to these, UK interventions also assess factors relating to systems and structures of economic governance; the transparency and accountability of systems; resource allocation; the quality of statistics; and, for many programme countries, the consistency of the conditionality agreed in the Fund programme. Specifically for HIPC countries, UK interventions would also be based on an assessment of Public Expenditure Management, the extent to which pro-poor resource allocation is demonstrated, and the availability of data and statistics.

There are also a number of other factors which influence UK interventions in the Board on all Article IVs, including whether the country has been identified by the Financial Action Task Force as a non-cooperative jurisdiction on money laundering, by the Financial Stability Forum as a poorly regulated offshore financial centre, or by the OECD for its harmful tax regime.

Executive Board Surveillance Discussions

During 2001 the Executive Board discussed Article IV consultations for the following countries:

2000 Article IV consultations

Antigua and Barbuda*; Belgium*; Benin*; Botswana*; Brunei Darussalam; Bulgaria; China (in respect of Hong Kong)*; Croatia*; Dominican Republic*; Ethiopia; Greece*; Hungary*; Lesotho*; Libya; Lithuania*; Marshall Islands; Micronesia; Norway*; Panama*; Philippines*; Sierra Leone*; Solomon Islands; South Africa*; St. Lucia*; Tunisia*; United Kingdom*; Uzbekistan; Venezuela; and Yemen*.

2001 Article IV consultations

Albania*; Algeria*; Armenia; Aruba; Australia*; Bahamas*; Barbados; Belize*; Bhutan; Bolivia; Burkina Faso; Cameroon*; Canada*; Cape Verde*; Chile*; China*; Colombia*; Comoros*; Congo*; Costa Rica; Cote D'Ivoire*; Czech Republic*; Djibouti; Dominica*; Egypt; El Salvador; Equatorial Guinea*; Estonia; Eritrea; Finland*; France*; Gambia*; Georgia*; Germany*; Ghana*; Grenada*; Guatemala; Honduras*; Iceland; India*; Ireland*; Israel*; Islamic Republic of Iran*; Italy; Jamaica; Japan*; Kiribati*; Kyrgyz Republic*; Lao*; Lebanon*; Madagascar*; Maldives; Mali; Malaysia*; Mauritania; Mauritius; Mexico*; Morocco*; Nepal*; Netherlands Antilles*; Nicaragua; Nigeria*; Oman*; Paraguay; Peru*; Poland*; Samoa; San Marino*; Saudi Arabia*; Slovak Republic*; Slovenia; Sri Lanka; Sudan; Suriname; Syrian Arab Republic; Sweden*; Switzerland; Tajikistan*; Tanzania; Thailand*; Togo*; Tonga*; Trinidad and Tobago; Uganda; United Arab Emirates; United States; Uruguay; Zambia*; and Zimbabwe*.

They also conducted a number of multilateral surveillance discussions, including World Economic Outlooks, World Economic and Market Developments; and other regional discussions including euro area monetary and exchange rate policies.

In these discussions the UK's interventions were based on the themes and principles set out in paragraphs above. Public Information Notices are available for all of those consultations marked with an asterisk* at www.imf.org

Discussions of lending programmes

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

Discussions of PRGF Programmes

In the specific cases involving IMF lending to poor countries under the PRGF, the Government prepares a view of country progress, based partly on in-country analysis by development experts from the Department for International Development. The Government is also monitoring progress on the "Key Features" that IMF programmes are expected to meet in poor countries (see chapter 6.2), for example through reporting on pro-poor budgets or Poverty and Social Impact Assessment.

PRGF arrangements are typically 3-years in length, with programmes agreed annually and biannual reviews of progress. As of January 2002, 37 countries have PRGF arrangements, of which nine are in Africa. During discussions of PRGF countries, the UK interventions have focussed on questions related to programme design, including:

- does the programme adequately reflect the needs of the country, are required reforms well sequenced and realistic and does the programme support the country developed PRSP?
- performance – have targets been met, if not are waivers justified, and is commitment to ongoing reform and poverty reduction sufficient?
- Generic PRGF issues – how does the PRGF measure up against its objectives? In particular, we have encouraged increasing poverty and social impact assessment of programme elements, and a focus on improving public expenditure management and fiscal flexibility in the programme.

Discussions on the budget and administrative issues

There have also been a number of discussions covering the IMF's operational budget and various administrative and management issues, including committees on the Budget and the Budget Framework, the Staff Compensation 2001 Review, Staff retirement plan and medical benefits.

The UK Government has consistently supported the efficient use of resources, stressing the need to prioritise activities, and ideally cutting back on low priorities when faced with new demands. The UK has tended to be sceptical of generalised proposals for increases in resources. But has accepted proposals where needs are more pressing, for example, in the staffing of the two offices representing African countries in order to facilitate implementation of the Poverty Reduction Strategy Paper and Financial Sector Assessment Programme initiatives.

In discussions on staff compensation and benefits, the UK takes a rigorous approach, stressing the public service nature of the IMF and the need to consider the financial and budgetary constraints within which member governments are required to operate. In matters relating to the treatment of different staff groups, equity and fairness are the underlying principles.

II THE UK'S FINANCIAL POSITION WITH THE IMF

There is no annual subscription for IMF membership. Instead there are two parts to the UK's financial relationship with the IMF;

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

In previous reports we have calculated the cost of the UK's membership to the IMF assuming that, if we were to leave the IMF, the reserves that have been held in association with our membership would not be replaced with 'conventional' reserves (option A). This year, in the interests of greater clarity and transparency, we have gone a step further and also considered what the cost would be if these reserves were replaced by 'conventional' reserves (option B).

The results, using either method, are subject to considerable variability from one year to the next. This is driven by movements in the sterling, SDR, and foreign exchange interest rate differentials, and, to a greater extent by currency fluctuations ($, Euro, Yen and SDR versus £).

Quota-based system

The IMF is primarily financed through members' quotas. Each member of the IMF is assigned a quota, which is expressed in Special Drawing Rights (SDRs), the IMF's unit of account. This determines the member's maximum financial commitment to the IMF, its voting power, and is the basis for determining access to IMF financing.

The UK's quota is currently 10,738.5 million SDRs. Up to 25 per cent of the quota is payable in SDRs or other specified, useable currencies ("reserve assets"), the balance is payable in the member's own currency. The IMF is entitled to call on anything up to our total quota.

The proportion held in SDRs is called the "reserve tranche". This consists of the proportion of our quota originally paid in SDRs, plus the part of our quota that the IMF has drawn upon (by converting sterling assets, i.e. promissory notes, into SDRs). As the IMF cashes in sterling notes and draws upon the UK's quota, the UK's reserve tranche rises. The reserve tranche is financed from the National Loans Fund, which is audited by the National Audit Office. The accounts are laid before Parliament.

We are also able to call upon our own reserve tranche at short notice, in the event of a balance of payments need. Therefore the UK's reserve tranche forms part of our reserves and as such, increases in its size are not regarded as increases in public expenditure. However there is an opportunity cost to membership.

The larger part of the UK's reserve tranche is remunerated at the SDR interest rate. The remainder [approximately one quarter] is unremunerated. This is because part of the UK's quota was made available to the IMF prior to the 1970s, before the IMF instituted the policy of remunerating members' reserve tranches. We therefore receive no interest to offset the cost of financing this portion. In FY2000/01 the unremunerated portion of the UK's reserve tranche cost £31.83 million.

SDR Allocation

In addition to our qota the UK also has an allocation of 1.6 billion SDR, from the IMF. SDRs are an international reserve asset introduced by the IMF in 1969 out of concern amongst members that the current stock and prospective growth of international reserves might not be sufficient to support the expansion in world trade. The IMF allocates SDRs to members as reserve assets as a percentage of their quota. We pay interest to the IMF, at the SDR interest rate, on this allocation. At the same time the IMF remunerates all holdings of SDRs at the SDR interest rate. Therefore the net interest cost of our SDR allocation would be zero if we held our full allocation in SDRs.

However, members have the option to sell part of their SDR allocation and hold alternative reserve assets. During FY2000/02 we chose not to retain all of the SDR that we had been allocated. The UK has tended to sell SDRs and invest the proceeds in dollar, euro and yen assets for portfolio management reasons. In FY2000/01 we held on average the sterling equivalent of 0.2 billion in SDRs and 1.4 billion in foreign currency. As a result we paid interest to the IMF on our allocation of SDR 1.6 billion, and received interest from the IMF on our holdings of SDR 0.2 billion. We also received interest on our 1.4 billion in foreign exchange holdings at the foreign exchange interest rate. Differences between the SDR interest rate and the foreign exchange interest rate. Differences between the SDR interest rate and the foreign exchange interest rate resulted in a net interest cost to holding our SDR allocation in these proportions of £2.7 million during FY2000/02. Currency movements also resulted in a further cost of 2.2 million.

Net Financial Cost of Membership of the IMF

The net financial cost of the UK's membership of the IMF is therefore driven by movements in the sterling, SDR and foreign exchange interest rate differentials, and to a greater extent by currency fluctuations ($, , Yen and SDR versus £). It also depends crucially on whether the UK would hold other forms of foreign exchange reserves if we did not hold SDRs.

Overall the net income to the UK of its membership of the IMF in FY 2000/01 was £67.5 million assuming that if the UK left the IMF then its reserves would not be replaced by 'conventional' reserves (option A). This is made up of an income of £389.6 million, less a cost of £322.1 million.

However, a set of conventional reserves of the same value would have resulted in a net income of £133.3 million (income of £400.8 million less a cost of £267.7 million). As a result, assuming that, were we to leave the IMF the reserves held in association with membership of the Fund would be replaced with "conventional" reserves, this becomes a net cost to the UK of £65.6 million (option B).

The difference between the costs of membership calculated according to the different options is primarily due to foreign exchange gains being greater under option B. But these figures vary sharply from year to year. On average over the past three years IMF membership has come to a cost of £38.3 million using option B.

III IMF LENDING FACILITIES

Review and reform of the IMF facilities

In March 2000 the Executive Board began a general review of the IMF's financial facilities. The review was completed in November 2000 and has resulted in a number of measures designed to update its facilities, sharpen the focus of lending on crisis resolution and prevention, and to make more efficient use of Fund resources. Some important changes have been approved, including;

- improving the attractiveness of the Contingent Credit Line as a precautionary line of credit to help member countries, that follow strong economic policies, to guard against contagion;
- actions to reduce reliance on the IMF as a source of long-term financing and to free up funds for use by other members, including measures to encourage early repayment; and
- strengthening the Fund's monitoring of countries' economic policies after conclusion of a Fund-supported programme, particularly in cases where there is substantial credit outstanding to the IMF.

Regular lending facilities

Stand-By Arrangements (SBA). SBAs form the core of the IMF's lending policies and are designed to deal mainly with short-term balance of payments problems, of a largely cyclical nature. Under an SBA, the member carries out a programme, which it has designed in consultation with the IMF, focussing on key macroeconomic policy measures. To receive financing the member must meet performance criteria marking its successful implementation of the programme. The access limit is 100% of quota annually, and 300% cumulatively, although the Fund may grant access beyond these limits in exceptional circumstances. The country is expected to repay the money it has borrowed over 2-4 years (with a period of 3-5 years for obligatory repayment).

Extended Fund Facility (EFF). Longer-term assistance to address balance of payments problems that stem largely from structural problems and take longer to correct, is provided under an EFF. A member requesting an EFF outlines its goals and policies for the period of the arrangement, usually three years but can be extended to a fourth, and provides a detailed, annual statement of the policies and measures it will implement over the next 12 months. The expected repayment period is 4-7 years (with a period of 4-10 years for obligatory repayment).

Special lending facilities and policies

Supplemental Reserve Facility (SRF). The SRF was established in December 1997 in response to the unprecedented demand for IMF assistance resulting from the Asian Crisis. It is intended to provide additional short-term financing to member countries experiencing exceptional balance of payments difficulty because of a sudden and disruptive loss of market confidence, reflected in capital outflows. Financing under the SRF is disbursed over one year, in the form of additional resources under a Stand-By of an Extended Arrangement. The expected repayment period is 12-18 months. The Board can extend this by one year, but an interest surcharge is levied to encourage early repayment.

Contingent Credit Line (CCL). Where countries operate transparent and effective policies, the CCL provides a precautionary line of credit designed to help them strengthen their financial position and guard against contagion. Approval of financing under the CCL would signal the IMF's confidence in a country's economic policies and provide further incentives for the adoption of strong policies and adherence to internationally recognised standards. This is the only facility that operates on the principle of pre-qualification. The surcharge on the use of credit under the CCL is at all times 150 basis points lower than the surcharge that would be applicable under the SRF.

Further information on the UK's policy regarding the CCL is set out in chapter 5 of this report.

Concessional lending facility

Poverty Reduction and Growth Facility (PRGF). The PRGF is a low-interest facility to help the poorest member countries facing protracted balance of payments problems. A Poverty Reduction Strategy Paper produced by the borrowing country in cooperation with the IMF and the World Bank, describes the authorities' goals, macroeconomic and structural policies for the three-year programme. This provides the framework for Bank and Fund concessional lending.

Further information on the continued development of the PRGF is set out in chapter 6 of this report.

IV COMMUNIQUÉ OF THE INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE OF THE BOARD OF GOVERNORS OF THE INTERNATIONAL MONETARY FUND - APRIL 29, 2001

1 The International Monetary and Financial Committee held its third meeting in Washington, D.C. on April 29, 2001, under the Chairmanship of Mr. Gordon Brown, Chancellor of the Exchequer of the United Kingdom.

The World Economy

2 In the increasingly interconnected global economy, we will continue to promote international economic cooperation and work together, adopting a forward looking approach to meeting our common objective of open trade for greater global prosperity, maintaining the momentum for reform in the international financial system, strengthening our economies through structural reform, maintaining sound macroeconomic conditions for strong non-inflationary growth, and encouraging poverty reduction and growth in the poorest countries.

3 The Committee agrees that short-term prospects for global growth have weakened significantly since its September 2000 meeting in Prague. The Committee considers it likely that the slowdown in global growth will be short-lived, though it notes that the downside risks have increased. Underlying inflationary pressures generally remain subdued.

4 Against this background, the Committee stresses the need for policymakers in the advanced economies to remain vigilant and forward looking:

- In the United States—which has provided important support for the growth of the world economy in recent years—there has been a marked deceleration of activity. The significant easing of monetary policy in recent months is timely and welcome, and monetary policy should remain directed at restoring growth potential while maintaining price stability. The Committee considers that timely fiscal policy measures would also provide support to economic growth.

- In view of the persistence of slow growth in Japan, the Committee welcomes the recent introduction of a new monetary policy framework, and underscores the importance of the authorities' commitment to an expansionary policy stance until the risk of deflation is eliminated. Given the high level of public debt, the gradual fiscal consolidation currently under way remains appropriate. Prospects for a return to sustained growth depend

most critically on determined action to address structural weaknesses, especially in the financial and corporate sectors.

- In this context, growth in the euro area remains relatively well sustained, although a slowing in activity is under way. The Committee agrees that policies should continue to support confidence and strengthen growth potential. Fiscal policy needs to continue to be geared toward fiscal consolidation in the medium term. Tax reforms should contribute to enhanced economic efficiency. The Committee underscores the importance of a further deepening and acceleration of structural reforms, especially in labour and product markets and in strengthening pension systems, for boosting longer-term growth potential.

5 The Committee notes that other countries are being adversely affected by both the slowdown in growth in the advanced economies and the deterioration of conditions in international financial markets. The Committee, however, notes that growth is expected to be relatively well maintained in India and China. The Committee welcomes the steps taken by many emerging market economies in recent years to reduce external and financial sector vulnerabilities, including by adopting sustainable exchange rate regimes and prudent debt and reserve management policies. In view of the present fragility of external financing conditions, the prospects for emerging market economies depend critically on maintaining investor confidence, which, the Committee agrees, will require pursuing prudent macroeconomic policies and pressing ahead with corporate, financial, and institutional reforms. The Committee welcomes the recent comprehensive set of measures being implemented by the Argentine government to improve the underlying fiscal position and provide a strong basis for the sustained recovery of the economy, in line with the objectives of the IMF-supported program that is in place. It considers that these measures are an important and decisive step to boost confidence. The Committee also welcomes the comprehensive strategy of bank restructuring, fiscal consolidation, and structural reform initiated by the Turkish authorities. The Committee considers these policies, together with the provision of the needed external financing by the Fund and the Bank, provide the basis for the reestablishment of financial stability and sustained disinflation with growth, and merit the support of the international community and the private sector. The Committee looks forward to a rigorous implementation of all the necessary measures. The Committee welcomes the additional financing proposed by the Managing Director to support those policies, and looks forward to the forthcoming Executive Board discussions of these topics.

6 The Committee expresses particular concern that the slowdown in global growth risks adversely affecting the Fund's poorest member countries. The Committee stresses that developing countries need to pursue sound and stable policies and to build strong institutions as part of a commitment to poverty reduction and growth, and to create a favorable environment for domestic and foreign investment and private sector activity. The Committee emphasizes that the advanced economies have a special responsibility to assist poor countries' own efforts as they work to achieve the International Development Goals. This includes

adequate flows of official development assistance, and carrying forward the HIPC Initiative to deliver sustainable debt levels, as well as more rapidly and decisively opening their markets to developing countries' exports. The Committee welcomes recent market-opening actions, and urges all countries to remove remaining barriers to the exports of the poorest countries. The Committee looks forward to the joint meeting with the Development Committee later today. The Committee welcomes the cooperation of the Fund and Bank on the International Development Goals, addressing the importance of delivering on the commitments made at Dakar on education and the need for global action on health to address diseases such as the HIV/AIDS pandemic.

7 The Committee underscores more broadly the importance of open markets for strengthening the global economy and for enhancing the growth prospects of developing countries. It urges all countries—developed and developing—to find common ground for the launch of new multilateral trade negotiations this year. The Committee is unanimous in its view that recourse to protectionism would be the wrong response to the global economic slowdown and the attendant difficulties in particular sectors. The Committee calls upon all countries to resist protectionist pressures and to reduce or eliminate trade barriers and trade-distorting subsidies. Looking forward, it requests the Fund to pay attention to the effects of trade policy developments and to continue to encourage trade liberalization in the context of all its activities with its members, both developed and developing. The Committee welcomes and encourages greater cooperation between the Fund, the Bank, and the WTO.

The IMF in the Process of Change

A. Progress Report by the Managing Director

8 The Committee welcomes the work program outlined in the Managing Director's progress report. It welcomes the recent moves to refocus the Fund in order to maximize its effectiveness in reducing members' vulnerability to currency or balance of payments crises, and in supporting their policies toward promoting sustainable growth and poverty reduction. It considers that the Fund is appropriately focusing on:

- promoting macroeconomic and financial stability, as a precondition for sustained economic growth;
- promoting the stability and integrity of the international monetary and financial system, as a global public good; and
- helping member countries to develop sound financial sectors in order to protect against vulnerability, to mobilize financing for productive investment, and to take advantage of the opportunities of global financial markets.

9 The Committee endorses the further steps that are being taken to increase complementarity and strengthen cooperation with other organizations, especially the joint work with the World Bank in strengthening financial sectors, fighting poverty, and making progress towards the achievement of the International Development Goals. It stresses the need to maintain and deepen this collaboration and extend it into other areas. The Committee also welcomes the steps under way to align more closely the Fund's technical assistance with its key policy priorities, and to better coordinate this assistance with that of the Bank and other providers.

10 The Committee strongly supports the redoubling of the Fund's efforts to put crisis prevention at the heart of its activities, and especially of its bilateral and multilateral surveillance (as described below). The Committee encourages countries to pursue strong policies and, to minimize contagion, reemphasizes the precautionary nature of the CCL for those purposes. At the same time, it welcomes the steps being taken—including the recent reforms of the Fund's financing facilities—to strengthen the Fund's capacity to respond to financial crises in member countries and to minimize their adverse impact.

11 The Committee notes the recent experience in applying the agreed framework for private sector involvement in crisis prevention and management, which relies as much as possible on voluntary, market-oriented approaches. The Committee welcomes the Executive Board discussion and the consultations with other international institutions, member governments, and the private sector on the possible use of collective action clauses, investor relations programs, corporate workouts, and techniques for bond restructuring. Looking forward, the Committee reaffirms the exceptional character of financing beyond normal access limits, and repeats that reliance on the catalytic approach at high levels of access must presume substantial justification. Within the framework of private sector involvement, there may be cases requiring more concerted approaches, and the Committee asks the Fund to continue its work on articulating the circumstances in which such approaches would be applied and the specific role of the IMF. The implementation of this framework should be subject to a well-defined monitoring and assessment procedure. The Committee also looks forward to progress by the Annual Meetings on practical issues involved in applying the framework, including: an improved basis for assessing debt sustainability; prospects for regaining market access; the risk of contagion; and the comparability of treatment between official and private creditors. The Committee stresses the importance in the future of taking decisions in a way that is consistent with the framework.

B. Strengthening the IMF's Focus on Financial Markets and Crisis Prevention

12 The Committee stresses that strong and effective crisis prevention is a top priority. It welcomes the Managing Director's decision to establish an International Capital Markets Department, as part of the effort to deepen the Fund's understanding of and judgment on international capital market issues; to improve

its early warning capabilities; and to strengthen crisis prevention. This will complement the earlier establishment of the Capital Markets Consultative Group as a channel for regular, informal, and constructive dialogue with private sector representatives. The Committee calls on the Fund to make progress with its work on early warning indicators of potential crises in individual countries and in international financial markets, taking full account of the need to avoid instability. The Fund should stand ready to help countries that wish to proceed with an orderly liberalization of their capital accounts.

13 The Committee is pleased to observe continued progress since its last meeting in implementing previous Fund initiatives on crisis prevention and financial sector surveillance. In particular, it notes:

- the agreement by the Executive Board on a list of international standards and codes relevant for the Article IV surveillance process and on the modalities by which staff assessments of members' implementation of these standards and codes will be brought into surveillance and made public, while paying due regard to the voluntary nature of these standards and codes. It agrees that ROSCs should be established as the principal tool for assessing the implementation of standards and codes. It also takes note of the revised version of the ***Code of Good Practices on Fiscal Transparency*** and the accompanying ***Manual on Fiscal Transparency;***

- the recent steps to adapt the Fund's analytical framework to better assess external vulnerability, as well as its development of guidelines for reserves management and, with the World Bank, of guidelines for public debt management;

- the Fund's work with countries to strengthen data underpinning external vulnerability analyses, in particular the wider use of the Fund's ***Special Data Dissemination Standard*** (SDDS) and ***General Data Dissemination System (GDDS)***, and the expanded coverage of the Coordinated Portfolio Investment Survey to include more instruments and additional jurisdictions, including offshore financial centres;

- the implementation of initiatives on the Fund's transparency policy that has progressed significantly over the last year, including the decision to allow voluntary publication of all country staff reports and other country documents;

- the progress in strengthening financial sector surveillance both at the national and international levels. The Committee particularly welcomes the progress made in assessing member countries' financial sectors through the joint Bank-Fund ***Financial Sector Assessment Program (FSAP)***, which provides a coherent and

comprehensive framework for identifying financial system vulnerabilities, assessing development needs and priorities, and helping to develop appropriate policy responses. The Committee agrees that the Fund's Financial System Stability Assessments (FSSAs), which are derived from the discussion of FSAP findings in the context of the Article IV process, are the preferred instrument for strengthened monitoring of financial systems as part of Fund surveillance. It welcomes the agreement by the Executive Board to permit publication by national authorities of the detailed assessment of observance of standards and codes that are included in FSAP reports and to enable publication of FSSAs on a voluntary basis. The Committee welcomes the extension of the Fund's financial sector work to include voluntary assessments of offshore financial centres.

C. Combating Financial Abuse/Money Laundering

14 The Committee underscores that money laundering is an issue of global concern requiring strengthened policies and concerted action on the part of governments and a range of institutions. Effective anti-money laundering measures at the national level are important for all Fund members, especially those with large financial markets. In this regard, the Committee generally agrees with the recognition of the FATF 40 Recommendations as the appropriate international standard for combating money laundering, and that work should go forward to determine how the Recommendations can be adapted and made operational in the Fund's work. It endorses the proposed closer collaboration by the Fund and the World Bank with the FATF and other anti-money laundering groups in reviewing standards and procedures in this area. In this regard, the Committee notes that, to be consistent with the ROSC process, assessments should be undertaken on a uniform, cooperative, and voluntary basis. Action by the Fund on combating money laundering should aim to promote a more effective regulatory and supervisory environment and thus help prevent financial crime and money laundering. The Fund, in collaboration with the World Bank, should, if requested, also provide more technical assistance in this area to member countries to strengthen their economic, financial, and legal systems.

D. Streamlining Conditionality and Strengthening Ownership

15 The Committee welcomes the ongoing review of ***Fund conditionality*** and underscores that conditionality remains indispensable, together with financing, as an integrated response by the Fund to support its members' policy programs. While the expansion of conditionality in the structural area over the past several years reflects in part the critical importance of structural reforms for macroeconomic stability and sustained growth, its increasing scope and detailed nature warrant a review of recent practice. The Committee endorses the principles that Fund conditionality should focus on those measures, including structural, that are critical to a program's macroeconomic objectives. While this principle needs to be interpreted carefully on a case-by-case basis, the Committee notes that it shifts the

presumption of coverage from one of comprehensiveness to one of parsimony. Enhanced collaboration and clearer division of labor between the Fund and other international agencies, in particular the World Bank, is an important element of streamlining. The Committee reaffirms that the overarching objective of streamlining is to make conditionality more efficient, effective, and focused, without weakening it, and welcomes the progress being made in this respect. The Committee considers it particularly important that Fund-supported programs take adequate account of national decision-making processes and the administrative capacity to implement reforms, and be founded on strong country ownership. The objective should be to provide maximum scope for countries to make their own policy choices, while ensuring that the Fund's financing supports needed policy adjustments, and while safeguarding the Fund's resources. The Committee notes that greater efforts to help countries strengthen institutional capacity for sustained implementation of structural reforms are an essential complement to this approach. The Committee urges the Executive Board to continue its review of Fund conditionality, in the light of experience and feedback from the broad public consultation now under way on these issues, and including the important question of how to deal with structural issues, which are relevant but not critical to the success of macroeconomic objectives. It looks forward to a report on further progress at its next meeting, with a view to drawing firm conclusions on the streamlining of conditionality.

E. Governance

16 The Committee agrees that the Fund should address governance issues that have a significant macroeconomic impact, both through initiatives that apply across the membership and through specific measures to address particular instances of poor governance and corruption. The Committee requests the Executive Board to keep under close review the use of specific remedial measures, which should be applied with careful judgment and flexibility. The Board should also address the two-sided nature of corruption, by following up on the implementation of OECD-led initiatives to combat bribery of foreign public officials, and similar initiatives, in the context of surveillance.

F. Other Issues

17 Quotas should reflect developments in the international economy. The Committee looks forward to further work on this issue.

18 The Committee welcomes ongoing measures to improve transparency, governance, and accountability in the Fund. The Committee particularly welcomes the appointment by the Executive Board of Mr. Montek Singh Ahluwalia as Director of the Fund's Independent Evaluation Office (EVO). Noting that the EVO will become operational in August 2001, the Committee reiterates its expectation that the work of the EVO will help the Fund to improve its future operations and enhance its accountability. It looks forward to receiving regular reports on the EVO's work and hopes that a first report, on the forward work plan, will be available in time for the Committee's next meeting.

19 The Committee notes the joint draft report of the Fund's Working Group to Review the Process of Selection of the Managing Director and the World Bank Working Group to Review the Process of Selection of the President.

20 The Committee takes this opportunity to thank Michael Mussa for his outstanding contribution to the institution. It notes that under his intellectual stewardship, the World Economic Outlook has become a flagship product of the Fund.

Next Meeting of the Committee

21 The next meeting of the IMFC will be held in Washington, D.C. on September 30, 2001.

V COMMUNIQUÉ OF THE INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE OF THE BOARD OF GOVERNORS OF THE INTERNATIONAL MONETARY FUND - NOVEMBER 17, 2001

1 Recognizing the need for a determined and cooperative policy response to the challenges facing the world economy, the International Monetary and Financial Committee held its fourth meeting in Ottawa on November 17, 2001, under the Chairmanship of Mr. Gordon Brown, Chancellor of the Exchequer of the United Kingdom. The Committee expresses its gratitude to Finance Minister Paul Martin and the Canadian government for hosting this meeting and for the excellent arrangements.

2 The Committee notes that the September 11 terrorist attacks have prolonged the slowdown in the world economy. Bold policy action has already been taken to support a robust recovery during 2002, but the outlook remains subject to considerable uncertainty. Continuing vigilance is needed, and it is essential that the international community stands ready to take timely action to maintain stability and invigorate growth. The Committee welcomes the Managing Director's October 5 statement on the situation of the world economy and the IMF response, which outlines a collaborative approach to give a new momentum to the world economy. The IMF has a central role to play, including through a strengthened focus on surveillance, in ensuring global macroeconomic and financial stability and in ensuring that globalization works for the benefit of all.

3 The advanced economies have a key responsibility to promote early recovery in global growth. The recent easing of monetary policy in the United States, the euro area, and other advanced economies is welcome, and the authorities stand ready to take further action if appropriate. While the scope for discretionary fiscal policy action varies across countries, the advanced economies should allow automatic stabilizers to operate. The Committee stresses that determined implementation of structural reforms to take advantage of the promise of technology for increased productivity is important to restore confidence and growth. Japan, in particular, needs to move ahead with vigorous reforms of its banking and corporate sectors, and Europe should give priority to accelerating labor and product market reforms. The United States stands ready to take further action to support growth, consistent with maintaining sound public finances in the medium term.

4 Increased trade opportunities will play a vital role in the recovery, and the Committee strongly welcomes the outcome of the Doha meeting of the World Trade Organization and the Doha Development Agenda. All countries should stand firm against protectionist pressures, and the advanced economies, in particular, should improve access to their markets and reduce trade-distorting subsidies both for the benefit of their own citizens and to provide critical support for developing countries. The IMF should strengthen its surveillance of these issues and help promote

international efforts to open markets. The Committee is vigilant on stability in the oil market at prices reasonable for consumers and producers.

5 Emerging markets and developing countries are facing a weakening of global demand, reduced capital flows, higher risk aversion in financial markets, reduced income from tourism, and lower and more volatile commodity prices. Sound and proactive policies in these countries will be critical. The IMF stands ready to provide additional financial assistance, where needed, to those countries pursuing sound policies. The IMF has a range of instruments available and its current financial position is strong. The IMF should be ready to adjust its policies if necessary. The Contingent Credit Line (CCL) is an important signal of the strength of countries' policies and a safeguard against contagion in financial markets, and the Committee encourages eligible countries to consider applying for it. The Committee also underscores the critical importance of involving the private sector in the prevention and resolution of financial crises. The Committee recommends an early implementation of the Fourth Amendment.

6 The Committee expresses particular concern at the adverse impact of the global slowdown on low-income countries and heavily indebted poor countries (HIPCs). It calls on the IMF, in close collaboration with the World Bank, to respond flexibly and proactively to the needs of these countries, including through additional concessional financing and debt relief where appropriate. The Committee welcomes the additional contributions to the Poverty Reduction and Growth Facility (PRGF), and encourages further contributions. The IMF, working closely with the World Bank, should intensify its efforts within the Poverty Reduction Strategy Paper (PRSP) framework to assess the poverty and social impacts of reforms on the poor. The Committee looks forward to discussing the findings of the PRGF and the PRSP Reviews at the Spring Meetings next year. The enhanced HIPC Initiative framework provides for the consideration of additional assistance at the completion point if there has been a fundamental change in a country's economic circumstances due to exceptional exogenous shocks. The Committee recognizes the need to take into account worsening global growth prospects and declines in terms of trade when updating HIPC Initiative debt sustainability analyses at completion point. It encourages the heavily indebted poor countries to continue to work expeditiously toward meeting the conditions that will secure access to debt relief and ensure its effective use, including through the maintenance of sound economic policies. Advanced economies must also be prepared to meet their special responsibility in providing increased development assistance and debt relief to tackle the increased challenges of poverty reduction, and to achieve the Millennium Development Goals. The Committee reiterates the importance of fully financing the enhanced HIPC Initiative, and it urges bilateral donors to fulfill this commitment.

7 Recognizing the importance of close collaboration and effective partnership among the community of international institutions in this endeavor, Committee members look forward, with their colleagues in the Development Committee, to their joint discussion with the U.N. Secretary-General, Mr. Kofi Annan, on how best to work together to meet the challenges ahead, including in the context of the upcoming Conference on Financing for Development.

8 The Committee expresses grave concern at the use of the international financial system to finance terrorist acts and to launder the proceeds of illegal activities. It therefore calls on all member countries to ratify and implement fully the UN instruments to counter terrorism, particularly United Nations Security Council Resolution 1373, and welcomes and supports the Special Recommendations of the Financial Action Task Force (FATF) to combat terrorist financing. Each member should freeze, within its jurisdiction, the assets of terrorists and their associates, close their access to the international financial system, and, consistent with its laws, make public the list of terrorists whose assets are subject to freezing and the amount of assets frozen, if any, with monthly reports. The fight against money laundering and the financing of terrorism requires the active participation of both financial intermediaries and the public sector. The Committee endorses the IMF's action plan to intensify, where consistent with its mandate and expertise, its contribution to this global effort, namely by:

- extending the IMF's involvement beyond anti-money laundering to efforts aimed at countering terrorism financing;
- expanding its anti-money laundering work, including through FSAPs, to cover legal and institutional frameworks;
- accelerating its program of Offshore Financial Centre assessments, and undertaking onshore assessments in the context of the FSAP;
- helping countries identify gaps in their anti-money laundering and anti-terrorist financing regimes in the context of Article IV voluntary questionnaires;
- enhancing its collaboration with the FATF on developing a global standard covering the FATF recommendations, and working to apply the standard on a uniform, cooperative, and voluntary basis; and
- increasing technical assistance to enable members to implement effectively the agreed international standards.

In addition, the Committee urges further international action to combat the financing of terrorism, and calls for:

- all countries to establish financial intelligence units to receive and process reports of suspicious transactions from the country's financial sector, and to monitor and analyse suspected terrorist funds;

- provisions to ensure the sharing of information and cooperation between national financial intelligence units, building on the work of the Egmont Group; and

- the deployment of technical assistance to ensure that every country can play its part, based on support either bilaterally or through an international trust fund.

Countries are urged to take these measures as soon as possible, preferably by February 1, 2002.

The IMF should report on progress at its spring 2002 meeting, with a full report at its Annual Meeting.

9 The Committee encourages the IMF to continue to strengthen its surveillance and crisis prevention, including through the implementation of standards and codes (and related technical assistance), and emphasizes that these remain key priorities. It calls on the IMF to implement the agreed framework for private sector involvement, and to intensify the ongoing analysis of outstanding issues. It welcomes the progress on improving the effectiveness of conditionality through streamlining and enhancing the country ownership of IMF-supported programs, and looks forward to reviewing progress in this area at its next meeting. Quotas should reflect developments in the international economy. The Committee looks forward to further work on this issue. The Committee looks forward to the Independent Evaluation Office (IEO) finalizing its work program and to receiving a progress report on its activities at the next meeting.

10 The Committee expresses its heartfelt appreciation to Stanley Fischer and Jack Boorman for their eminent records of service to the IMF and deep commitment to the well-being of all its member countries. Both have been pivotal in shaping the role of the IMF in the globalized economy and the evolving international financial architecture.

11 The next meeting of the IMFC will be held in Washington, D.C. on April 21, 2002.

Please send any comments on the contents of this report to:
lindsey.whyte@hm-treasury.gov.uk

Further copies of this document are available from:

HM Treasury
The Public Enquiry Unit
Room 89/2
Parliament Street
London SW1P 3AG

Tel: 0207 270 5607

http://www.hm-treasury.gov.uk

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