



THE UK AND THE IMF 2006

Reform to deliver prosperity for all



HM TREASURY

March 2007



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ISBN 978-1-84532-249-6

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FOREWORD BY THE CHANCELLOR OF THE EXCHEQUER

The world is currently undergoing a rapid and extensive transformation: the sheer scale, speed and scope of globalisation is transforming the global economic order. The challenge for the international community is to ensure that the benefits of this new world order can be shared by not just some but all. We must match our commitment to openness, free trade and flexibility with an equal commitment to creating opportunities for all and tackling poverty around the world.

This emerging new world order cannot work unless we recognise that we are in an age of interdependence. The global public goods on which we depend such as peace, stability, natural resources and the environment can only be secured through cooperation across borders. Therefore, in this new world order, international institutions are more important than ever.

The post 1945 system of international institutions - built for a world of sheltered economies and just 50 states - is urgently in need of reform. The modernisation of the International Monetary Fund is a crucial part of this process and we must ensure that the IMF is fit for purpose in a global economy.

The role of the IMF is to ensure the stability of the whole world economy, with its primary role no longer focused on resolving crises, but preventing them, through the surveillance of our economies. In 2006, the Fund made it clear that it is prepared to take forward the measures necessary to adapt to the changing global environment. Members made a number of commitments to reform and delivery, which must now be embedded in the institution. These include:

- delivery of the multilateral debt relief commitments made at Gleneagles in 2005, providing over \$3.7 billion in debt relief to some of the world's poorest countries;
- a new focus on the principal means of crisis prevention: IMF surveillance. The Fund has initiated a fundamental review with a view to revising the framework that underpins all of IMF surveillance, to make it relevant and effective in a rapidly changing world, and also begun a new approach to multilateral surveillance, taking into account the linkages and spillover effects of one country's policies on others in the global economy; and
- agreement that quotas should be reformed to reflect the changing international economic weight of countries in the global economy, alongside fair voice and representation for low-income countries.

The work of the UK and others through the IMF complements and reinforces the UK's commitment to tackling poverty around the world. In 2006, following our G7 and G8 Presidency in 2005, the UK remained at the forefront of this agenda: taking forward international work to tackle climate change and provide primary education for all; launching the International Finance Facility for Immunisation, which will deliver \$4 billion of front-loaded resources to immunise 500 million children against preventable diseases; and launching a pilot Advanced Market Commitment to tackle pneumococcus. These are significant achievements, but it will be necessary for the IMF and the world community to continue to build on these achievements in 2007.

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



Rt Hon Gordon Brown MP
Chancellor of the Exchequer

REPRESENTING THE UK IN THE IMF



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TOM SCHOLAR
UK Executive Director

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

The day-to-day work of the IMF is conducted by the Executive Board of the IMF. The Board comprises 24 Executive Directors representing all 185 members of the IMF. The UK, as one of the five largest contributors to the IMF, has its own Executive Director - currently Tom Scholar.

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

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

INTRODUCTION

Global stability and prosperity

1.1 The global economy is changing and the interlinkages between economies are strengthening. As a result, multilateralism and the institutions that support it are increasingly important. But as the global economy changes, so the institutions should reform and adapt to new realities. The UK is committed to the objectives of multilateralism and has been a fervent advocate of reform to ensure the continued relevance and effectiveness of the global institutions. This approach is naturally complemented by other UK international economic objectives – specifically to work with development partners to ensure that the benefits of global prosperity are spread to all.

1.2 The IMF is an important component in supporting the UK's strategy. In 1945, countries around the world recognised that to guarantee the global financial stability that underpins growth and prosperity for all, it was necessary for nations to work together in cooperation. The UK has supported this principle, as embodied in the IMF's Articles of Agreement, since the foundation of the institution. However, in recent years, in the context of new challenges, it has sought to encourage the Fund to reform in order to meet its aims effectively in a globalised world.

1.3 In the face of changes to the global economy such as the growth of emerging market economies, increasing international capital flows and greater multilateral spillover effects, the IMF, like other international institutions, has faced difficult questions regarding its role. The UK believes that in 2006 the Fund made significant progress in answering these questions, by focusing on crisis prevention, taking steps towards fundamental reform of the surveillance framework, and addressing governance issues such as quota reform. This report will set out the UK's views on the Fund's approach to these issues, among others.

1.4 This report also sets out progress on debt relief, concessional lending for low-income countries and IMF-World Bank collaboration. It will also explain the UK's wider goals and strategies relating to international poverty reduction in 2006.

Reforming the IMF

1.5 The UK has been at the forefront of calls for reform of international financial institutions, including the IMF, since 1997. In 1998, at Harvard University, the Chancellor called for "a new economic constitution for a global economy, born out of new realities, grounded in new rights and responsibilities, enshrined in codes of conduct that are agreed nationally and applied internationally, rediscovering public purpose in the international economy." Since this time, the UK has promoted reform of the IMF, both at the Executive Board and through the International Monetary and Financial Committee (IMFC). A key component of this approach has been the need to switch the Fund's focus from crisis management to crisis prevention, promoting the policies that deliver long-term stable growth.

1.6 Since 1997, the Fund has adopted a number of UK-supported measures, including the establishment of: the codes and standards initiative, the Financial Sector Assessment Programme, and the IMFC, which has been chaired by the Chancellor since 1999. Shortly after his appointment in 2005, the Managing Director of the IMF, Rodrigo de Rato, recognised the need for a major programme of reform and launched the Strategic Review. The UK fully supported this review, but believed that it would be necessary to go further and faster in order to reinforce the Fund's authority on the international stage. In 2006, the UK believes that the Fund has taken significant steps to achieve this.

Crisis Prevention **1.7** The recognition that crisis prevention should be at the forefront of the Fund's work is central to the IMF's programme of reform, supported by the UK. Chapter 2 sets out significant progress in this area in 2006, including through:

- work on a new framework to underpin surveillance, which is the Fund's foremost crisis prevention instrument. Despite the increasingly significant role of surveillance, this framework was last updated in 1977, when global economic priorities were very different. The UK has long argued that the framework should be revised, to reflect the importance both of domestic, as well as exchange rate policies, and spillover effects. In April 2006, the IMFC proposed that the Fund should take forward options for a revision and that this should be complemented by a remit, setting out the accountability and independence structures for surveillance;
- continuing improvements in the practical application of surveillance, demonstrated by increased publication of Article IV reports and the introduction of the multilateral consultation process; and
- development of an instrument to provide contingent finance to countries with sound policies, who are nonetheless at risk from crises elsewhere. The Fund is now engaging in outreach with the membership on this subject, and the UK welcomes this ongoing work.

1.8 Alongside these key new developments the Fund continued to take forward crisis prevention work through other channels supported by the UK. Approximately three quarters of the IMF's membership are now participating in the codes and standards initiative, and the Fund implemented the 2005 reviews on technical assistance, as well as opening a third regional centre for technical assistance in Africa. Work on improving the Fund's response to crises has also continued, as set out in Chapter 2.

Governance Reform **1.9** Changes in the global economy do not only require the IMF to reform its crisis prevention policies, but also its governance arrangements, to ensure that its advice continues to carry weight with members. Progress on this agenda in 2006 is set out in Chapter 3. This includes:

- the adoption of the Board of Governor's Resolution on Quota and Voice Reform. This set out the framework for a package of reforms to be implemented within two years, starting with ad hoc quota increases for the most under-represented emerging market members of the Fund: China, Korea, Mexico and Turkey. The UK is highly engaged in the continuing reform process and is committed to enhancing the voice and representation of low-income countries;

- the establishment of a Committee of Eminent Persons, chaired by Sir Andrew Crockett, to investigate options for ensuring that the Fund has a sustainable and durable income base with which to finance its running costs in the long-term. The report of the Committee was published in February 2007; and
- further progress on the Medium-Term Budgetary Framework, with a transition budget adopted in 2006-7 as a prelude to the first full medium-term budget for 2007-8.

Delivering for Low-Income Countries

1.10 Growth and development is essential to long-term global financial stability: the UK therefore believes that the IMF's involvement in low-income countries is crucial. 2005 was a year of global commitments to poverty reduction, under UK chairmanship of the EU and G8. In 2006, the focus was on delivering these commitments. Chapter 4 sets out the IMF's role in this, including through:

- the implementation of the Multilateral Debt Relief Initiative (MDRI), agreed in 2005. 23 low-income countries have now benefited and as of September 2006, US\$3.7 billion of debt relief has been delivered. A potential further 19 countries will qualify when they reach Completion Point under the HIPC initiative;
- the introduction of a new approach to supporting low-income members that neither want nor need financial assistance but do want an explicit IMF endorsement of their policies, through the Policy Support Instrument (PSI). Nigeria was the first country to complete a review under the PSI, which led to the cancellation of \$18 billion in debt owed to the Paris Club. This was the largest ever debt relief package for sub-Saharan Africa; and
- the initiation of an External Review Committee on IMF-World Bank collaboration, to ensure that the organisations work together to achieve a comprehensive approach to country needs, while avoiding duplication.

1.11 The UK also delivered on a number of other policy priorities for global poverty reduction in 2006, outside the international financial institutions. These include:

- the launch of the International Finance Facility for Immunisation (IFFIm). Over the next ten years, IFFIm will deliver \$4 billion of front-loaded resources to immunise 500 million children in the world's 70 poorest countries against preventable diseases;
- the launch of a pilot Advanced Market Commitment to tackle Pneumococcus, which currently kills 6 million people a year;
- the announcement that the UK will spend at least £8.5 billion on aid for education over the next ten years, for the first time entering into ten year agreements with developing countries to help finance their education plans; and
- continuing support for a successful conclusion to the Doha Round of trade talks, and the announcement that the UK's total aid for trade is expected to increase by 50 per cent by 2010-11, equating to US \$750 million a year in 2010.

1.12 This report will detail important progress made in 2006, both in reforming the IMF, and delivering on development commitments. However, further work remains to achieve UK priorities and to ensure that the IMF can continue to help all countries meet the challenge of globalisation. Chapter 5 will set out how the UK will expect the IMF to build on this progress in 2007.

Supporting global economic growth by promoting economic stability is the Fund's central purpose. In 2006, the Fund's work on policies to support stability through avoiding disruptive economic crises moved forward significantly, with strong support through the UK. Achievements in 2006 included:

- an agreement to develop a new framework to underpin IMF surveillance, through a review to update the 1977 document that forms the basis of surveillance, supported by an annual surveillance remit;
- the publication of 84 per cent of surveillance reports in 2006, an increase of over 15 per cent since 2000, which has increased the transparency of the Fund; and
- around three quarters of the IMF's membership, 137 countries, are now participating in the standards and codes initiative, which helps countries to strengthen their policy frameworks and institutions to help reduce the likelihood of financial crises.

It is important that these developments maintain momentum into 2007, to further consolidate the Fund's role in crisis prevention. The UK believes that priorities for 2007 should include:

- completion of work on the surveillance framework, including a revision of the 1977 Decision;
- further progress on remit for surveillance before the Triennial Surveillance Review; and
- the development of proposals for a contingent financing instrument that is attractive to potential borrowers while also safeguarding the IMF's resources.

2.1 The IMF's overarching goal is to support international economic and financial stability. This stability is the precondition for national and international prosperity for all. When the IMF was founded, it cast its role in preserving stability in terms of maintaining a system of fixed exchange rates. With the demise of the Bretton Woods system in the early 1970s, its role moved decisively towards the provision of finance and - through the 1980s and 1990s - to trying to ameliorate the consequences of economic crises.

2.2 The UK since the late 1990s has laid a particular stress on strengthening the ability of the international community to prevent rather than resolve crises. Avoiding crises supports long-term stability and prosperity. In this, the IMF's role as a provider of analysis and policy advice to countries about the design and operation of their own national policies and their relationship to each other - its surveillance function - is of vital importance. This chapter sets out UK views on the Fund's crisis prevention activities in 2006, focusing in particular on the agreement to strengthen the Fund's surveillance role. This goes a long way towards meeting the UK's long held key objectives¹ for the IMF.

¹ The UK's long-term objectives have been set out in a number of speeches by the Chancellor, Economic Secretary to the Treasury and the Governor of the Bank of England. Please see www.hm-treasury.gov.uk/newsroomandspeeches, or www.bankofengland.gov.uk/publications/speeches, for further details.

SURVEILLANCE

2.3 The global economy is radically different in the early part of the twenty first century from the one that existed in the middle of the twentieth. The Managing Director's Report on the Fund's Medium Strategy² (also known as the IMF Strategic Review) placed particular emphasis on the importance of IMF surveillance in maintaining stability and prosperity in the global economy. Surveillance is the process of monitoring and consultation by which the IMF has a dialogue with member countries on the domestic and international consequences of their economic and financial policies. The legal basis for IMF surveillance and the responsibilities of members and the Fund are set out in Article IV of the Fund's Articles of Agreement. Surveillance is conducted at three different levels:

- global – including analysis of the world economy through the IMF World Economic Outlook and the Global Financial Stability Report;
- regional – including analysis of key regional economic areas such as the Eurozone; and
- country – the IMF holds what are known as Article IV consultations with each member country about its economic policies. This accounts for the vast majority of surveillance work and most countries take part in consultations on an annual basis.

2.4 In a world in which systemically important countries are unlikely to borrow from the Fund again, and where the potential for economic spillovers is increasing, the external analysis supplied by the IMF makes members more aware of the impact of their policies on domestic and international stability. The UK therefore welcomed the decision to make surveillance the first priority of the Fund's Strategic Review.

Reforming Surveillance

2.5 The Fund's Strategic Review recognised a number of difficulties with both the quality and effectiveness of surveillance at present. The UK supports this analysis and has long argued that reform is needed to both ensure that the analysis of the Fund is technically excellent and that the advice provided by the Fund has influence on policies that are critical to macroeconomic stability. It has been a long-standing principle of the UK that in order for surveillance to maintain credibility, it must be independent, transparent and accountable – and seen to be so. To ensure this, it is therefore vital to revisit and modernise the framework that underlies IMF surveillance.

2.6 The basis for this reform was set out in the communiqué from the International Monetary and Finance Committee (IMFC) meeting in April 2006, contained in Annex D. The Committee recommended a reform with four distinct and complementary elements:

- an increased focus of surveillance on multilateral issues, including global financial issues, and especially the spillovers from one economy on others. This should be the area where the Fund's universal character and analytical strength can add greatest value, yet the Independent Evaluation Office (IEO) report on multilateral surveillance found that only three per cent of the Board's time was spent on multilateral surveillance;

² Details available on the IMF website at www.imf.org/external/np/omd/2005/eng/091505.pdf

- a restatement of the commitments which member countries and their institutions made to each other under Article IV, clarifying how surveillance should focus on monetary, financial, fiscal and exchange rate policy;
- the introduction of a new procedure by the Managing Director for consultations among members on particular issues of multilateral interest; and
- the creation of a new annual remit for bilateral and multilateral surveillance, setting out the accountability and independence structures between the Managing Director, the Executive Board, Staff and members. This would reinforce the commitments of members and ensure mutual accountability for the results of surveillance.

Revising the surveillance framework

2.7 As a crucial part of this reform is the modernisation of the basis of surveillance, Box 2.1 sets out the structure of the this basis – called the 1977 Decision on Surveillance over Exchange Rate Policies. This Decision was adopted at a time of uncertainty in the world economy, following the breakdown of the Bretton Woods system of fixed exchange rates. This framework was designed to be flexible – and it has been highly effective in allowing practice to evolve over the last thirty years. However, the Decision risks being both too narrow in formal terms – dealing only with exchange rate policies and not other domestic policies which contribute to national and international stability; and too broad in practice, not focusing the Fund’s work on its core competences. To be an effective instrument for the international community it is essential that the Decision responds to the realities of the global economy and concentrates the Fund’s efforts on the areas of highest relevance to maintain its central objective of economic stability.

Box 2.1 The Surveillance Framework

The fundamental authority for surveillance is contained in Article IV of the IMF's Articles of Agreement, as amended in the 1970s, following the breakdown of the Bretton Woods par value system. Article IV states the commitment made by members to collaborate with the Fund to ensure external stability. It then sets out the obligation of members to "collaborate with each the Fund and other members to assure orderly exchange rates and to promote a stable system of exchange rates". To achieve this external stability, four obligations are set out, two each relating to domestic and exchange rate policy. The Article then calls for specific principles to be adopted regarding the surveillance of exchange rates. These additional principles were provided in the 1977 'Decision over exchange rate policies' – providing greater certainty over exchange rate obligations at a time of great flux in the global economy. This Decision had four parts:

- General Principles - these clarify that the Decision does not attempt to cover all aspects of surveillance, but deals specifically with exchange rate policies, as set out in Article IV. The UK supports a broadening of this scope in a revised version, so that the Decision reflects the principles relating to surveillance as a whole;
- Principles for the Guidance of Members Exchange Rate Policies (PGMs) – these provide a minimalist description of requirements for both fixed and floating currencies. It was expected that these would be revised as the new exchange rate system became clearer, however, despite the evolution of surveillance over time, this has not yet taken place;
- Principles of Fund Surveillance over Exchange Rate Policies – these list a series of indicators to be used to gauge whether members are abiding by the PGMs; and
- Procedures for Surveillance – these set out the specifics of how surveillance will take place, including Article IV consultations and special procedures.

The text of the original Decision has served the Fund well over the last thirty years and should remain the basis for any revision. However, it makes sense to now expand the scope to cover the whole surveillance process, including both domestic and exchange rate policy surveillance, as they relate to external stability. This way, when the IMF carry out surveillance, they will be able to refer directly to the framework to determine the scope.

A revised Decision 2.8 Through the IMFC, Ministers have stressed the importance they attach to the work currently going on in the Fund with a view to updating the Surveillance Decision. The UK strongly welcomes the work of Fund staff on this issue and the prominence within the Managing Director's work programme. The revised Decision should not impose any additional obligations on members, it should, however, provide an important opportunity for all members to restate obligations under Article IV. The UK supports a revised Decision that:

- is clearly anchored in the notion of external stability - surveillance should focus on the elements of both domestic and exchange rate policy that have the greatest impact on the overall external position of an economy. This also captures the commitments of members under Article IV;

- supports a more thorough conduct of exchange rate surveillance, setting out with greater clarity how the Fund will consider exchange rate policies and signalling that the Fund will be robust in its recommendations to members;
- responds to national circumstances, by grounding surveillance in the statement and assessment of policy frameworks and their consistency with each other. This will provide a better basis for assessing the priorities for external stability, while clearly demonstrating that the IMF supports countries in setting their own priorities and policy instruments;
- reinforces the links between multilateral and bilateral surveillance in the context of increased global spillovers; and
- sets out the requirement for a new annual remit through which the Fund would be accountable to the membership for the quality of surveillance. This will provide increased focus, transparency and independence to the surveillance process.

2.9 A revised Decision would give focus and clarity to the obligations of the Fund and the membership in the conduct of surveillance. To strengthen accountability, it also needs to be complemented by a clearly defined remit. This was set out in the 2006 Annual Meeting communiqué, which stated that a remit would “provide a statement of objectives, priorities, and responsibilities for the medium-term.” Through this statement, a clear framework for independent and accountable surveillance would be provided. The UK believes that a remit is central to surveillance framework reform – allowing member countries to set the priorities for surveillance over a time period, with IMF Staff accountable for delivering them, demonstrably independent of political interference. The UK supports setting the first remit in Autumn 2007. The UK will also continue to build support for moves towards a clear separation of lending and surveillance functions within the Fund.

Multilateral Consultations

2.10 A further significant development in surveillance in 2006 concerned the IMF’s introduction of a multilateral consultation process. This recognised both the increasing importance of international spillovers and the need for the Fund to respond to these in a flexible and ad hoc manner, as well as through standard surveillance procedures. In June 2006 the Managing Director launched a process that would bring together groups of members to discuss particular priority issues. The first multilateral consultation, held at the IMF headquarters in June 2006 was focused on global imbalances and brought together the United States, the Euro-area, Japan, China and Saudi Arabia. The UK believes that this process is a helpful addition to the surveillance reform agenda.

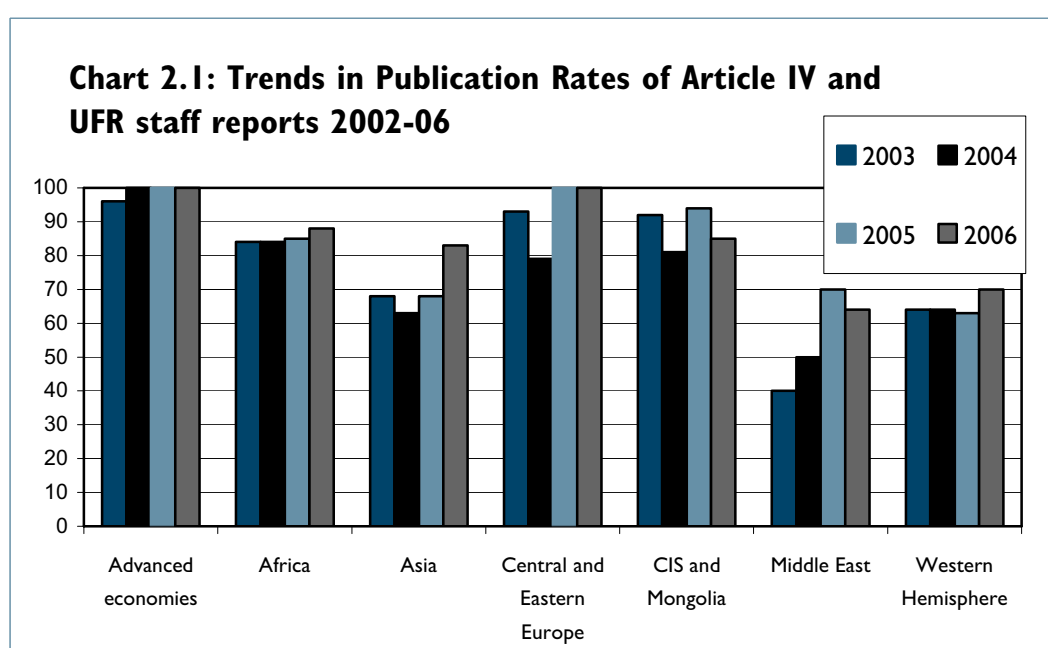
Reforming the practice of surveillance

2.11 A revised surveillance framework should support countries in taking forward the advice provided by IMF surveillance – but advice itself can also be improved directly, as recognised in both the IMF Strategic Review and the 2004 Biennial Surveillance Review³. Since the launch of the IMF Strategic Review Article IV reports have increasingly focused on the key external risks faced by the country in question, making links between multilateral issues and the external stability of the individual country. Financial sector surveillance has long been recognised as a priority area for improvement. In 2006 the Fund moved to strengthen the Fund’s financial sector work, following the recommendations of the McDonagh Review. The McDonagh group will return to review the IMF’s progress in this area and a Board seminar is due to take place in 2007.

³ Details available on the IMF website at www.imf.org/external/np/pdr/surv/2004/082404.htm

Increasing transparency

2.12 Increased transparency relating to IMF surveillance is important to enhancing the credibility and accountability of the process. Transparency acts a device through which the work of Fund Staff is exposed to external scrutiny, strengthening the incentives to excellence. It also enriches the policy debate in member countries and consequently the influence of the Fund's policy advice. Over recent years there has been impressive progress in this area, following agreement in 2003 on a new IMF transparency policy that included voluntary but presumed publication for Article IV country papers. This took place on the basis that publication of IMF analysis both supports an improvement in quality of IMF advice and increases the traction of surveillance by giving wider exposure to IMF recommendations. Publication of Article IV and Use of Fund Resources (UFR) reports has since increased dramatically, from 67 per cent between 2001 and 2003, to 84 per cent in 2006. Chart 2.1 below shows how the publication rate has altered over the last four years in different areas of the world.



2.13 Chart 2.1 shows that progress on transparency policy has varied across different regions over the last four years. There has been steady progress in Africa, Asia, Central and Eastern Europe and the Western Hemisphere (Latin America), however, there is scope for further improvements in the publication rates of the CIS and the Middle East. A fifth of all reports remain unpublished and the UK continues to regard progress in this area as a priority.

Surveillance in 2006

2.14 In 2006, 122 Article IV reports were brought to the IMF's Executive Board for peer review, as well as two editions of the World Economic Outlook and Global Financial Stability Report and a number of regional surveillance reports. As set out above, the UK was pleased to note improvements since the start of the Strategic Review process, but recognised that there is still progress to be made.

The UK approach at the Executive Board

2.15 The nature of UK interventions in surveillance discussions at the Executive Board varies depending on the regional circumstances and the level of economic development in the given country, however, the UK applies certain principles in all cases. In line with the agenda for surveillance reform, in each Article IV discussion the UK considers whether the report has focused satisfactorily on the most important issues for a country's external stability and whether the UK believes this analysis to be sound. In this context, there are a number of issues that the UK will consider:

Macroeconomic outlook and vulnerabilities:

- Is there an explicit discussion of the risks to the external position of the country under review, from both external and internal factors?
- Have the key vulnerability assessments and the balance sheet analysis been integrated into the main body of the Article IV report?
- Does the report consider debt sustainability? Have alternative scenarios been used in the presentation of these risks and vulnerabilities, and has their potential impact been qualified?

Macroeconomic policy frameworks:

- Is the current fiscal framework appropriate and could the country benefit from some form of fiscal rule? Is the monetary framework effective?
- Have structural reforms that impact on the external position been identified and effectively implemented?
- How transparent are the macroeconomic policy frameworks? Have alternative macroeconomic policy frameworks been analysed?

Exchange rate regime:

- Is there a clear identification of the exchange rate regime?
- Does the report consider the adequacy and sustainability of the exchange rate regime?
- Have staff used an appropriate range of indicators to assess external competitiveness?
- Has the policy dialogue between staff and the authorities on the exchange rate been fully presented?

Financial sector issues:

- Does the Article IV assess the key vulnerabilities in the financial sector?
- Is the country suitable for a ROSC/ FSAP? If they have undertaken one, how do they plan to implement the recommendations? Could they be eligible for FIRST funds?

2.16 UK interventions on low- and middle-income countries also emphasised the need for IMF surveillance to assess progress towards meeting the UN Millennium Development Goals (MDGs). For low-income countries, the UK also concentrated on the need for effective public expenditure management, for resources to be allocated towards pro-poor expenditure, the need for improved donor co-ordination including IMF-World Bank collaboration, and whether the country has an external financing gap and a need for more resources to assist progress towards the MDGs. In surveillance of advanced economies, the UK supported IMF work on monitoring trade policies, and encouraged progress towards the 0.7 per cent aid ratio.

UK Article IV 2.17 The UK is committed to the bilateral surveillance process as it applies to the UK. An IMF mission visited the UK to conduct its 2006 Article IV consultation in December 2006. In its concluding statement, issued following the visit, the IMF delegation noted that “macroeconomic performance in the United Kingdom remains impressive. The growth of investment, productivity and output has rebounded from a softer 2005”. The statement further noted that “macroeconomic policy frameworks are supportive: they have contributed to the good performance and are guiding policies in ways that are responsive to the requirements for strong growth with low inflation.” Looking ahead, the statement predicts that the strong GDP growth of the last year is expected to continue, but that the UK authorities need to remain alive to both the global and domestic risks to this favourable outlook. The IMF Executive Board discussed the Article IV in February 2007. The concluding statement of the IMF mission can be found in Annex C, whilst further information about the IMF surveillance of the UK is available on the IMF website⁴. In line with UK priorities for surveillance reform, the UK values the findings of the UK Article IV and publishes them.

CRISIS PREVENTION

2.18 The IMF Strategic Review recognises surveillance as key to crisis prevention, however, it is not the only means of crisis prevention. In recent years, the UK has supported a number of important initiatives, to build the institutions of developing countries and therefore their ability to avoid crises, and promoted the use of contingent financing as a means of preventing future crisis contagion.

Building institutions and capacity

Technical Assistance 2.19 Technical assistance accounted for 29 per cent of the IMF’s budget in 2006 and continued to play a crucial role in helping low-income countries strengthen their economic institutions. This not only contributes to crisis prevention, but to economic development in low-income countries, via a more stable and robust economy. Technical assistance is one of the benefits of IMF membership, provided free to countries that have requested support. Technical assistance is funded primarily by the IMF, with contributions from a range of bilateral and multilateral donors, including the Department for International Development (DfID), which will provide around \$3 million per annum in the years 2006-09.

⁴ Available on the IMF website at www.imf.org/external/country/GBR/index.htm

2.20 In 2005, two reviews⁵ put forward recommendations relating to technical assistance, which supported UK principles that there should be a more co-ordinated and integrated approach to assistance, where priorities are established through Poverty Reduction Strategy Papers. The UK was pleased to see the implementation of this review in 2006. The UK also welcomes the addition of a third regional centre for technical assistance in Africa, in March 2006 - Technical Assistance Regional Centres have provided a more regional, tailored approach to delivery of technical assistance to countries with similar economic and institutional problems.

Standards and Codes

2.21 The adoption and implementation of internationally agreed standards and codes can help countries to strengthen their policy frameworks and institutions to help reduce the likelihood and impact of financial crises. The Standards and Codes initiative, launched in 1999, was therefore an important step in strengthening the international financial architecture. Under this initiative, there are 12 individual standards and codes, devised by the IMF and World Bank with the aim of providing clear and transparent benchmarks of good practice; the five financial sector modules are usually undertaken within the framework of the Financial Sector Assessment Programme (FSAP). Observance of these standards and codes is examined by Fund and Bank staff and summarised in Reports on the Observance of Standards and Codes (ROSCs), which are then routinely referred to in Article IV surveillance reports.

2.22 The UK remains a strong advocate of the standards and codes initiative and has been pleased to see further progress in this area in 2006. In December 2006, 137 countries, around three quarters of the IMF's membership, had participated in the initiative, up from 126 in October 2006 and 109 in June 2004. 914 individual assessments, reassessments and updates had been produced, up from 724 in April 2005. Over three quarters of these assessment, reassessments and updates have been published. Despite this success, however, the UK believes that more effort is needed to encourage further countries to participate and to better integrate ROSCs into Fund surveillance and technical assistance.

2.23 The UK itself is committed to undertaking all 12 modules – eight have been completed to date and the UK is now working with the World Bank on completing both the accountancy and auditing ROSC and the corporate governance ROSC. The importance of the initiative to the UK is shown by the fact that it forms part of HM Treasury's Public Service Agreement (PSA) targets⁶. Objective V, target 8 commits the Treasury to promoting increased global prosperity and social justice in a number of ways, one of which is through the standards and codes initiative. As shown by the figures for participation, progress towards this target continues to be strong and steady.

Anti –money laundering and counter-terrorist financing

2.24 The financing of crime and terrorism is a global challenge. In responding to this challenge the international community has prioritized work to combat money laundering and the financing of terrorist groups. The UK has worked with its international partners in 2006 to enhance further the global implementation of the 40 + 9 Recommendations on anti-money laundering/counter terrorist financing (AML/CTF) developed by the Financial Action Task Force (FATF), the international standard-setter. These standards provide the basis to safeguard the integrity of financial systems and enable co-ordinated action at the international level to disrupt the financing of terrorism and criminality.

⁵ Details are available on the IMF website at www.imf.org/external/np/exr/facts/tech.htm

⁶ Details are available on the HM Treasury website at www.hm-treasury.gov.uk/documents/public_spending_and_services/publicservice_performance/pss_perf_technote.cfm

2.25 The IMF has an important role in the evaluation and assessment of the implementation of these standards. In 2006, the IMF has continued its country surveillance activity contributing to assessing the AML/CTF safeguards in place, identifying technical assistance needs, and evaluating assistance that has been provided. In April 2006 the IMFC reaffirmed its commitment to this work, calling for “continued actions by all countries to develop strong programs on anti-money laundering and combating the financing of terrorism, and continued support for comprehensive assessments of these programs within the context of the Financial Sector Assessment Program”. The UK welcomes the commitment to AML/CTF work as a long-term activity. From July 2007 the UK will hold the Presidency of the FATF and we will use our Presidency to encourage further cooperation between the FATF and the IMF.

Contingent Financing

2.26 Since the Asian financial crisis in the late 1990s, the Fund has considered how it can best use its financial facilities to promote the strengthening of domestic policies and to protect countries with essentially sound policies from the impact of crises elsewhere. The UK has been a key supporter of these objectives and has supported Fund work to design a new instrument to achieve them following the decision not to continue with the Contingent Credit Line in 2003. The UK continues to believe that there is a need for a liquidity instrument for emerging markets that have implemented strong policies but may nonetheless be vulnerable to external financial shocks. This would be a natural complement to improvements in surveillance.

2.27 As part of the Strategic Review, the Fund’s Managing Director called for consideration of a new financing instrument for crisis prevention. This instrument would aim to provide substantial contingent financing and would be available to members with strong macroeconomic policies, sustainable debt, and transparent reporting, but that still face balance-sheet weaknesses and vulnerabilities. An example of a possible instrument, referred to as the Reserve Augmentation Line (RAL), has been discussed at the Board. The Fund has also engaged in outreach, both to assess the membership’s interest in adding such an instrument to the Fund’s toolkit and to solicit views on its appropriate design. The UK believes that a new liquidity instrument should have the following features:

- well defined entry criteria to promote the strengthening of policy;
- sufficient financial size to provide a positive signal and prevent crises;
- the ability to provide timely access to finance, since capital account crises, by their nature, evolve quickly and the speedier the potential disbursement the more credible the signal;
- certain access to finance; and
- protection for the Fund’s finances.

2.28 The UK welcomes the ongoing work of the IMF to design such an instrument, in consultation with potential customers. The RAL proposal goes a long way towards meeting the key aims of speed, size and certainty in the access to finance. The key challenge in 2007 will be to design an instrument that it is attractive to potential borrowers but at the same time able to adequately safeguard the IMF’s resources.

Preventing crisis escalation

2.29 Although the primary aim of the Fund is to prevent crises before they occur at all, and although there have been fewer crises in recent years, it nonetheless remains important to ensure that the Fund is prepared to act to both prevent any future crisis from worsening and to resolve crises effectively in the future. Chapter 3 sets out the details of the Fund's lending mechanisms – to ensure that these mechanisms work effectively, the Fund has made progress in a number of areas in recent years.

Exceptional access framework **2.30** The amount a country can borrow from the IMF is based on access limits. Normally, access to IMF resources is limited to 100 per cent of a member's quota within any 12 month period and a cumulative limit of 300 per cent of quota. However, in certain cases, access can exceed this limit under the Fund's exceptional access framework.

2.31 The exceptional access criteria were developed for capital account crises. However, in practice, the Fund has provided exceptional financing even when needs did not relate to an ongoing capital account crisis, most recently in Turkey and Uruguay. While the guidelines allow this, the fact that the criteria do not apply has led to perceptions that decisions are ad hoc and unpredictable. As part of the Managing Director's Strategic Review, the IMF Board will consider the exceptional access framework and how coverage of non-capital account cases could be clarified in Summer 2007. Though not used in 2006, the UK continues to support the exceptional access framework and its rigorous application and welcomes the review of the framework for non-capital account cases.

Debt restructuring framework **2.32** Sovereign debt crises entail significant economic costs for all parties. In recent years, the UK has been at the forefront of efforts by the international community to improve the framework for crisis resolution through debt restructuring. Progress has been made in two areas. Firstly a set of voluntary Principles⁷ for debtors and creditors was agreed in 2004, and secondly, Collective Action Clauses (CACs) in international bonds were adopted, allowing a qualified majority of bondholders to agree changes to the terms of a bond with the issuer. These have become the market standard for bonds issued under New York law (as was already the case under English and Japanese law). The UK continues to support further progress in this area.

Lending into arrears **2.33** Following a sovereign default to private creditors, a key question facing the IMF is whether to extend new loans to the debtor. In this it is guided by the Lending Into Arrears (LIA) policy – as part of the Strategic Review, the Fund is re-assessing this role, along with its broader aims on debt restructuring. An informal seminar will take place at the Fund in early 2007, with the aim of clarifying the scope of a subsequent Board review. The UK believes that a comprehensive review of the LIA policy is needed and that the policy should be reformed within the broader context of a reassessment of the way in which the IMF engages with debtor countries that are in arrears.

⁷ Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets

Capital account liberalisation **2.34** The UK believes that the liberalisation of the capital account can yield essential efficiencies and benefits. However, countries opening their capital account should proceed prudently in order to avoid excessive volatility of capital flows. Fund advice in this area should be based on the individual circumstances and priorities of the country concerned, reflecting the broader macroeconomic, financial and structural situation. The UK believes that Fund advice should have a strong analytical base and as such welcomes the work the Fund has undertaken on this issue to date. The IMF's Seventh Annual Research Conference in November 2006 discussed the issue of how capital account liberalisation affects economic growth and the UK looks forward to further research of this topic.

The IMF must respond to changes in the global economy in both its actions, as outlined in Chapter 2, and also in its governance and management. To achieve this, it must not only be governed effectively but be seen to be governed effectively. A number of reforms to improve the organisation of the Fund and to increase its legitimacy took place in 2006, including:

- the Resolution of the Board of Governors on Quota and Voice Reform, setting out a framework for a package of reform to be implemented within two years, including immediate increases in quota for the four most under-represented members of the Fund;
- the establishment of an Investment Account, to diversify the Fund's source of income, and the Committee of Eminent Persons, chaired by Sir Andrew Crockett, to consider more medium-term solutions to the IMF's budget shortfall; and
- further progress on the Medium-Term Budgetary Framework, with a transition budget adopted for 2007-8.

It will be important for the IMF to build upon this progress in 2007, by:

- developing a quota reform package which reflects the weight and role of countries in the global economy, and enhances the voice and participation of low-income countries, to be finalised no later than the 2008 Annual Meetings;
- responding to the Committee of Eminent Persons report on Fund financing and developing an appropriate package of financial reform; and
- finalising the first full medium-term budget for 2007-08.

3.1 The IMF's ability to support its membership in delivering national and international prosperity depends on it providing excellent and credible advice. For this advice to carry weight, the Fund as an institution must not only be run effectively, but must be seen to be run effectively, with governance representing the legitimate views of members. The IMF's Strategic Review recognises widespread concerns around both the governance and financing of the Fund; progress on both of these areas in 2006 is set out in this Chapter.

IMF GOVERNANCE

3.2 The governance structure of the IMF has remained largely unchanged since the institution was founded over sixty years ago. As shareholders of the IMF, each member country appoints Governors to the Fund. The full Board of Governors assembles at the Annual Meetings every autumn and governors vote on a limited number of major decisions. However, much of the ongoing oversight of IMF management and staff is undertaken by the Executive Board, composed of 24 Executive Directors. Executive Board meetings are chaired by the Managing Director of the IMF and is in continuous session in Washington DC, meeting as often as needed. Information relating to the UK's voting record in 2006 is contained in Annex A.

3.3 In addition to their representation day to day through the Board, a committee of governors, formalised in 1999 as the International Monetary and Financial Committee (IMFC) meets twice a year to discuss IMF policies and provide strategic direction to the work programme of the IMF. The Chancellor of the Exchequer is the current chair of the IMFC and communiqués from the last two meetings can be found in Annexes D and E.

Quotas and Voice Reform

3.4 The changing nature of the global economy and the need for institutions to adapt to meet their core objectives has led to a new focus on the issue of representation within the major international financial institutions. 2006 saw the start of a major reform process addressing this issue within the IMF, as part of the Fund's Strategic Review. There is wide agreement by members that as the IMF is a global institution, with near universal membership, members' representation should broadly reflect their economic weight. In addition, members have recognised for a number of years that the voice and representation of low-income countries needs to be strengthened (see Box 3.1). The UK has strongly supported the process for meeting these objectives. This is being taken forward comprehensively, including through voting power, access to Fund resources and representation at the Executive Board.

Board of Governors' Resolution on Quota Reform

3.5 A key element of this process has been voting power. IMF quotas serve three purposes: they provide the basis for determining members' financial contribution to the Fund and access to financial resources from the Fund, and set relative voting power in the institution. The sum of members' quotas also determines the size of the IMF's total lending capacity – see Annex B for more information on the financial relationship between the UK and the Fund. Quotas are reviewed by the Fund at least every five years, although the Fund's Articles allow adjustments to take place outside this fixed cycle. The distribution of quotas has been supported by the results of formulae that use a range of economic variables including the capacity to contribute resources to the Fund and the potential need to access them.

3.6 The distribution of quotas tends to change only slowly and at irregular intervals. As a result, the distribution of quota shares and consequently voting weights within the Fund have not reflected changes in the world economy in recent years, notably the rapid growth of some emerging market economies. There have also been long held concerns about the usefulness of the formulae that have been used to guide the distribution of quotas. In response to this, at the 2006 Annual Meetings, a large majority of the membership adopted the Board of Governors' Resolution on Quota Reform. This Resolution, which was fully supported by the UK, sets out the framework for a package of reforms to be implemented within the next two years. The initial stage of the reforms involved ad hoc quota increases for the most clearly underrepresented members of the Fund: China, Korea, Mexico and Turkey. These ad hoc increases addressed the most pressing imbalances, but were limited to ensure incentives for the more fundamental reforms in the package are preserved.

Further reform in 2007

3.7 A key element of the reform package will be the agreement of a new quota formula to provide a more transparent basis on which to assess the distribution of quotas. These discussions are ongoing in the Executive Board within the parameters defined by the Board of Governors' Resolution, which calls for a significant increase in the weight given to GDP and notes an important role for openness to trade. The resolution stressed that these discussions must be concluded by the Annual Meetings in 2007. A second round of ad hoc increases will follow agreement on the formula and under the terms of the resolution must be implemented by the 2008 Annual Meetings. The UK is highly engaged in the reform process and believes that a successful conclusion to this is important to safeguard and enhance the IMF's effectiveness and credibility.

3.8 In addition to reform of the quota system to reflect developments in the world economy, the Resolution includes – most importantly – the objective to, at a minimum, protect the voting power of the smallest and poorest members of the IMF. In addition to their quota share all members of the IMF have a portion of their voting power determined as a right of membership. This 'basic vote' is the same for all countries and is most important for small economies. The proportion of the total votes in the Fund accounted for by basic votes has reduced from 11.3 per cent at the foundation of the Fund to 2.1 per cent today. The resolution states that basic votes should be at least doubled as one way of achieving the objective to, at a minimum, preserve the voting power of low-income countries. As set out in Box 3.1, the UK is firmly of the view that low-income voting share should rise as a result of this process of reform.

Box 3.1 Low-income countries and governance reform

The UK believes that quota and voice reform is necessary not only to better reflect the changing economic weight of countries within the global economy but also to address the need for greater representation for low-income and transition countries. These countries form the bulk of the call on Fund resources and it is therefore important for the legitimacy of the Fund, that they are able to have sufficient voice within its structures. At the March 2002 International Conference on Financing for Development, in Monterrey, Mexico, all governments committed to finding ways of enhancing the voice of developing and transition countries in the international financing institutions, including the IMF. The UK believes that it is important to honour these commitments.

A number of measures to enhance low-income country representation are suggested in the IMF's Governor's Resolution passed in September 2006, the most significant of which is an increase in basic votes. The IMF's Articles of Agreement allocate a set amount of basic votes to each member, irrespective of their quota or economic weight. As each country has the same basic vote allocation, raising that allocation will increase the relative voting power of the IMF's smaller or poorer economies. The Resolution calls for at least a doubling in basic votes to at minimum preserve the existing voting power of low-income countries. The UK supports efforts to increase their voting power and to introduce a mechanism that maintains the ratio between basic votes to total voting power following its increase. The UK also supports the additional operational measures mentioned in the Resolution including strengthened capacity of the African offices at the Fund and increased dialogue between the Fund management and African Ministers.

FUND FINANCES

3.9 To be effective the Fund needs to have sufficient financial resources to meet the demand from members for loans. In addition, to function, the Fund's budget must be sufficient to meet its operating costs. Lending and the Fund's budget are linked since the Fund's day-to-day operations are financed by the rate of charge paid by debtor countries. By 2006 it became clear that the Fund had entered a period of fewer lending operations – in itself a positive development, but one that has raised wider questions about how the Fund itself should be financed in the medium-term.

IMF Lending in 2006

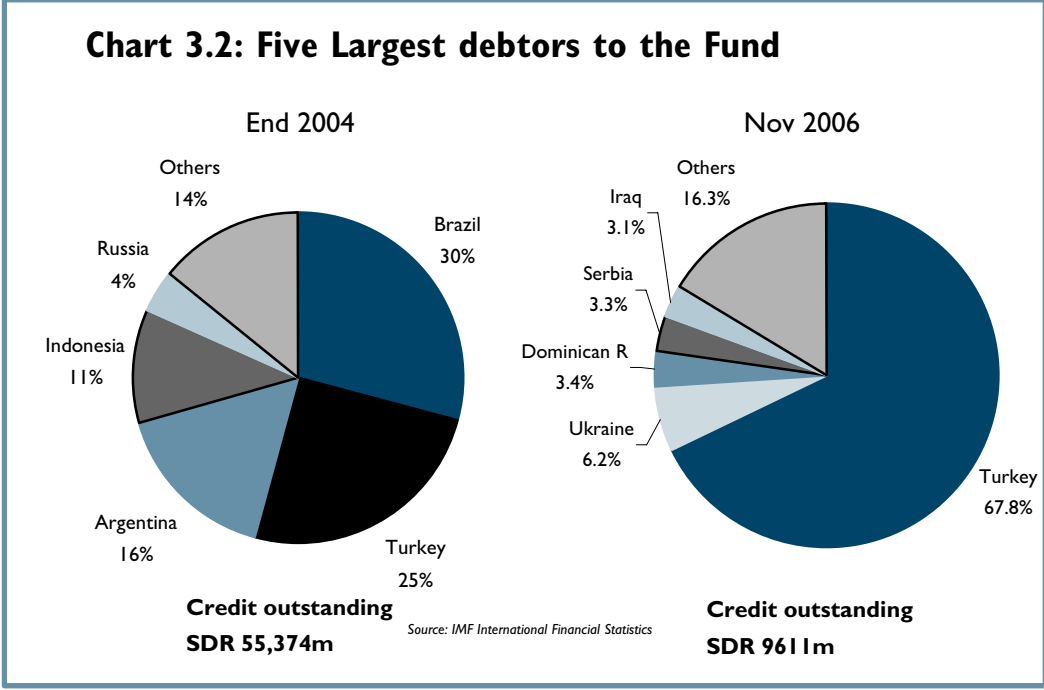
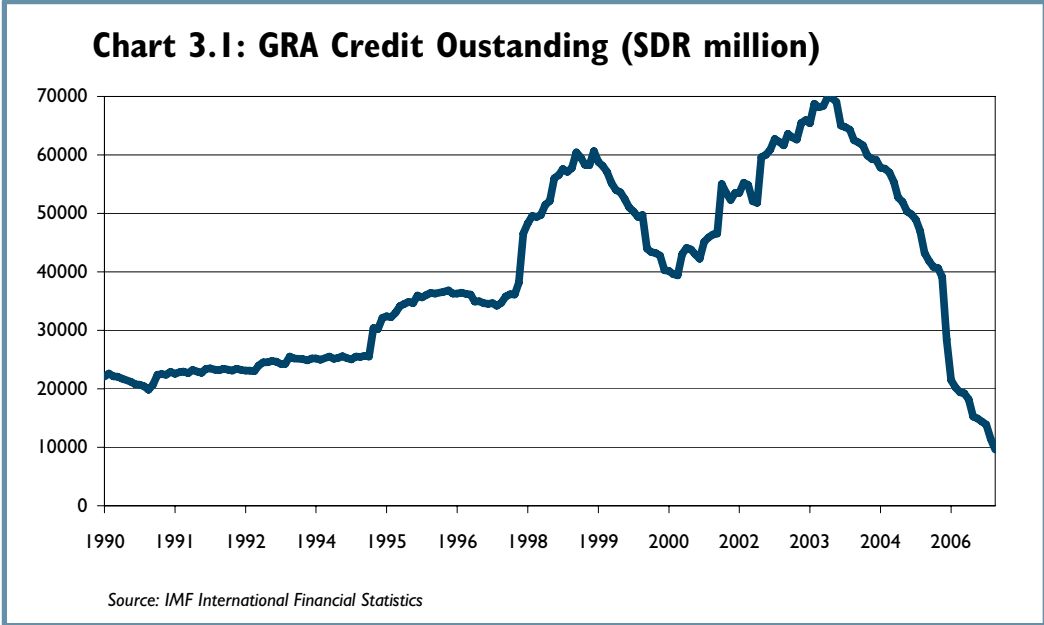
3.10 The Fund's lending operations are financed by drawing on the reserves provided to the Fund through the quota system. An explanation of how this system works and the UK's position within it, as a creditor, is contained in Annex B. IMF lending arrangements are conducted through a number of facilities, including the core facility: the Stand-By Arrangement (SBA). Concessional lending to low-income countries is provided through the Poverty Reduction and Growth Facility (PRGF), which is covered in more detail in Chapter 4.

3.11 The majority of IMF lending is financed through the General Resource Account (GRA) of the IMF, while concessional lending is paid for through various trust fund arrangements such as the PRGF Trust Fund. At the beginning of 2006, following the early repayments of Argentina and Brazil, the total credit outstanding to the GRA stood at around SDR⁸ 20,000 million, down from around SDR 53,000 million at the start of 2005. By the end of 2006, Turkey accounted for over two thirds of outstanding lending, with outstanding credit owed to the Fund of SDR 6,510 million. Turkey's SBA is due to run until May 2008 and the Executive Board approved the fifth review of the programme in December 2006.

Current liquidity and income position

3.12 Repayments by members throughout 2006 meant that total outstanding lending by November 2006 was around SDR 9,000 million and only six countries had an IMF SBA programme in operation. The following charts demonstrate how far the total credit outstanding to the IMF has fallen in recent years. Chart 3.1 shows how credit outstanding to the GRA had fallen by the end of 2006, from a peak of SDR 69,000 million in 2003. Chart 3.2 shows the make-up of the Fund's income position, at End 2004 and End 2006, demonstrating how the Fund has come to rely on only a few countries for its day-to-day resources.

⁸ Special Drawing Rights (SDRs) are the IMF's unit of account. The SDR exchange rate is based in movements in the dollar, euro, sterling and yen. In December 2006, the sterling/SDR exchange rate was 0.76 on 31 December 2006. As the sterling/SDR exchange rate alters over time, but IMF programmes are denominated in SDRs, the SDR provides the clearest picture of the IMF's lending over time.



The UK's approach to lending

3.13 The Executive Board acts on the principle of consensus in its lending decisions. However, the use of members' assets as the basis for Fund lending gives Executive Directors a fiduciary responsibility to their taxpayers and the UK, like other countries, also considers it a priority to ensure that programmes are of maximum benefit to the programme country and their citizens.

3.14 In 2006 Paraguay was the only country to request access to an IMF SBA programme. The UK supported Paraguay's request, after assessing programme design against factors related to the need to promote not only macroeconomic stability, but also sustainable economic growth and poverty reduction in Paraguay – the Executive Board extended an SBA programme to Paraguay in May 2006. In all Board discussions on SBA lending, the UK tries to ensure that assessments of monetary and fiscal policy and financial sectors are robust, that the programme is sustainable and that there are appropriate assumptions regarding private sector involvement.

Financing the running of the IMF

3.15 The fact that fewer countries had debts outstanding to the IMF in 2006 than in previous years, as set out above, is a positive development, indicating a lack of financial crises in the global economy. However, as IMF running costs are financed through the rate of charge on loan payments, what has been good news for the global economy has created difficulties for the finances of the Fund itself. In 2006 there was broad agreement that the Fund needed to consider the options for generating income from other sources.

IMF Financing Reform

3.16 The lower level of debt interest payments in 2006 led to an anticipated shortfall of SDR 60 million in the 2006-07 IMF budget, revised up to SDR 70 million in December 2006. It is expected that this shortfall will increase in future years, following further repayments and in the absence of further borrowing from large emerging market economies. While it is possible that part of this downturn is merely cyclical, there is broad agreement that the trend will continue in the long-term, as emerging market economies continue to become more credit worthy and build reserves. In 2006, the IMF's membership, including the UK, recognised that it would be necessary both to take short-term measures to guard the Fund's immediate budget and to consider long-term options for financing the organisation.

3.17 To deal with the immediate shortfall in 2006, the Fund responded both by temporarily suspending reserve accumulation and by setting up an Investment Account. This account, sanctioned by the Fund's Articles of Agreement, utilises the reserves held by the IMF in the GRA and invests them in a range of low risk financial assets, generating income that can then be used to meet some of the IMF's operational costs. This Fund was set up in April 2006, and holds almost SDR 6,000 million in reserves. Of this, approximately SDR 390 million was provided by UK reserves - the impact of this on total reserve holdings was offset by selling an equivalent amount of foreign currency (further details are provided in Annex B). However, the investment account is only part of a long-term solution, as it is limited to the size of the IMF's current reserves. For this reason, the Fund's Managing Director set up a Committee of Eminent Persons, chaired by Sir Andrew Crockett, to investigate medium-term options for Fund financing.

Box 3.2: The Committee of Eminent Persons

In response to the recognition by members that the IMF's income is likely to continue decreasing, in May 2006 the Managing Director announced the appointment of a Committee of Eminent Persons, to provide the Fund with an independent view of the available options for ensuring that it has a sustainable and durable income base with which to finance its running cost over the long term.

The Committee was chaired by Sir Andrew Crockett, President of JP Chase International, and its members included Alan Greenspan, the former Chairman of the Federal Reserve Board, Jean-Claude Trichet, President of the European Central Bank, and the Governors of the central Banks of South Africa, Mexico and China. Sir Andrew met with finance ministers of IMF member countries and the Committee's report was presented to the Executive Board in January 2007.

In its report, the Committee emphasised that the Fund should link the sources and uses of finances and suggested that it was helpful conceptually to think in terms of three categories of Fund activity: credit intermediation, provision of public goods and bilateral services. The report does not recommend the precise amounts to be raised but makes suggestions for potential sources of revenue, including: broadening the Fund's investment mandate for existing reserves, using quota resources for additional investment, selling a proportion of the IMF's gold to create an endowment, and identifying the full costs of bilateral services.

3.18 The UK supports the work of the Committee of Eminent Persons and has a number of principles that it believes should be applied to any future financing arrangement for the IMF, including:

- a stable flow of income from more diverse sources. This should avoid income volatility that makes it difficult to plan future Fund activities;
- decisions on income and expenditure should be taken within an integrated framework – i.e. financial constraints should be taken into account when determining expenditure and reduced expenditure should be considered as part of the solution;
- the system should be more simple and transparent, minimising the degree of cross-subsidisation;
- it should avoid the incentive problem at present, whereby the Fund could be tempted to lend more to cover running costs; and
- it should address what is increasingly viewed as an inequitable distribution of the Fund's financing burden, in which a small number of lower-income countries are responsible for the financing of the organisation.

3.19 In 2007, the UK will respond to the Committee's recommendations in line with these principles.

The IMF Budgetary Framework

3.20 Until recently the IMF annual budget has been set without a medium-term framework. The UK has long advocated the adoption of such a framework, similar to that taken by some IMF member countries and other international financial institutions. This is more important in the context of declining lending. As part of the Strategic Review, the Fund is now in the process of developing a new Medium-Term Budgetary Framework (MTBF), which the UK strongly supports. The UK believes that a medium-term budget for the IMF should have the following features:

- the integration of resource and expenditure decisions, to ensure that the activities of the Fund represent its financial position;
- the prioritisation of Strategic Review issues through the budgetary framework – there was already evidence of this in the 2006-7 budget; and
- clear objectives and performance indicators, that reflect the quality as well as the quantity of the IMF's work, linking back to the Fund's overall objectives.

3.21 The Fund made significant progress on each of these issues in 2006 and was able for the first time to take set out indicative budgets for the following two financial years, when setting the budget for 2006-7. It was not, however, possible to consider all elements of the budget over three years – the 2006-7 budget therefore marked a transition between previous systems and the implementation of the complete Medium-Term Budgetary Framework.

3.22 Staff salaries and compensation constitute 70 per cent of the Fund's budget. The Fund's Employment Compensation and Benefits Review (ECBR) considered improvements to the system through which salaries and benefits are determined. The UK believes that the Fund should: have a simple and transparent employment and compensation framework that allows it to respond more flexibly to the changing strategic demands placed on it; make better use of the skills of mid-career expertise; and improve the systems for rewarding excellence and managing poor performance whilst promoting diversity. The ECBR took some steps towards this and succeeded in reducing overall administrative costs, however, the UK continues to support further efforts in this area, particularly in matching the Fund's salary structure more clearly to the market realities.

The IMF Budget for 2007

3.23 The Fund is on course to implement the first complete medium-term budget for the financial year 2007-08. The UK is pleased to note that this is likely to seek to reduce the Fund's budget by one per cent in real terms, measured against an external deflator, for each of the three years from 2007-08 onwards. The UK supports this policy. However, the UK also believes that it will be necessary for the Fund to make a more fundamental examination of expenditure, when it considers the recommendations of the Committee of Eminent Persons on Fund financing in the medium-term.

IMF Risk Management **3.24** The Fund is a distinctive financial institution and, by its cooperative nature, has limited discretionary control over the make up of its loan portfolio. There is a tendency for credit outstanding to be concentrated in a few member countries. However, the recent concentration in the Fund's lending portfolio has highlighted the need for the Fund to adopt a modern and credible risk management framework, encompassing strategic, core mission, financial and operational risks. This should, based on rigorous analysis, anticipate key risks going forward and consider possible strategies to mitigate their impact. The UK has consistently stressed the need to improve the Fund's ability to assess and manage risk and in 2005 the IMF set up a Task Force to look at these issues. The Task Force has now produced its first reports, and the UK broadly supports the measures put forward. However, the UK believes that there is still scope for the IMF to go further in conforming to international best practice.

THE INDEPENDENT EVALUATION OFFICE (IEO)

3.25 The IEO was set up in 2001 with the aim of improving the effectiveness and credibility of the IMF by carrying out thorough and objective evaluations on issues relating to the Fund's work. Being fully independent from IMF management and staff means that the IEO should be able to offer a non-biased view of the IMF's operations in key areas. In 2006, the IEO produced a number of helpful reports, as set out in Box 3.3 below.

Box 3.3: IEO Reports in 2006

During 2006, the IEO undertook a number of reports into different elements of the IMF's activity and provided a number of useful conclusions to the Board. The topics that it chose to focus on included:

- an assessment of the effectiveness of the Financial Sector Assessment Programme (FSAP) was published in February 2006. The IEO concluded that the FSAP had led to a significant improvement in the quality of financial sector surveillance – however, there is scope for further enhancing incentives for participation, strengthening FSAP quality and working even more closely with the World Bank on this issue; and
- the effectiveness of multilateral surveillance. This report, published in April 2006, concluded that while the Fund's individual multilateral surveillance products are impressive, they are insufficiently integrated, with messages not well communicated. A number of recommendations were taken up by the Executive Board, in line with the overall surveillance reform strategy.

The UK believes that these reports highlighted important issues that should be taken forward by the Fund. In 2007, the IEO is due to publish reports on Structural Conditionality, and IMF advice on Exchange Rate Policy. The UK looks forward to their conclusions.

3.26 In 2006, the IEO itself was itself subject to review, for the first time since its establishment, by an External Evaluation Panel. The review panel made recommendations for improving the IEO's effectiveness further in fulfilling its mandate. The UK has been a keen supporter of the work of the IEO since its creation and looks forward to the implementation of the committee's recommendations to ensure that the IEO's topics are fundamental to how the IMF performs its mandate, its staff are able to bring a sufficiently wide range of experience to their evaluation, and that there is a more systematic approach to following up its recommendations. This should enable the IEO to play a key role in influencing both IMF activity and the perception of the IMF.

4

THE IMF IN LOW-INCOME COUNTRIES

2005 was a year of global commitments to poverty reduction. Important steps were taken by the EU and G8, under UK chairmanship, to helping the poorest countries achieve the Millennium Development Goals. 2006 saw progress in delivering these commitments. In the IMF this meant:

- the implementation of the Multilateral Debt Relief Initiative (MDRI), now delivering US \$3.7 billion in debt relief to 23 low-income countries;
- the introduction of a new approach to supporting low-income members that neither want nor need financial assistance but do want an explicit IMF endorsement of their policies, through the Policy Support Instrument; and
- the initiation of an External Review Committee on IMF-World Bank collaboration.

There is still more progress to be made in 2007, however, where UK priorities for the IMF's role in low-income countries will include:

- ensuring that the MDRI and HIPC Initiative delivers debt relief to more countries; and
- ensuring an outcome of the IMF-World Bank External Review that supports a comprehensive approach to low-income countries, in which the organisations work together but exploit their own strengths to avoid duplication.

4.1 The UK Presidency of the G8, G7 and EU in 2005 was a unique opportunity to drive forward UK priorities for global poverty reduction. Significant commitments were made by donors and the international financial institutions in a number of areas. The IMF's dedication to taking these forward in 2006 was impressive. Debt relief was a particular focus, but the IMF also continued to make progress on its own poverty reduction programmes, working closely with the World Bank. Delivering these commitments has required a global effort, and will continue to do so. The IMF's role in poverty reduction is closely linked to other priorities being taken forward by the UK, which are also covered in this Chapter.

THE DEVELOPMENT FRAMEWORK

Millennium Development Goals

4.2 The work of the IMF – and the UK within it – is set within the international framework of the Millennium Development Goals (MDGs). These were endorsed by all United Nations member states and every major international body, including the IMF, at the UN Millennium Summit in September 2000. These provide the high-level framework through which international efforts are channelled towards poverty reduction. These goals include to: significantly reduce poverty and hunger; reduce both infant and maternal mortality; address HIV/AIDS; increase education; promote gender equality; and promote a sustainable environment⁹.

4.3 The UK believes that, in a world of growing wealth, extreme poverty is both morally unacceptable and against UK interests. The problems associated with global poverty also affect the UK, though trade, war and conflict, international crime, refugees and the spread of diseases such as HIV and AIDS. The UK therefore remains committed to reducing poverty around the world, meeting the MDGs by 2015.

⁹ Further information on the MDGs is available at www.un.org/millenniumgoals

DEBT RELIEF

4.4 The UK believes that no poor country should have to choose between servicing their debt obligations and making the investments necessary to meet the MDGs. The Government has been at the forefront of international efforts to cancel the debts of the most heavily indebted poor countries over a number of years.

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

Multilateral Debt Relief Initiative

4.6 The IMF moved quickly to implement this agreement in 2006. It began to deliver MDRI debt relief to 19 countries in January 2006 (17 Completion Point HIPCs and two non-HIPCs whose per capita income was below the established threshold.) This has since been increased to 23 countries and additional countries will qualify on reaching Completion Point under the HIPC initiative. As of September 2006, US \$3.7 billion of debt relief had been delivered by the IMF under this initiative.

Heavily Indebted Poor Countries initiative

4.7 The UK is fully committed to the financing and implementation of the HIPC initiative. During 2006, Cameroon, Malawi and Sierra Leone reached Completion Point, and Haiti reached Decision Point, giving a total of 21 countries that have completed HIPC, and a further nine that are receiving interim HIPC assistance. Ten other countries have been identified as meeting the income and indebtedness eligibility criteria for HIPC, and will be eligible for HIPC debt relief when they have a track record of macroeconomic stability and have shown a commitment to poverty reduction.

4.8 In 2006, the Bank and Fund agreed to changes to the HIPC sunset clause, removing the requirement for potential HIPCs to have started a qualifying programme by end 2006. All countries that meet the income and indebtedness criteria for end-2004 will now be eligible for HIPC debt relief, enabling them to move towards Decision Point, and debt relief, at their own pace - a change that the UK strongly lobbied for.

Debt sustainability framework

4.9 The Joint World Bank and IMF Debt Sustainability Framework (DSF), introduced in 2005, was developed with the intention of better monitoring the accumulation of debt. The Framework puts responsibilities on both borrowers and creditors and provides guidance on financing strategies to help borrowing countries to devote resources toward achieving the MDGs, while also considering their current and prospective ability to repay their debts. This is designed to avoid the build up of unsustainable debt in the future.

4.10 During 2006 the UK has worked closely with the Bank and Fund to help strengthen the Framework in light of the implementation of the MDRI. Improvements to the DSF have focussed on the rigour and quality of its analysis and the application of the Framework, as well as increasing the DSF's effectiveness by improving creditor co-ordination and the active use of the Framework when making borrowing and lending decisions.

IMF INSTRUMENTS FOR LOW-INCOME COUNTRIES

4.11 The UK fully supports the work of the IMF in low-income countries and believes that it should continue to strengthen this role, in order to help make progress towards the MDGs. The UK welcomed the suggestions for greater focus of the Fund's work in these countries in the IMF Strategic Review, and agrees that the Fund should ensure that this does not lead to a decreased role by the organisation. The following section highlights the different instruments that the IMF uses to support low-income countries.

Poverty Reduction and Growth Facility

4.12 The Poverty Reduction and Growth Facility (PRGF) is the IMF's main concessional lending programme for low-income countries and is the prime vehicle for the Fund's engagement in these countries. The facility was established in 1999 to make the objectives of poverty reduction and growth central to the Fund's lending operations in low-income countries. PRGF programmes are financed separately to General Resource Account Lending, as set out in Chapter 3. PRGF-supported programmes are framed around comprehensive country-owned Poverty Reduction Strategy Papers (PRSPs), prepared by governments with the active participation of civil society and other development partners. The targets and policy conditions in a PRGF-supported programme are drawn from the country's PRSP. As a result of the MDRI, credit outstanding under PRGF arrangements has fallen from SDR 6.2 billion in December 2005 to SDR 3.8 billion in October 2006.

4.13 In December 2006, 29 IMF members were benefiting from PRGF programmes; no new programmes were approved during the year. The UK has a consistent approach at the Board when considering and reviewing PRGF loans, informed by in-country analysis from DfID development experts. The UK also monitors progress on the key targets that PRGF programmes are expected to meet in developing countries through reporting on pro-poor budgets and Poverty and Social Impact Assessments (PSIA). PRGF arrangements are typically three years in length, with programmes agreed annually and biannual reviews of progress brought to the Board. During discussions of PRGF countries, UK interventions in 2006, as in previous years, typically focused on questions related to the programme design:

- Does the programme support the country-led Poverty Reduction Strategy Paper, adequately reinforce the needs of the country, and embody reforms that are well sequenced and realistic?
- How does the PRGF measure up against its objectives? The UK emphasises use of PSIA, and a focus on improving public expenditure management and fiscal flexibility.
- For Highly Indebted Poor Countries (HIPC), is the country making progress through the HIPC initiative? When is it likely to be eligible for Completion Point and assistance under the Multilateral Debt Relief Initiative?
- Have the necessary performance targets been met? If not, are waivers justified and is commitment to ongoing reform and poverty reduction sufficient?
- On aid, has donor coordination been effective? Are proposed conditions essential to achieve the objectives of the programme, and are they well-timed and appropriately sequenced?

Policy Support Instrument **4.14** The Policy Support Instrument (PSI), introduced in October 2005, is a non-financial arrangement designed to meet the needs of countries that do not need, or want, Fund financial assistance but do want an explicit IMF endorsement of their policies. The PSI is available to all PRGF-eligible Fund members with a Poverty Reduction Strategy in place. However, it is designed principally to meet the needs of countries that have achieved a level of macroeconomic stability such that they no longer need Fund financial support often referred to by the IMF as ‘mature stabilisers’. The PSI is voluntary, demand-driven, and intended to be supported by strong country ownership.

4.15 On 17 October 2005, Nigeria was the first country to gain IMF Executive Board approval of a PSI. In April 2006, the IMF approved the completion of Nigeria’s first review under its Policy Support Instrument. This was key to securing agreement on the Paris Club debt deal for Nigeria that saw \$18 billion cancelled (about 60 per cent of Nigeria’s debt in the Paris Club) and represented the largest single debt relief package ever for sub-Saharan Africa. This deal secured Nigeria’s exit from the Paris Club and transforming Nigeria from a net debtor to net creditor. PSI programmes were also approved for Uganda, in February 2006, and Cape Verde, in August 2006. The IMF is currently working towards a programme under the PSI for Tajikistan.

Exogenous Shocks Facility **4.16** Part of the Fund’s commitment to meeting the needs of its poorest members involves temporary assistance to help countries that are experiencing exogenous shocks. In November 2005 the Fund introduced the Exogenous Shocks Facility (ESF), which provides concessional financing to PRGF-eligible countries that are experiencing sudden shocks, but do not have a current PRGF programme in place. The UK has pledged £50 million in grants to the ESF and provided £10 million in 2005 – see Annex B for further details. Pledges have also been made by France, Japan, Canada, Russia, Norway and Saudi Arabia

4.17 The instrument is applicable to a range of exogenous factors including terms-of-trade shocks, natural disasters (including extreme weather events related to climate change), export demand shocks, or conflict or crisis in neighbouring countries. ESF loans will have the same interest rate, 0.5 per cent, and maturity, five and a half to ten years, as the PRGF. However, ESF programmes will be shorter than PRGF programmes, lasting only 1-2 years; and their structural reform component will be less demanding than in a PRGF programme. The level of financing available in an ESF programme is also expected to be smaller, reflecting their role in catalysing additional finance from other sources, including donors and the availability of funding. The norm for ESF access will be 25 per cent of a member’s IMF quota. Countries with PRGF programmes in place that experience shocks will receive any additional assistance necessary through an augmentation of their existing PRGF programme.

4.18 No countries accessed the facility in 2006, but the underlying vulnerabilities of low-income countries to economic shocks remain - the UK therefore continues to fully support the instrument

Conditionality in IMF programmes **4.19** When considering and reviewing potential IMF loans and programmes for low-income countries, the UK follows a number of principles with regard to conditionality. These include: reducing the number of conditions where possible, only including conditions that are critical to the success of the programme and ensuring strong country ownership. The Fund’s Independent Evaluation Office is currently reviewing the Fund’s conditionality policy and the UK welcomes the opportunity to further consider this issue.

Box 4.1: Collaboration between the IMF and the World Bank

In its operations in low-income countries, the UK believes that it is essential that the IMF works in a close and cooperative manner with the World Bank. We see a continued role for both institutions in providing the long-term finance and support for poverty relief. The comparative advantage of each institution can contribute to a comprehensive approach that can meet country needs without a duplication of efforts. Further to the IMF's Strategic Review, in March 2006 the Managing Director of the IMF and the President of the World Bank brought forward a review of current collaboration processes and appointed a six-member External Review Committee, headed by Pedro Malan, the former Finance Minister of Brazil. The External Committee has worked alongside the Joint Task Force made up of senior IMF and World Bank staff and published its findings in March 2007.

A number of instruments and systems for collaboration between the Fund and the Bank are already in place. For example, Poverty Reduction Strategies allow the Fund and the Bank to maintain close collaboration while also identifying which institution will lead on a particular policy area in each low-income country ('the lead agency model'). In addition, the institutions have worked together on a number of specific initiatives, including the joint Debt Sustainability Framework, cooperation on financial sector reform through their joint Financial Sector Liaison Committee, the preparation of Reports on the Observance of Standards and Codes and an expansion of their work on Anti-Money Laundering/Countering the Financing of Terrorism. These are set out elsewhere in this report.

The UK is strongly supportive of these joint instruments and systems and has worked to reinforce their usage. Furthermore, the UK has also called for the creation of stronger institutional incentives to ensure that working-level collaboration between the institutions is routine. Clarification of roles in a number of areas such as financial sector work, donor coordination and the PRSP process can be improved, as can standard collaboration practices within countries. Entrenching the examples of good practice would strengthen the role that both the Fund and Bank can play in the world today.

The UK also ensures that its own representation to the Fund and Bank is well coordinated by operating a joint office with a single Executive Director who represents the UK on the Boards of each institution. This coordination is supported by close work between HM Treasury, the Bank of England and DfID, the lead UK department for relations with the World Bank. Further information on UK engagement with the Bank is included in an annual statement to Parliament produced by DfID.

Technical Assistance **4.20** IMF technical assistance supports members, particularly low-income countries, in strengthening the capacity of both human and institutional resources and assisting countries in the design of appropriate macroeconomic and structural policy reforms. More detail on technical assistance in 2006 is contained in Chapter 2.

FINANCE FOR GROWTH AND POVERTY REDUCTION

4.21 The role of the IMF in tackling poverty directly is only part of the UK's approach to global poverty reduction. Details on some of the UK's international priorities in 2006 are set out below.

Aid 4.22 In 2005 UK Official Development Assistance (ODA) reached 0.47 per cent of Gross National Income (GNI). The increase reflects both the implementation of the spending plans set out in the 2004 Spending Review to increase DFID's budget, and a significant short term increase due to the debt deal agreed with Nigeria and Iraq in 2005. The Government has set a timetable to meet the UN's target of 0.7 per cent of UK national income being spent on overseas aid by 2013. Figures on UK ODA in 2006 will be available from DfID in October 2007.

4.23 The Comprehensive Spending Review (CSR), to be finalised in Summer 2007, will decide detailed levels of UK ODA for 2008-2011. Assessing the long-term challenges for poverty reduction, such as global uncertainty and pressures on natural resources, will be one of the key themes for the CSR¹⁰. As part of the CSR, the Treasury is working closely with DfID to look at how these challenges can be met and where they can focus their work to have the most effect on reducing poverty.

Trade 4.24 Under the right circumstances, trade can be a key driver of economic growth, development and poverty reduction. The UK was extremely disappointed by the suspension of negotiations in the Doha Round of world trade talks last July and welcomes their full-scale resumption. Key World Trade Organisation (WTO) players need to show bold and concerted leadership to deliver a successful conclusion, including significant increases in market access for developing countries, ending export subsidies, substantially reducing all trade-distorting domestic support, and providing effective special and differential treatment to enable developing countries to capture the gains from trade. Developing countries must also have the flexibility to design, plan and sequence trade reforms in line with their country-owned development and poverty reduction strategies.

Aid for trade 4.25 Efforts to open markets and phase out subsidies will only generate a limited supply-side response from poorer countries unless they are complemented by the necessary aid to boost their capacity to trade to help them participate effectively and fairly in the global trading system. Such 'aid for trade' should proceed independently of progress on the Doha Round. In 2006, the UK led international efforts to ensure that existing aid for trade commitments, particularly the G8 pledge to provide US \$4 billion a year by 2010, are transformed into concrete and credible financing. At the Annual Meetings of the IMF and the World Bank, the UK announced that its total aid for trade is expected to increase by 50 per cent by 2010-11, equating to US \$750 million a year in 2010.

¹⁰ Further information available on the HM Treasury website, at www.hm-treasury.gov.uk/spending_review/spend_csr07/spend_csr07_index.cfm

4.26 In October 2006, the WTO's General Council approved the recommendations of the Aid for Trade (AFT) Task Force established at the December 2005 Ministerial meeting in Hong Kong. These recommendations included that the Integrated Framework (IF) be expanded - the IF is an international initiative to assist low-income countries in identifying their trade-related capacity-building needs and coordinate assistance. It is a partnership that contains six multilateral agencies, including the IMF. An Enhanced Integrated Framework (EIF) would provide US \$400 million to 40 low-income countries over a five year period. The UK wants the EIF to be operational by early 2007 and also supports an EIF type mechanism for all low-income countries.

Box 4.2: Innovative Financing for Development

The International Finance Facility for Immunisation (IFFIm) issued its first bonds on 7 November 2006, raising \$1 billion for immunisation. Over the next ten years, IFFIm will deliver \$4 billion of front-loaded resources through the GAVI Alliance (formerly the Global Alliance for Vaccines and Immunisation) to immunise 500 million children in the world's 70 poorest countries against preventable diseases such as polio, measles and tetanus. It is estimated this will save 5 million lives in the years up to 2015, a further 5 million afterwards, and help lead to the eradication of polio.

The IFFIm uses long-term, binding commitments from donors as collateral against which to borrow money up front from institutional and private investors, which can be spent immediately on mass vaccination programmes. Contributions have so far been made by the UK, France, Italy, Spain, Sweden and Norway, alongside a grant from the Gates Foundation. Brazil and South Africa have also announced that they will be contributing to the IFFIm.

The UK is also leading efforts to accelerate the development and availability of new medical technologies for developing countries. At present, only 10 per cent of global research and development devoted to health is targeted on diseases that affect 90 per cent of the world's population. The UK Government will double development research funding by 2010 and in 2006 worked with Canada and Italy to develop a \$1.5 billion Advance Market Commitment (AMC), as a means of harnessing greater private sector investment and expertise into research and development for vaccines against diseases that kill millions in developing countries each year.

A pilot AMC for a pneumococcus vaccine was launched in Rome on 9 February 2007 with the support of Italy, the UK, Canada, Russia, Norway and the Gates Foundation. Pneumococcal disease kills 1.6 million people a year, of which nearly a million are children. A successful AMC could save 5.4 million lives by 2030. The UK believes that AMCs have the potential to accelerate the discovery of vaccines against other killer diseases like Malaria and AIDS.

Education 4.27 Education is vital in the fight against extreme poverty in developing countries. Investment in education contributes to economic growth and enables people to raise themselves from poverty and better support their families. Girls' education also helps to reduce the rates of child mortality, combat the spread of diseases such as HIV and AIDS and improve the nutrition and prospects of future generations. Yet every day almost 80 million primary school aged children are denied the opportunity of an education.

4.28 Achieving the education Millennium Development Goals isn't just about money. It is about long-term predictable financing so that developing countries can meet recurrent costs and invest in training teachers and in schools. The UK announced in 2006 that, for the first time, we will enter into 10 year agreements with developing countries to help finance their education plans and that we will spend at least £8.5 billion (\$15 billion) on aid for education over the next ten years. The UK will continue to call on other donors to support poor countries' long-term education plans.

Box 4.3: Tackling Climate Change

Climate change is the most pressing environmental issue the world faces, which will require a coordinated, international response so that the worst effects can be avoided at manageable cost. The recently published *Stern Review on the Economics of Climate Change* has highlighted how long-term global prosperity will be undermined if early and coordinated international action is not taken. The Review also emphasised that the impact of climate change will be most strongly felt in developing countries and that investment in these countries will therefore be needed to help them adapt to climate change.

The IMF, like other international organisations, has recognised that tackling climate change will be an additional challenge for development over coming years: the macroeconomic impact of climate change, for example increased fiscal pressures resulting from extreme weather patterns, is therefore considered within Article IV and programme reports. The mainstreaming of climate change is also occurring in the multilateral development banks – particularly through the development of a Clean Energy Investment Framework, the principles of which were endorsed at the 2006 Annual Meetings, and related initiatives in the regional development banks. The IMF and World Bank jointly organised a presentation of the Stern Review's work on 12 February 2007.

5

THE 2007 AGENDA

5.1 2006 was an important year for reform and delivery at the IMF. This report has described significant progress made in delivering policies to combat global poverty and reforming the IMF as an institution, through both crisis prevention and governance reforms. In order to ensure that this progress is [permanently] embedded, however, the IMF must be sure to take forward these agendas in 2007.

Crisis Prevention 5.2 The UK believes that completing reforms to improve the Fund's crisis prevention function, particularly through a revision of the surveillance framework, will be vital in 2007. Priorities for the UK, and the Fund, will include:

- a revision of the 1977 Decision on surveillance, to bring the Fund's framework up to date by better defining the scope and focus of surveillance;
- work on the design of a remit for surveillance, to better demonstrate the accountability and independence of surveillance;
- further development of a Reserve Augmentation Line, to provide contingent financing to countries at risk from spillover effects; and
- continued expansion in the number of countries publishing their Article IV reports and participating in the Codes and Standards initiative.

Governance Reform 5.3 It will also be important that in 2007 the IMF builds on progress made in Governance Reform in 2006. Priorities will include:

- developing a quota reform package that both reflects the weight and role of countries in the global economy, and enhances the voice and participation of low-income countries, in preparation for finalisation no later than the 2008 Annual Meetings;
- producing an appropriate package of Fund financing reform, in response to the publication of the Committee of Eminent Persons report; and
- the introduction of the first full medium-term budget for the 2007-08 financial year, incorporating work on income, expenditure and performance indicators.

Tackling global poverty

5.4 The IMF will continue to be central to the delivery of the UK's international poverty reduction goals in 2007. In particular, the Fund must:

- deliver debt relief to an increasing number of low-income countries through the MDRI and HIPC initiative;
- provide support through the Policy Support Instrument, to more countries that want an explicit IMF endorsement of their policies; and
- ensure a response to the IMF-World Bank External Review that supports a comprehensive approach to low-income countries.

5.5 Outside of the IMF, the UK will continue to promote a number of initiatives to reduce poverty in low-income countries. Priorities in 2007 will include:

- the implementation of the pilot Advanced Market Commitment to tackle Pneumococcus, which kills 1.6 million people a year, 1 million of whom are children;
- the successful conclusion of the Doha Round of world trade talks, to deliver significant increases in market access for developing countries;
- the launch of an Enhanced Integrated Framework to provide US \$400 million to 40 low-income countries over a five year period, as recommended by the Aid for Trade Task Force;
- continuing to work with countries and donors to secure long-term predictable financing of countries' education plans; and
- the development of the World Bank led Clean Energy Investment Framework, and related initiatives in the regional development banks, in order to tackle the challenge posed by climate change in developing countries.

A

THE UK'S VOTING RECORD

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

Votes by the Board of Governors

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

A.3 The resolutions that are passed as a result of Governors' votes are currently published by the IMF, with a two-year delay, in the 'Summary Proceeding of the Annual Meeting of the Board of Governors'. Governors voted on the following decisions in 2006:

NO.	RESOLUTION	VOTING RESULT	EFFECTIVE DATE	UK POSITION
61-1	Forthcoming Annual Meetings of the Boards of Governors - Proposed Dates for the 2007 and 2008 Annual Meetings in Washington, D.C.	Passed	July 17, 2006	Approve ¹¹
61-2	Direct Remuneration of Executive Directors and their Alternates	Passed	August 2, 2006	Abstain
61-3	2006 Regular Election of Executive Directors	Passed	August 1, 2006	Approve
61-4	2009 Annual Meetings of the Boards of Governors of the World Bank Group and the International Monetary Fund	Passed	August 21, 2006	Approve

¹¹ Although the UK approved the date of the Annual Meetings, due to a technicality the UK vote was cast after the ballot was closed.

61-5	Quota and Voice Reform in the International Monetary Fund	Passed	September 18, 2006	Approve
61-6	Financial Statements, Report on Audit, and Administrative and Capital Budgets	Passed	September 19, 2006 Annual Meeting Singapore	Approve
61-7	Amendments of Rules and Regulations	Passed	September 19, 2006 Annual Meeting Singapore	Approve
61-8	Membership for the Republic of Montenegro	Passed	December 15, 2006	Approve

A.4 Consistent with the UK's approach to budget discipline, the UK abstained during the vote (61-2) concerning the direct remuneration of Executive Directors and their Alternates. The UK believes that the remuneration of Executive Directors and their Alternates should reflect their primary role as appointed public officials and representatives.

A.5 The UK voted in favour of Resolution 61-5 to reach agreement on a new quota formula. The Resolution states that the new formula should provide a simpler and more transparent means of capturing members' relative positions in the world economy. It also provided ad hoc quota increase to four countries – South Korea, China, Turkey and Mexico – and commits to safeguarding the power of basic votes to enhance the voice and participation of low-income countries. The UK is a strong proponent of increasing the role of developing countries in the governance of the Fund.

A.6 Decision 61-6 gave the Board of Governors' certification that the audited accounts, financial statements, and administrative and capital budgets fulfil the requirements of the Articles of Agreement and by-laws. The UK is content that this is the case. In Decision 61-8 the UK supported the membership of the newly formed Republic of Montenegro to the IMF following the formal separation of the country from the Republic of Serbia.

B

THE UK'S FINANCIAL RELATIONSHIP WITH THE IMF

B.1 This Annex considers the UK's financial relationship with the IMF in 2006 and assesses the 'cost' of Fund membership. The financial relationship of any member with the Fund is complex. Its main impact is felt via the impact on UK reserve holdings. This Annex therefore calculates the net financial cost of holding official reserves in the form required by IMF membership. Separate to this, the Fund's involvement in low-income countries means that Department for International Development (DFID) resources are provided for specific IMF programmes.

IMPACT OF IMF MEMBERSHIP ON UK RESERVES

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

- the financial effect of the operation of the UK's quota;
- the financial effect of managing the UK's allocation of SDRs; and
- the calculation of the alternative, where the national reserves currently held in the Fund have been invested alongside other UK reserves.

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

Quotas

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

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

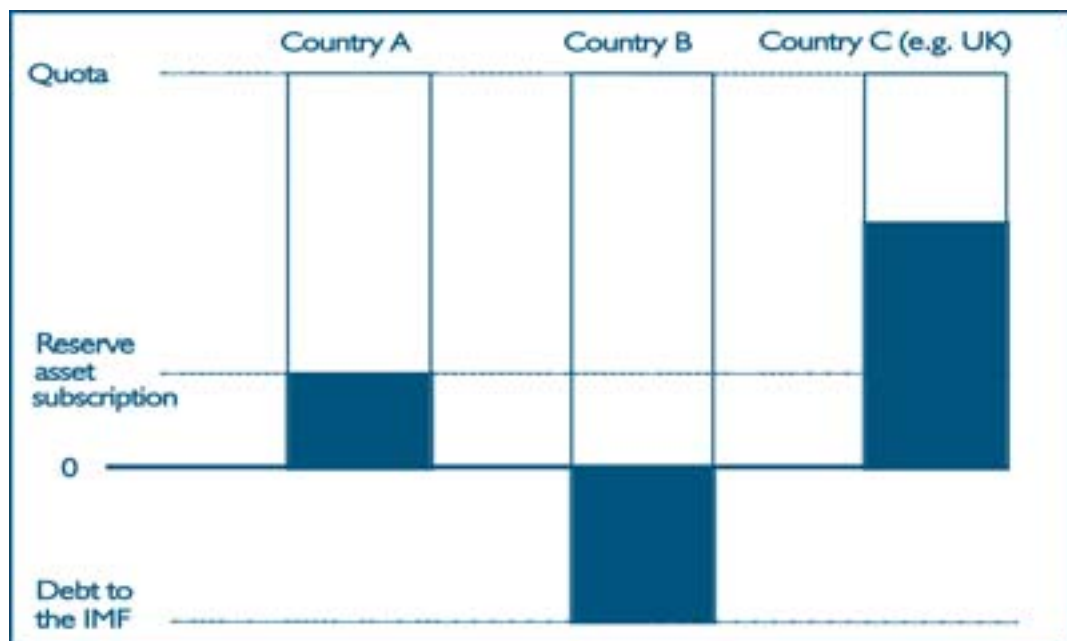
B.6 The Reserve Tranche Position (RTP) describes the amount of a members' quota that the IMF has drawn upon. It consists of the proportion of quota originally provided in reserve assets, plus the additional part of the quota that the IMF has drawn upon by exchanging non-interest bearing notes. As a result,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

B.7 Conversely, when a country requires IMF resources, in the first instance, the borrowing country can call back from the Fund the proportion of its quota originally paid in reserve assets. However, the borrowing country can also request additional funds, financed by other member countries as set out above. The total amount that can be borrowed will be 100 per cent of quota in the first instance – see Chapter 2 for more details on the Exceptional Access Framework.

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

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

Chart B.1: Possible Financial Positions in the IMF



The UK position

B.10 The UK's quota is SDR 10,739 million and has remained at this level in SDRs since 2000, when it was increased from SDR 10,461 million. This amounts to 4.94 per cent of the overall quota of all members, and equated to £8918 million at the exchange rate at the end of March 2006 and £8230 million at the exchange rate at the end of December 2006. The UK's RTP at 31 December 2006 was SDR 941 million (around £721 million), down from SDR 1229 million at 31 March 2006, and SDR 3441million at end March 2005. The RTP is an asset of the National Loans Fund (NLF).

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

B.12 As the UK reserves provided to the IMF can be called back by the UK at any point, the RTP forms part of the UK's official reserves. When there are changes in the level of the RTP, UK policy is therefore to neutralise the impact of this on the official reserves. For example, repayment of other countries' loans in sterling to the IMF in 2005-6 led to a fall in the UK's RTP and therefore would have led to a fall in the official reserves – however, to offset this reduction and ensure the official reserves remained stable, the EEA12 bought other foreign currency assets with the sterling repayment. Conversely, if the IMF were to make loans in sterling and so increase the UK's RTP, this would cause the official reserves to rise. Therefore, in this event, the UK would sell foreign currency to offset such increases.

Investment Account **B.13** In April 2006, in response to a projected shortfall in the Fund's day-to-day finances, the Executive Board exercised its right under the Articles of Agreement to create an Investment Account, as set out in Chapter 3. The Investment Account was financed by drawing upon the RTP of members, including the UK, and now holds almost SDR 6,000 million in reserves. It therefore impacted on the UK RTP, which is approximately SDR 390 million higher than it otherwise would have been – the UK neutralised the impact of this on official reserves as set out above.

Costs and benefits of holding reserves at the IMF **B.14** As the UK's RTP forms part of the official reserves, any increases in its size are not regarded as public expenditure or as an increase in net public sector debt. There can, nonetheless, be costs and benefits associated with IMF membership, related to the remuneration paid on UK reserves held at the IMF and capital gains or losses on holdings. These depend on the level of the IMF's interest rate, the SDR rate - based upon a basket of high credit quality short-term interest rates in the four SDR currencies. The IMF remunerates the UK's RTP at slightly below this rate, in common with all other members.¹³ However SDR 700 million is unremunerated, reflecting the element of the UK's quota that was made available to the IMF before 1st April 1978 in gold. The UK does not receive any interest on this portion.

B.15 For the RTP in 2005-06, the interest loss (driven by the difference between the SDR-based interest rate earned on the RTP and the sterling interest rate paid on the NLF liability that funds the RTP) was £52 million and the capital gain (due to sterling-SDR exchange rate movements) was £97 million. The total profit on the UK RTP was therefore £45 million.

¹² The Exchange Equalisation Account (EEA) is the account that holds the UK's official reserves of foreign exchange, gold and IMF Special Drawing Rights (SDRs). The accounts are audited annually and is available at the HM Treasury website, at: http://www.hm-treasury.gov.uk/documents/uk_economy.

¹³ The rate is slightly below the SDR rate due to a burden sharing mechanism set in place to provide the IMF with specific monies to guard against the risk of protracted arrears from borrowers. The rate of charge for borrowers is adjusted upwards by the same amount. These adjustments are determined after the end of each financial quarter and on average the adjustment is of the order of 0.1 percentage points.

SDR Allocation

B.16 In addition to the UK quota, another element of the UK's financial relationship with the IMF is via one-off SDR allocations. SDR allocations first took place in 1969, as an attempt to give member governments of the Fund access to the reserve assets they needed to manage their currencies within the Bretton Woods fixed exchange rate system¹⁴. The last allocation took place in 1981. The UK has received a total of SDR 1900 million in SDR allocations since 1969 and this equated to £1466 million at the exchange rate for the end of December 2006. The UK pays the IMF interest on this allocation at the SDR rate. At the same time, the Fund remunerates any UK SDR holdings at the SDR rate. Therefore, if the UK held its full allocation in SDRs, the interest paid on this allocation would cancel out the interest received, resulting in a net cost of zero.

B.17 However, members have the option to sell part of their SDR allocation and to hold alternative reserve assets instead. The UK has tended to sell SDRs and invest the proceeds in dollar, euro and yen assets for portfolio management reasons. In 2005-06, of its total SDR allocation, the UK chose to hold on average £168 million in SDRs and £1397 million in foreign currency. As a result, interest was paid to the IMF for the full UK allocation but interest received from the IMF on only the £200 million UK SDR holdings. However, the UK received interest on £1397 billion in foreign exchange holdings at market interest rates¹⁵ in the respective currencies.

B.18 Under this arrangement, the UK would make a profit if the average interest rate on these foreign exchange holdings was higher than the SDR rate. In 2005-06, this was not the case, the SDR rate instead exceeded the average interest rate on foreign exchange holdings and the UK therefore made a net loss of £6 million. A very small capital gain¹⁶ on the allocation led to a total loss of £5 million to the official reserves.

Net financial cost of membership

B.19 Taking together the financial effect of the UK holding official reserves at the Fund and the effect of the UK SDR allocation, it is possible to calculate the net financial impact of IMF membership on UK reserves. As the UK made a gain of £45 million by holding reserve assets in the RTP but a loss of £5 million on the SDR allocation, the total benefit of IMF membership to UK reserves in 2005-06 was £39 million (based on non-rounded figures).

B.20 The third element in assessing the overall cost of Fund membership, however, is to compare this figure to the gain or loss that the UK would have made on the same level of reserves, had they been held in line with other UK reserves. If amounts equal to the RTP and SDR allocation had been held as reserve assets in the EEA¹⁷, alongside the rest of the net foreign currency reserves, it is calculated that the UK would have made a net profit of £85 million.

¹⁵ EEA holds foreign currency debt securities at a range of maturities. The assumption about the income the UK receives, for the purposes of calculating the cost of IMF membership, is based on a three-month repo (collateralised) market interest rates.

¹⁶ A capital gain or loss will occur if the basket of foreign exchange investment (40:40:20 Dollar: Euro:Yen) changes against the SDR, leading to a change in the sterling value of foreign exchange reserves versus the SDR holdings. If the UK held the whole allocation in SDRs, then there would be no capital gains or losses, as both asset and liability would be denominated in SDRs and would therefore move in line with each other.

¹⁷ Existing holdings in the EEA are made in dollar, euro and yen at a ratio of 40:40:20, and it is assumed that they also earned interest at the three month repo rates in the respective markets.

B.21 Therefore, while IMF membership in 2005-6 led to the UK gaining £39 million, had the UK not been an IMF member, and had maintained its level of foreign exchange reserve assets through holdings of short-term conventional reserve assets, there would have been a gain of £85 million. Overall, therefore, IMF membership cost the UK £46 million in 2005-6, as set out in Table B1. Last year, the opposite situation took place – there was a loss on the RTP and SDR allocation, however, there would have been a larger loss if the UK had not been an IMF member. This meant that there was an overall gain from IMF membership. In this table, a positive number indicates a saving to the UK and a negative number indicates a cost.

Table B1: A summary of the cost of UK membership of the IMF

Financial Year	Gain/loss from membership (£m)	Gain/loss of non-membership (£m)	Net benefit/cost of membership (£m) ²⁰
2005-06	+39.37	+85.45	- 46.09
2004-05	-123.96	-181.08	+57.13

B.22 As this table reveals, the impact of IMF membership on UK reserves may have a different impact from year-to-year. The estimated net financial cost to the UK of membership of the IMF is driven by sterling, SDR and foreign interest rate differentials and by exchange rate movements (dollar, euro, yen and SDR versus the pound). It is also worth noting that an additional cost of IMF membership is that reserves held by the IMF are less liquid than those held in the EEA. This analysis does not, however, include the non-financial benefits of IMF membership such as enhanced voting powers and bigger access to IMF financing.

UK FINANCIAL CONTRIBUTION TO IMF DEVELOPMENT INITIATIVES

B.23 In addition to providing loans to countries experiencing balance of payments difficulties, financed by national reserves, the IMF provides loans to low income countries aimed at poverty reduction, financed directly from contributions by members. Lending through the Poverty Reduction and Growth Facility (PRGF) and the Poverty Reduction Strategy Papers (PRSP) process also provides the basis for debt relief under the Heavily Indebted Poor Countries Initiative (HIPC).

B.24 The UK voluntarily contributes to these programmes, through DFID, as part of official overseas development aid (ODA). This therefore does not impact on UK reserves, or affect the overall financial position of the UK vis a vis the IMF. However, it does account for a portion of DFID's budget, and therefore UK public spending overall. In 2006, the Department of International Development made payments of £23.7 million to the PRGF, of which £13.7 million was the UK's share of the G8's pledge of SDR 100 million in relation to the Multilateral Debt Relief Initiative. A further £40 million over the next four years has been pledged by the UK to the PRGF Exogenous Shocks Facility. More details on these issues are set out in Chapter 4.

THE UK ARTICLE IV STATEMENT

UNITED KINGDOM – 2006 ARTICLE IV CONSULTATION CONCLUDING STATEMENT OF THE IMF MISSION

C.1 Macroeconomic performance in the United Kingdom remains impressive. The growth of investment, productivity, and output has rebounded from a softer 2005. Net immigration has spurred capacity growth, though inflation has risen and the current account deficit has widened slightly. Macroeconomic policy frameworks are supportive: they have contributed to the good performance and are guiding policies in ways that are responsive to the requirements for strong growth with low inflation. Financial markets too have performed well: London continues to grow as a global financial center with sound institutions and a good record of supervision. The near- and medium-term outlook is for continued strong and stable growth with a return of inflation to target.

C.2 Given this benign outlook, much of our discussion has reviewed how well macroeconomic policies place the economy to respond to shocks. Openness and flexibility, reflecting in part the wide-ranging structural reforms undertaken over the last two decades, have paved the way for enormous benefits from globalization, which has played to the strengths of the UK economy. Alongside such benefits, economies need to be prepared to weather any downside developments. For the United Kingdom, flexibility and sound macro frameworks are key shock absorbers. It is important also that fiscal and monetary policies are positioned to respond effectively. This means that public debt must be kept at moderate levels, in line with the fiscal framework; monetary policy must disentangle and respond to the wider variety of factors now driving inflation; and thorough and effective supervision of the financial system must be maintained. On the whole, we are reassured by our discussions, though we believe that efforts to increase margins for responding to adverse developments need to be sustained, particularly in the current favorable conjunctural conditions.

Policy challenges in a strong growth environment

C.3 GDP growth picked up in 2006 and is expected to remain robust. We see growth at about 2¾ percent in each of the next two years, broadly in line with potential and close to the forecasts in the Pre-Budget Report and the latest Inflation Report. Business investment is being boosted by healthy corporate balance sheets and the low cost of capital. Solid growth of private consumption is based on rapid employment growth and generally strong household balance sheets. The external current account deficit should be stable, as the sizable deficit on trade in goods and services continues to be partly offset by strong net investment income. The unemployment rate has risen, but we expect this to be temporary as the dampening effect on labor demand from higher energy costs dissipates and the recent surge in new entrants to the labor force is absorbed. Over the medium term, immigration is expected to boost growth, through both the direct effect on labor supply and the need to equip new workers with capital.

C.4 Consistent with this favorable outlook, financial sector prospects are strong. Net exports of financial services have risen steadily over the past decade and increased sharply in recent years. UK banks are among the most profitable in the G7 and ratings agencies rank the UK banking system as one of the strongest in the world. The strength of the banking system reflects effective financial regulation and supervision in the context of improved risk management, geographical diversification, and the growth of new business activities. In particular, the development of financial markets has allowed banks to transfer some of the risk that they traditionally held on their own balance sheets. The insurance sector has returned to a more stable outlook. And the ongoing shift from negotiated, bilateral banking finance to arms-length finance through asset markets has facilitated consumption smoothing.

C.5 In an environment of healthy growth, taming the energy-price-related increase in inflation remains a challenge. With energy prices now expected to be permanently higher than they were a couple years ago, full adjustment to them—via a temporary slowing in real wage growth to rebuild the profit margins of firms using energy inputs—is inescapable. Some of the adjustment has occurred; the sooner it is fully realized, the sooner inflation will return to target and the more robust will be economic performance. Yet, with diminishing economic slack and possibly rising inflation expectations, incentives to achieve this adjustment are weakening. The gentle tightening of monetary policy in recent months has therefore been appropriate to help ensure that inflation returns to target, as we expect, over the coming year. For the immediate future, continuing to communicate the importance of wage restraint will help minimize the need for increases in interest rates. Depending on evolving prospects for wage growth, some further tightening of monetary policy may be needed.

C.6 Continued fiscal restraint is also essential given the still sizable overall deficit. The strong macroeconomic outlook provides a favorable environment for it. Following the substantial fiscal adjustment in 2005/06, we expect a further modest narrowing of the overall deficit relative to GDP in 2006/07. After the sharp increase in spending during 2002/03-2005/06, the targeted slowing this year is welcome. However, the spending pattern thus far means strong discipline through the remainder of the year is needed. With the overall deficit close to 3 percent of GDP, the Pre-Budget Report contains plans for the further adjustment needed to halt, in the medium term, the rise in net debt as a share of GDP. We broadly agree with the Treasury that tax buoyancy alone should result in a modest increase in revenue relative to GDP. Also, we strongly support the government's plans to first stabilize and then lower spending as a share of GDP. This will require tough choices in the Comprehensive Spending Review, particularly as important infrastructure needs argue for maintaining capital spending as a share of GDP at its present level. With the implementation of these plans, we expect the overall deficit to decline gradually to 1½ percent of GDP by 2011/12, a level consistent with maintaining debt below 40 percent of GDP and only slightly higher than the forecast in the Pre-Budget Report. We welcome the proposed pension reform to address the long-term challenges of the pension system without jeopardizing fiscal sustainability.

C.7 The fiscal framework is supporting the improvement in public finances. The fiscal rules—the sustainable investment rule and the golden rule—have helped to constrain discretion and protect investment. Continuing commitment to the framework during the prospective period of strong growth will help ensure that good times are indeed used to reduce the underlying fiscal deficit. As experience grows, further improvements to strengthen the framework should be considered. An important pillar of the framework is the auditing by the National Audit Office of certain key assumptions underpinning the fiscal projections. Broadening the reach of this auditing process would further enhance confidence in the fiscal projections. And, once current balance is regained, consideration should be given to alternative formulations of the golden rule that preserve its constraint on discretion and fit likely future circumstances.

Positioning the economy to respond to global and domestic shocks

C.8 Ensuring that the economy can take advantage of upside opportunities for growth and weather downside developments lies at the heart of good policymaking. For even as remarkably strong world economic conditions persist, global and domestic risks are sizable. These create a great deal of uncertainty on both sides of our projections. On the upside, immigration may be expanding the economy's productive capacity more quickly than is currently envisaged, which would lead to higher growth. Three other low-probability but potentially high-impact risks are important at the present juncture. First, a disorderly adjustment of the US dollar could put upward pressure on sterling, leading to a further widening of the UK current account deficit. Second, a global reassessment of risk could trigger a sharp increase in interest rates. This could cause, among other disruptions, a decline in UK property prices. Third, notably slower-than-envisaged global growth would adversely impact the UK economy.

C.9 Openness and flexibility continue to position the United Kingdom to benefit from the opportunities of globalization and absorb shocks. The recent rapid growth of the world economy has boosted demand for exports, especially of financial services, and allowed the United Kingdom to source goods from the lowest cost global producers. The combination of benign global financial conditions and openness to capital flows has contributed to record levels of foreign direct investment inflows, while allowing the United Kingdom to earn substantial net investment income. The decision to admit workers from the new EU member states has boosted the flow of immigrants and helped to fill skills gaps. While openness may increase exposure to downside global risks, it also contributes to the flexibility that allows the economy to respond to adverse developments quickly. However, this flexibility alone would not be sufficient to smooth developments in the face of some major international shocks.

C.10 Fiscal policy needs to have sufficient cushions to permit a response to shocks. During the global downturn of 2000-03, a large fiscal expansion played an important role in moderating the slowdown in the United Kingdom. At present, the capacity for similar action is narrowing. First, we expect net debt to rise to around 39 percent of GDP before it stabilizes, leaving little room even for automatic stabilizers to operate fully in a downturn if debt is to remain below 40 percent of GDP. Second, the tax-to-GDP ratio has risen in recent years to about its level in the second half of the 1980s. Further tax increases would risk adversely affecting incentives to work and invest. Finally, favorable global financial conditions may be providing a temporary boost to the financial sector; in this case, some of the recent strength in revenue would not be permanent. Against this background, realizing the government's medium-term projection of an overall fiscal deficit below 1½ percent of GDP is essential to stabilize

and then gradually reduce the ratio of net debt to GDP. This would ensure—even through difficult times—that debt remains below 40 percent of GDP, a limit that has served the economy well.

C.11 Monetary policy is well-positioned to respond to shocks. Given projected nominal GDP growth of about 5 percent over the medium term, the policy interest rate is now broadly neutral and has ample room for maneuver. However, globalization is providing challenges to the formulation of monetary policy in at least three respects. First, the impact of immigration is making it harder to assess the balance between demand and supply. Second, rapid growth in manufactured imports from emerging Asia has dampened inflation in recent years, but judging the duration of this effect is difficult. Third, greater mobility of labor and goods may be weakening the relationship between economic slack and inflation, possibly increasing the time it takes for inflation to return to target. Against this background, we support the Bank of England's efforts to disentangle the wider range of current influences on inflation, effectively communicate them to the public and financial markets, and, if necessary, respond aggressively to contain inflation.

C.12 The financial sector starts from a position of strength, and the authorities continue to promote the system's resilience. The key concerns are low-probability events with potentially severe consequences. In addition to global risks, vulnerabilities include high and rising household debt, increasing exposure to complex and potentially illiquid instruments, and growing reliance by banks on wholesale funding, which raises liquidity risk. In addressing these risks, the authorities are, appropriately, aiming to balance the costs and benefits of regulation. We support the authorities' efforts to identify and encourage best practices in stress-testing. Given the growing cross-country linkages between financial systems, the authorities' plans to further enhance international crisis prevention and management arrangements are welcome.

D.1 The International Monetary and Financial Committee held its thirteenth meeting in Washington, D.C. on April 22, 2006 under the Chairmanship of Mr. Gordon Brown, Chancellor of the Exchequer of the United Kingdom.

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

D.2 The Committee welcomes the continued strong expansion of the global economy, despite higher oil prices. The expansion is becoming geographically more broadly based, and global growth is expected to remain strong in the next couple of years. Inflation and inflationary expectations remain well contained—although with excess capacity diminishing, continued vigilance will be required. The Committee notes that downside risks arise from continued high and volatile oil prices, the potential for an abrupt shift in global financial market conditions, a rise in protectionism, and a possible avian flu pandemic. The major risks posed by underlying vulnerabilities, including from widening global imbalances, have yet to be comprehensively addressed.

D.3 The Committee reiterates that action for orderly medium-term resolution of global imbalances is a shared responsibility, and will bring greater benefit to members and the international community than actions taken individually. While progress has been made, more concerted and sustained implementation—with every country doing its part—is needed to help reduce medium-term risks associated with the imbalances. Following the discussion at the Global Imbalances Conference held at the IMF on April 21, the Committee confirms that the agreed policy strategy to address imbalances remains valid. Key elements include raising national saving in the United States—with measures to reduce the budget deficit and spur private saving; implementing structural reforms to sustain growth potential and boost domestic demand in the euro area and several other countries; further structural reforms, including fiscal consolidation, in Japan; allowing greater exchange rate flexibility in a number of surplus countries in emerging Asia; and promoting efficient absorption of higher oil revenues in oil-exporting countries with strong macroeconomic policies. Given economic interlinkages, all countries and regions will have a role to play by increasing the flexibility of their economies and adapting to changing global demand patterns. The Committee therefore asks the IMF to work on modalities, in consultation with country authorities, aimed at encouraging actions needed to reduce the imbalances, and calls for a report at its next meeting. More generally, the new multilateral consultations, as outlined in the Managing Director's report on implementing the IMF's medium-term strategy, can play a role in promoting multilateral action.

D.4 The Committee welcomes the actions already taken to address capacity constraints in oil production. Building on this progress, it calls for further measures to improve the supply-demand balance in oil markets over the medium term, with oil producers, oil consumers, and oil companies all playing their part, including through closer dialogue. The Committee emphasizes the importance of further upstream and downstream investment, policies to promote energy efficiency, conservation, and alternative sources of energy, reducing subsidies on oil products, and further efforts to improve the quality and transparency of oil market data. The Committee will review progress on these issues at its next meeting.

D.5 Steps to strengthen medium-term fiscal positions remain crucial to support growth and stability, and improve resilience against future shocks. Greater advantage should be taken of the economic expansion to reduce fiscal deficits, and to move forward with reforms to ensure the sustainability of pension and health systems. The Committee also underscores that faster progress to remove constraints to growth in labor and product markets and improve the business and investment climate is essential to reap the benefits of globalization. The Committee welcomes the continued strength of the global financial system, and calls for continued vigilance by financial supervisors, especially regarding the potential impact of a turn in the credit cycle. The Committee calls on members to ensure the robustness of essential economic and financial infrastructure as part of a broad strategy to address the risk of an avian flu pandemic and, in this context, supports the IMF's outreach initiative to promote business continuity planning among financial institutions.

D.6 The Committee emphasizes the importance of an ambitious and successful outcome to the Doha Round by the end of 2006 for global growth and poverty reduction. The Committee calls on all members to resist protectionism in both trade and foreign direct investment. With time running increasingly short, all members must urgently contribute to reaching agreement on the key elements of a comprehensive package supporting a strengthened multilateral trading system. The Committee also calls for continued efforts to help countries take full advantage of the opportunities of global integration arising from ambitious trade liberalization. For poor countries in particular, the Committee urges Aid for Trade assistance firmly grounded in national development strategies and full use of existing and enhanced mechanisms for trade-related technical assistance.

D.7 The improving growth prospects in poor countries, including in Sub-Saharan Africa, are encouraging. The Committee emphasizes that achieving the Millennium Development Goals (MDGs) requires a partnership between poor countries and donors. Developing countries should continue to pursue sound macroeconomic policies and growth-critical reforms, including further substantial efforts to build sound, accountable, and transparent institutions. The international community should follow through expeditiously on its commitment to provide additional resources.

Implementing the IMF's Medium-Term Strategy

D.8 The Committee welcomes the Managing Director's report on implementing the IMF's medium-term strategy, and appreciates the public debate on the role of the IMF. It calls on management and the Executive Board to complete their considerations and then move rapidly to implementation.

D.9 The Committee reiterates that the IMF's effectiveness and credibility as a cooperative institution must be safeguarded and its governance further enhanced, emphasizing the importance of fair voice and representation for all members. We underscore the role an ad hoc increase in quotas would play in improving the distribution of quotas to reflect important changes in the weight and role of countries in the world economy. The Committee agrees on the need for fundamental reforms. The Committee calls upon the Managing Director to work with the IMFC and Executive Board to come forward with concrete proposals for agreement at the Annual Meetings.

D.10 The Committee reiterates the importance of making IMF surveillance more effective and supports a review of the 1977 Surveillance Decision. In the context of the Managing Director's medium-term strategy, the Committee proposes a new framework for IMF surveillance which will consist of four elements. First, a new focus of surveillance on multilateral issues, including global financial issues, and especially the spillovers from one economy on others. Second, a restatement of the commitments which member countries and their institutions make to each other under Article IV on which surveillance can focus on monetary, financial, fiscal and exchange rate policies. Third, the Managing Director should implement his proposal for a new procedure, which will involve the IMFC and the Executive Board, for multilateral surveillance. Fourth, the IMFC should set a new annual remit for both bilateral and multilateral surveillance through which the Managing Director, the Executive Board and the staff are accountable for the quality of surveillance. This should involve the independence of Fund surveillance, greater transparency and the Independent Evaluation Office.

D.11 As emerging market members pursue sound policies and integrate effectively into world trade and capital markets, they make a welcome contribution to global economic stability and avoidance of financial crises. The Committee welcomes the IMF's efforts to respond to the new challenges and needs of emerging market members. Financial and capital markets issues should be increasingly at the center of the IMF's work in these countries. The Committee supports further examination of the Managing Director's proposal on a possible new instrument to provide high access contingent financing for countries that have strong macroeconomic policies, sustainable debt, and transparent reporting but remain vulnerable to shocks. The Committee encourages the IMF to explore the role it can play in supporting regional arrangements for pooling reserves. A review is also needed of the operational aspects of the IMF's policy on lending into arrears.

D.12 The Committee stresses that the IMF has a critical role in low-income countries, including in helping to ensure that expected increases in aid flows and debt relief are absorbed effectively and in a manner consistent with macroeconomic stability. The IMF needs to play its part within its areas of core competence in monitoring progress toward the MDGs. The Committee welcomes the establishment of new instruments that will strengthen the IMF's support for low-income countries, including the Policy Support Instrument and the Exogenous Shocks Facility, and underlines the importance of further contributions to enable the IMF to provide timely concessional shock financing. The Committee welcomes debt relief provided by the IMF and other institutions under the HIPC Initiative and Multilateral Debt Relief Initiative (MDRI). It also welcomes the agreement on the final list of potentially eligible members that meet the criteria of the HIPC Initiative. The Committee underscores the importance of ensuring debt sustainability in countries receiving debt relief by refining the joint IMF-World Bank debt sustainability framework, and helping countries to implement sound medium-term debt strategies and strong public expenditure management and tax systems. The Committee notes the importance of countries avoiding the re-accumulation of unsustainable debt and the potentially adverse consequences of nonconcessional borrowing for debt sustainability. It urges all creditors to work with the IMF and the World Bank to adhere to responsible lending. The Committee considers it critical for the effectiveness of the IMF's work in low-income countries that its policy advice, support for capacity building, and financial assistance are closely aligned with the countries' evolving needs and poverty reduction strategies, and focused on macroeconomic issues, including institutions relevant to financial stability, trade, and economic growth.

D.13 The Committee supports efforts to clarify the division of responsibilities and accountabilities of the IMF and the World Bank, and to improve their collaboration. It welcomes the establishment of the External Review Committee on World Bank-IMF Collaboration, and looks forward to its conclusions.

D.14 The Committee notes that the IMF's budgetary position has changed following the recent decline in IMF credit, and this requires actions on both income and expenditure. The Committee calls on the Managing Director to develop proposals expeditiously for more predictable and stable sources of income. The Committee welcomes that the medium-term strategy is formulated in a budget-neutral way, and encourages the IMF to further prioritize and streamline its work.

Other Issues

D.15 The Committee recommends members' acceptance of the Fourth Amendment of the Articles of Agreement. The Committee calls for continued actions by all countries to develop strong programs on anti-money laundering and combating the financing of terrorism (AML/CFT), and supports the comprehensive assessment of these programs within the context of the Financial Sector Assessment Program.

D.16 The Committee notes the upcoming discussion by the Executive Board of the external evaluation of the Independent Evaluation Office (IEO), and looks forward to the continuing contribution of the IEO to the IMF's work.

D.17 The next meeting of the IMFC will be held in Singapore, on September 17, 2006.

E.1 The International Monetary and Financial Committee held its fourteenth meeting in Singapore on September 17, 2006 under the Chairmanship of Mr. Gordon Brown, Chancellor of the Exchequer of the United Kingdom. The Committee expresses its gratitude to the Singapore authorities for the excellent arrangements.

Quota and Voice Reform in the IMF

E.2 Following the call at our last meeting to safeguard and enhance the IMF's effectiveness and credibility, the Committee stresses the importance of IMF quota and voice reforms. The Executive Board has submitted a comprehensive two-year program of quota and voice reforms in a draft resolution to the Board of Governors. Subject to the adoption of the resolution, the September 2006 meetings would initiate an integrated set of reforms, to be completed no later than by the 2008 Annual Meetings. Starting with initial quota increases for China, Korea, Mexico, and Turkey, this package of reforms, when implemented, would make significant progress in realigning quota shares with members' relative positions in the world economy and, equally important, in enhancing the participation and voice of low-income countries in the IMF as set out in the resolution. The Committee urges the Executive Board to work constructively and expeditiously on all elements of the reforms so as to garner the broadest possible support, underlines the importance of timely implementation of the program, and calls on the Managing Director to provide a status report at its next meeting.

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

E.3 The Committee welcomes the ongoing strong and broad-based global economic expansion. Growth is expected to remain robust in 2007. However, there are downside risks from the possibility of a continued build-up of inflationary pressures, a slowdown in consumption in a number of countries, continuing high and volatile energy prices, and the spread of protectionism. The Committee agrees that in the period ahead the IMF should focus on supporting its members in promoting policies for: reducing global imbalances while sustaining global growth; addressing the impact of high oil prices, in particular on the most vulnerable countries; managing the likely transition to less generous liquidity conditions; and ensuring medium-term fiscal sustainability and financial stability. The Committee underscores that reinvigorating the momentum of multilateral trade liberalization is critical so as to sustain and strengthen the foundations of global growth.

E.4 In the advanced economies, monetary policy will need to continue solidly anchoring inflation expectations and to balance the relative risks to price stability and growth. The current favorable economic environment provides an opportunity for ambitious fiscal consolidation, backed up with credible policy measures to put social security and health care systems on sounder footings to cope with the challenges of population aging. Growth prospects should be bolstered by structural reforms needed in many countries to improve the business environment and product market flexibility, enhance the capacity of labor to adapt to globalization, and spur productivity advances.

E.5 In emerging market and other developing countries, improved fundamentals have underpinned the resilience of growth to high oil prices and tighter global financial conditions. Growth performance, especially in emerging Asia, has benefited from market-oriented reforms, open trade, and competition. In countries where vulnerabilities remain, further efforts are needed to strengthen public sector balance sheets, anchor inflation expectations, improve the functioning of financial sectors, and ensure the sustainability of external positions.

E.6 Growth in low-income countries overall, including in Sub-Saharan Africa, remains strong. The Committee emphasizes the importance of a strong partnership between poor countries and donors to underpin further efforts to accelerate growth to help achieve the Millennium Development Goals (MDGs). Countries should persevere with sound macroeconomic policies, strengthening institutions, and growth-critical reforms. The international community should also support countries' own poverty reduction efforts with increased and more effective aid, agreed debt relief, and bold market-opening initiatives.

E.7 The Committee calls for sustained actions to implement the agreed policy strategy to underpin an orderly unwinding of global imbalances. The strategy involves: steps to boost national saving in the United States, including fiscal consolidation; further progress on growth-enhancing reforms in Europe; further structural reforms, including fiscal consolidation, in Japan; reforms to boost domestic demand in emerging Asia, together with greater exchange rate flexibility in a number of surplus countries; and increased spending consistent with absorptive capacity and macroeconomic stability in oil producing countries. The Committee welcomes the multilateral consultation by the IMF, which provides an opportunity to support the agreed policy strategy.

E.8 The Committee remains concerned about high and volatile prices in world energy markets. It welcomes the actions taken to address capacity constraints in oil production, and calls for continued measures from all sides to improve the supply-demand balance in oil markets over the medium term. This will involve increased investment to build up adequate production and refining capacity, incentives to encourage energy conservation by consumers, steps to improve the quality and transparency of oil data, and closer dialogue among oil producers and consumers. The Committee also calls on the IMF to continue to provide advice and support-in particular, to its low-income members-to help countries adjust to high oil prices.

E.9 Following our meeting with business leaders, we reconfirm our shared commitment to strengthen the foundations of a globalized economic and financial system that promotes growth and poverty reduction and provides equitable opportunities for all. The Committee also received a report on the current status of the multilateral trade negotiations under the Doha Round from Mr. Pascal Lamy, Director-General of the WTO. The Committee expresses its deep disappointment that the trade negotiations have been suspended. It urges all WTO members to maintain their commitment to the rules-based multilateral trading system, resist protectionist calls, and preserve progress that has already been made. The Committee calls for leadership from the major trading nations to work urgently toward an early resumption of the negotiations, and an ambitious, successful outcome by the end of the year, based on a commitment to a comprehensive package on agriculture, industrial products, and services, to which all countries will need to contribute.

E.10 The Committee recognizes the importance of achieving the MDGs. In this context it also stresses the importance of implementing Aid-for-Trade assistance, which is firmly grounded in national development strategies, independent of progress on the Doha Round. We welcome the reports of the taskforces on the Integrated Framework and on Aid for Trade and the financing commitments by donors for the enhanced Integrated Framework.

Implementation of the IMF's Medium-Term Strategy

E.11 Following the agreement at its last meeting, the Committee welcomes the progress made in the reform of the IMF surveillance framework. It welcomes the steps to put greater focus on financial and capital market issues in the IMF's work. The Committee welcomes the multilateral consultation approach, which aims at fostering discussion and cooperation on common economic and financial issues. The Committee looks forward to the conclusions of the first multilateral consultation on global imbalances, and proposals by the Managing Director for possible further consultations and work on issues of multilateral concern. The Committee welcomes the ongoing review with a view to updating the 1977 Decision on Surveillance over Exchange Rate Policies to secure a common understanding and consensus on the responsibilities under Article IV and the foundations and objectives of surveillance, covering monetary, fiscal, financial, and exchange rate policies. The Committee takes note of the work to date by the Board on a remit for surveillance, which would provide a statement of objectives, priorities, and responsibilities for the medium term, and it looks forward to further work as part of the wider program to improve the effectiveness of surveillance. The Committee will discuss progress on the remit at its Spring meeting.

E.12 The Committee supports the strengthening of IMF policies to better assist its emerging market members. The Committee welcomes the recent discussion in the Executive Board on a new liquidity instrument for countries that are active in international capital markets, aimed at supporting these countries' own strong policies, and ensuring that substantial financing will be available if needed while safeguarding IMF resources. The Committee calls on the Executive Board to continue its work on the necessary design features of a new instrument, while paying due regard to the interaction with existing IMF facilities, and invites the Managing Director to present a concrete proposal by the time of its next meeting. The Committee also looks forward to the upcoming review of the IMF's policy on lending into arrears.

E.13 The Committee considers that the IMF should give priority to enhancing the effectiveness of its work in low-income countries by focusing on sustainable growth and macro-critical areas that support the achievement of the MDGs. It welcomes implementation of the MDRI by the IMF, World Bank, and African Development Bank; the provision of debt relief under the HIPC Initiative to two further countries (Cameroon and Malawi); and the decision to grandfather all eligible HIPCs when the sunset clause of the HIPC Initiative takes effect at end-2006. The Committee underscores the importance of helping countries reap the benefits of higher aid and debt relief, and avoid a new build-up of unsustainable debt. The Committee stresses that the debt sustainability framework jointly developed by the IMF and the World Bank is the primary tool to be used by borrowers and creditors in assessing alternative financing strategies, identifying emerging debt-related vulnerabilities, and developing coherent lending practices, and urges all creditors and borrowers to use the framework in their lending and borrowing decisions. The Committee urges all creditors to work with the IMF and the World Bank to adhere to responsible lending. The Committee

looks forward to further refinements to the framework and the development of practical guidelines for borrowers and creditors.

E.14 At its next meeting, the Committee will consider further work on ways to enhance collaboration and clarify the division of responsibilities and accountabilities between the IMF and the World Bank, taking account of the work of the External Review Committee on World Bank-IMF Collaboration.

E.15 The Committee looks forward to the development of proposals for more predictable and stable sources of IMF income, in the context of the IMF's overall budgetary position. It looks forward to the recommendations of the Committee of Eminent Persons appointed by the Managing Director.

Other Issues

E.16 The Committee calls for closer cooperation between the IMF and Financial Action Task Force in promoting stronger implementation of international anti-money laundering and combating terrorist financing (AML/CFT) standards and encourages publication of comprehensive country evaluations.

E.17 The Committee recommends members' acceptance of the Fourth Amendment of the Articles of Agreement.

E.18 The Committee welcomes the external evaluation of the Independent Evaluation Office (IEO). The IEO is continuing to make a valuable contribution to the IMF's learning culture and facilitating oversight and governance.

E.19 The Committee expresses its heartfelt appreciation to Anne Krueger for her exceptional contributions to a shared vision of a globalized economy providing equitable opportunities for all, and for serving the IMF and its membership with unwavering dedication and decisive intellectual leadership. It extends a warm welcome to John Lipsky, who has succeeded her as First Deputy Managing Director. The Committee also expresses its appreciation of the work of Raghuram Rajan as Economic Counsellor.

E.20 The next meeting of the IMFC will be held in Washington, D.C. on April 14, 2007.

ISBN 978-1-84532-249-6



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