

STABILITY GROWTH POVERTY REDUCTION



THE UK AND THE IMF 2002



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The UK and the IMF 2002

Stability

Growth

Poverty Reduction

March 2003

- **STABILITY**
- **GROWTH**
- **POVERTY REDUCTION**

The UK and the IMF 2002

CONTENTS

FOREWORD BY THE CHANCELLOR OF THE EXCHEQUER	1
REPRESENTING THE UK AT THE IMF	2
1. An IMF for the 21st Century	4
2. IMF Surveillance and the World Economy in 2002	13
3. Strengthening the International Financial System	23
4. Meeting the Millennium Development Goals	39
5. An Effective Actor in the International Community	61

ANNEXES

I IMF Decision Making – UK Positions	79
II The UK's Financial Relationship with the IMF	85
III IMF Lending Facilities	89
IV IMFC Spring Communiqué	92
V IMFC Autumn Communiqué	99

FOREWORD BY THE CHANCELLOR OF THE EXCHEQUER

These are testing times for us all. Testing, because in a world economy buffeted by stock market volatility and uncertainty in the Middle East, economic policy must be shown to work for the benefit of all, in the bad times as well as the good. Testing also, because in a world where over a billion people live on less than \$1 a day, there is a real risk we will miss our target of halving poverty by 2015.

Addressing world poverty and sustaining world growth are inextricably linked. Reducing poverty requires a strong world economy, but if the global economy is to sustain high rates of growth in the years to come, growth can and must come from bringing developing countries into the development process. At the same time, the world economy must advance in a stable and sustainable manner if all countries are to benefit from greater integration. As we saw in East Asia and more recently in Argentina, financial crises can drive millions of people into poverty.

The IMF - as the custodian of the international financial system - can play a decisive role in advancing a globalisation that works for all, but all member countries must also play their part. Only through continued international cooperation and partnership can we deliver stability, growth and poverty reduction on a global scale.

We made much progress in 2002, but there are many challenges that still face us. Foremost among these: economic uncertainty and extreme poverty. So this report also sets out our key priorities for reform at the IMF:

- encouraging member countries to adopt credible, transparent and sound domestic policy frameworks that facilitate integration into the international system while limiting vulnerability to crises;
- strengthening the Fund's crisis prevention and resolution capacity, particularly through greater independence for Fund surveillance, more widespread adoption of internationally agreed codes and standards and a more effective framework for the orderly resolution of financial crises;
- a stronger voice for developing countries in the IMF combined with greater transparency and accountability in its operations; and
- achieving the Millennium Development Goals through the primacy of Poverty Reduction Strategies that are fully country driven, with the requisite increase in resources to back them. To this end, the UK has proposed an International Finance Facility that will provide an additional \$50 billion in aid flows each year up to 2015.

As we make progress across these areas, we must move from a situation where crises happen and then we deal with them, to a situation where we can reduce the likelihood of crises and provide more orderly responses when crises have to be resolved. Additionally we can move beyond providing temporary relief to the poorest countries; instead providing predictable, long-term support for their economic and social development.

To that end, I am pleased to be able to present this fourth annual report to Parliament and to the public on the UK and the IMF. It demonstrates our continued commitment to transparency and accountability in our dealings with the IMF.



REPRESENTING THE UK IN THE IMF

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. This comprises 24 Executive Directors representing all 184 members of the IMF. The UK, as one of the five largest contributors to the IMF, has its own Executive Director – currently Tom Scholar.

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



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



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



**TOM SCHOLAR,
UK Executive
Director**



AN IMF FOR THE 21ST CENTURY

Since the creation of the IMF in 1944, the global economy has become increasingly interdependent. Events in one country, whether it be financial crisis or widespread poverty, can now have huge ramifications elsewhere. The IMF has a central role to play in managing this interdependence and correspondingly, has grown in membership and mandate. UK priorities for IMF reform are focused on ensuring that it effectively covers this mandate and has the capacity to respond to new challenges.

THE IMF IN A PROCESS OF CHANGE

I.1 Since its creation in 1944, the IMF has continually adapted itself to meet the changing nature of the global economy and the international environment. This constant evolution has been reflected in changes to the function, policies and institutional structure of the IMF, and it is a process that continues today.

I.2 When the IMF was established, together with the World Bank, its core function was to maintain the Bretton Woods system of fixed exchange rates, but when the major industrial countries abandoned this system in the 1970s, this function of the IMF was no longer relevant. However, the Fund has continued to play an important role in the international financial system by changing its operations in response to new economic realities. This has been particularly true since the early 1990s, with the increasing international integration of markets and economies.

I.3 Today's global economy is very different to that of 1944. Globalisation has brought the benefits of higher investment, faster growth and more effective poverty reduction to those countries that have become more integrated into the global economy, but globalisation has also brought new risks and challenges. Events in one country, whether it be financial crisis or widespread poverty, can have implications in many other economies. Globalisation also creates change, which labour markets, tax and social security systems, and fiscal and monetary policy must respond to, and there is a danger that the poorest countries, which have yet to fully benefit from globalisation, will fall further behind as living standards elsewhere rise.

I.4 So at the start of the 21st Century, the IMF must once again adapt to address a new, much larger challenge – how to ensure that the benefits of globalisation are sustained and shared.



Globalisation that works for all

I.5 Delivering a globalisation that works for all will once again require exceptional international cooperation, and the IMF has a central role to play in facilitating this cooperation. The core function of the IMF is “To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems”¹. In fulfilling this function, the IMF provides a mechanism for member countries to cooperate with others to promote both their own domestic economic prosperity and that of the entire membership.

I.6 The UK believes that this cooperation should focus on three core areas:

- strengthening the international financial system;
- meeting the Millennium Development Goals; and
- enhancing the IMF’s institutional framework.

I.7 In each of these areas, the UK has a number of specific priorities for reform that are aimed at ensuring the IMF’s policies and processes are geared to addressing the challenges of globalisation. Going forward, we will continue to advance these priorities at the IMF and other relevant fora. This chapter outlines those priorities. Subsequent chapters provide additional background and review the relevant discussions that took place at the IMF over the course of 2002, including summaries of the UK position.

STRENGTHENING THE INTERNATIONAL FINANCIAL SYSTEM

I.8 A credible domestic policy framework is essential in ensuring a country can fully benefit from globalisation. The IMF has an important role to play in helping its members establish these frameworks, and more broadly, in addressing the weaknesses of the international financial system. In particular, there are three areas where the UK believes the international financial system needs strengthening: crisis prevention, crisis resolution and combating money laundering and the financing of terrorism.

CRISIS PREVENTION

I.9 The IMF fulfils a vital role in preventing financial crises – through its promotion of codes and standards and its surveillance process. Central to this approach is encouraging members to adopt policies and reforms that support growth and strengthen the resilience of their economies to adverse external developments, thus contributing to the stability of the international financial system.

¹Article I, section (i) of the IMF’s Articles of Agreement



Macroeconomic Frameworks

I.10 The UK government believes these policies and reforms should be set within a credible, rules-based macroeconomic framework. This framework should constrain macroeconomic policy to achieve clear long-term goals, while providing the short-term flexibility to respond to temporary shocks. The underlying principles for such a framework are:

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

I.11 Sound macroeconomic frameworks must be accompanied by structural reforms to create a more dynamic, efficient and innovative economy. For example, effective corporate governance and financial sector regulatory regimes, as well as labour market reforms to promote flexibility and minimum standards.

Codes and Standards

I.12 The internationally agreed codes and standards framework provides clear benchmarks for good policy across the range of official, financial and corporate sectors. These codes embody the frameworks outlined above, so their adoption will strengthen national economies and promote stability. However, while considerable effort has gone into developing and promoting these codes, with over 80 countries participating, we need to do more to encourage all countries to adopt them.

I.13 The UK will seek to promote more widespread adoption of codes and standards. Where capacity constraints hinder take-up, we will also encourage countries to draw on technical assistance from the Financial Sector Reform and Strengthening (FIRST) initiative – supported by DFID.

Surveillance

I.14 IMF surveillance is an essential tool for strengthening crisis prevention. The Fund is uniquely placed – with its responsibility for overseeing the international monetary system and the economies of its 184 member countries - to assess national and global economic prospects, detect vulnerabilities at an early stage, and provide preventative policy advice to avert crises. Yet economic crises over the last decade have raised questions about the effectiveness and influence of Fund surveillance. Steps have been taken in recent years to strengthen surveillance. However, the UK believes further reforms are necessary. The challenge, as the Chancellor of the Exchequer has said, is to make the IMF as credible and independent from political influence in its surveillance of economies as an independent central bank should be in the operation of domestic monetary policy.

I.15 A key UK priority is therefore to strengthen IMF surveillance to make it more independent, authoritative, transparent and accountable.



Contingent Credit Line

I.16 The IMF's Contingent Credit Line (CCL) was introduced in 1999 to strengthen the IMF's focus on crisis prevention. It is available to countries that are pursuing strong policies but are nevertheless threatened by contagion from financial crises elsewhere. By linking support to strong policy performance, it aims to provide an incentive for countries to implement strong policies and to send a positive signal to markets. While other facilities aim to resolve crises, the CCL is designed to prevent crises. Yet the CCL has so far failed to attract any applicants.

I.17 The UK believes that the objectives of the CCL – to encourage good policies and protect 'innocent bystanders' in financial crises – remain important. However, given the lack of applicants to date, the UK and others called on the IMF to review the CCL to address concerns about its design and consider whether it can be modified to encourage greater use. The Fund has consulted widely with officials from a range of countries (including potential CCL applicants) and private sector participants and is considering the best way forward to achieve the CCL's objectives. We support this approach.

Advancing this Agenda

I.18 We will continue to press for a strengthening of the Fund's crisis prevention tools, both through the Executive Board and through the International Monetary and Financial Committee (IMFC).

I.19 In parallel, we will also work within the EU, G7 and other relevant fora to build support for UK priorities in this area.

CRISIS RESOLUTION

I.20 Even our best attempts to prevent crises are unlikely to be completely successful. The UK therefore strongly supports the IMF's efforts to complement its crisis prevention tools with stronger mechanisms for resolving financial crises once they have occurred.

I.21 The rapid growth in international capital flows has resulted in private sector debt dominating the capital accounts of many emerging markets. At the same time, official sector resources are limited. So once a financial crisis has occurred, it is essential that the private sector play its part in resolving it.

The Crisis Resolution Framework

I.22 The UK is keen to see progress in the following areas:

- development of a more orderly and transparent framework for facilitating a restructuring of sovereign debt;
- clear and consistent application of the policy on access to Fund resources to strengthen the market's understanding of how the official sector will respond to a crisis and hence, the role they will need to play.

I.23 We will continue to actively engage in Fund discussions on these issues, including their application to specific country cases. We will also work within the EU, G7 and G20 and through dialogue with the private sector to ensure the IMF's crisis resolution machinery is developed in an effective and consultative manner.



TACKLING ABUSE OF THE INTERNATIONAL FINANCIAL SYSTEM

I.24 Financial crises are one of the risks associated with the increased integration of financial markets. Another is the potential for the system to be abused through money laundering and the financing of terrorism.

I.25 The UK strongly supported an expansion of the IMF's work in combating these abuses, in particular the development of a new codes and standards module on anti-money laundering and combating the financing of terrorism (AMC/CFT), based on the Financial Action Task Force (FATF) recommendations, as the recognised international standard. The UK is keen to ensure that the pilot phase of this module is successful, with subsequent widespread uptake. In addition we will work with the FATF, the UN and the Egmont Group to deliver this. We will also continue to support the provision of technical assistance to address weaknesses in members' AML/CFT systems.

MEETING THE MILLENNIUM DEVELOPMENT GOALS

I.26 The international community is committed to meeting the Millennium Development Goals (MDGs), including halving the proportion of people living in poverty by 2015. As part of this wider effort, the IMF has an important role to play in supporting the efforts of low-income countries as they undertake and finance the reforms necessary to benefit from globalisation.

I.27 IMF support to low-income countries is increasingly focused on supporting the development and implementation of Poverty Reduction Strategy Papers (PRSPs) that are consistent with achieving the MDGs at the country level. The IMF provides support for PRSPs through its concessional facility: the Poverty Reduction and Growth Facility (PRGF); and through debt relief: the enhanced Heavily Indebted Poor Countries (HIPC) initiative.

The Poverty Reduction and Growth Facility

I.28 The PRGF should be fully aligned behind the PRSP, supporting country-ownership through streamlined conditionality. The UK will continue to push this with Fund staff and wider stakeholders.

I.29 If other development agencies are to also align their support behind PRSPs, they must be confident that the resources they provide in budgetary support are used effectively. This in turn requires effective public financial management and accountability (PFMA) systems. The IMF and World Bank currently have numerous tools for assessing the various components of these systems but this can lead to duplication and inefficiency. The UK is therefore encouraging the two institutions to place greater emphasis on streamlining their tools for assessing country performance, and on achieving concrete progress at the country level in improving PFMA systems.



The Heavily Indebted Poor Countries Initiative

I.30 Much progress has been made on the HIPC initiative. However, additional work is required. The UK will use international meetings to press for more flexible provision of topping-up at completion point, with additional voluntary bilateral debt relief excluded from the calculation, to ensure fair burden sharing among creditors and greater benefits to HIPCs. The government will also seek to ensure that all creditors play their part in financing and delivering the initiative and that technical assistance is made available to HIPCs being sued by creditors. The UK government will also continue to encourage those HIPCs affected by conflict to work towards peace and put in place the conditions necessary to ensure that debt relief is used for poverty reduction.

Resources for Development

I.31 The international community must also recognise that without additional support, even the best efforts of developing countries will not be enough to meet the MDGs. The IMF has an important international role to play in helping to mobilise these resources via increased aid and trade.

- **Aid:** No country genuinely pursuing stability and reform should be denied the possibility of help to finance education, health and anti-poverty policies. To this end, a major priority for the UK will be to build support for an International Finance Facility (IFF) that will leverage finance from international capital markets to provide an additional \$50 billion per year in aid to 2015. The UK will promote the IFF through all relevant national and international fora.
- **Trade:** Cutting developed countries' protection of their own agriculture, industrial goods and services sectors by 50 per cent could increase the world's income by as much as an estimated \$400 billion per year, with significant benefits for the poorest countries. The UK will continue to work with our European partners to ensure that the EU is able to take a strong, pro-development, position in all areas of negotiation at the WTO Ministerial meeting in Cancún, Mexico, in September 2003.

ENHANCING THE IMF'S INSTITUTIONAL FRAMEWORK

I.32 In addition to requiring changes to the IMF's policies, globalisation is also creating pressures for change in the IMF's institutional procedures and external relationships. Key UK priorities will be to increase transparency, strengthen developing country voice in the IMF's decision-making processes and encourage greater IMF/World Bank collaboration.

Transparency

I.33 Increasing the transparency of the IMF is a critical element of our efforts to strengthen crisis prevention and promote stability. The IMF has made much progress in its transparency in recent years. However, the UK believes that further progress is both possible and useful. In particular, we will continue to push strongly for:



- presumption in favour of publishing the IMF's surveillance reports and assessments of adherence to the codes and standards framework;
- compulsory publication of reports on Fund lending programmes (Use of Fund Resources – UFR – reports);
- further measures to enhance the transparency of the Executive Board, including through accelerated access to the minutes of Board Meetings; and
- greater dialogue by the Fund with non-governmental sectors within its membership, and in particular with Parliaments and civil society.

Representative Decision- Making

I.34 Developing countries constitute the majority of IMF membership and are often profoundly affected by its decisions, yet their ability to influence these decisions is limited. In part this is due to capacity commitments and the mismatch between resources and work volumes. Addressing this through measures to increase developing country voice in the Fund will improve the effectiveness of the IMF and strengthen these countries' sense of ownership of the institution and its policies.

I.35 We are considering a number of proposals to strengthen developing country voice. In the short-term, these include more staff and resources for their delegation offices, better training opportunities and improved communication links to capitals. A package of such measures will help to tackle the immediate voice problems facing the sub-Saharan African constituencies. In particular, that of high workload relative to capacity. We also believe that the proposal to increase the basic vote merits serious consideration. A joint World Bank/IMF paper on strengthening voice will be discussed by the Development Committee at the Spring Meetings in April 2003. Ahead of that, we are seeking to build support for a package of proposals on strengthening voice.

Collaboration with the World Bank

I.36 These reforms should strengthen the IMF's effectiveness and credibility in the wider international institutional system.

I.37 In parallel the government supports strengthened IMF/World Bank collaboration, consistent with their respective mandates. A particular priority is the use of Poverty and Social Impact Analysis (PSIA) in the policy design process. PSIA is an important tool in opening up the debate on alternative policy options and can help strengthen ownership of key reforms, but it has yet to be employed in a systematic manner. Through improved collaboration, the government believes the IMF and World Bank can address this and that PSIA can become an important tool for both institutions.

THE WAY AHEAD

I.38 Global problems increasingly require global solutions. This is placing renewed emphasis on the effectiveness of the international institutional system. The IMF is a key player in this system. Through strengthening the international financial architecture, contributing to the achievement of the Millennium Development Goals and promoting



sound economic policies in its members, it has a vital role to play in delivering global growth, stability and poverty reduction. The UK government will continue to push for IMF policies that serve these objectives.

2

IMF SURVEILLANCE AND THE WORLD ECONOMY IN 2002

The IMF has an important role to play in monitoring economic and financial developments, both in its member countries and globally. In 2002, these surveillance discussions focused on the fragile recovery in the world economy and the potential impact of shocks on this recovery. The adverse effects of the slowdown on emerging markets and developing countries were a particular concern.

IMF SURVEILLANCE

2.1 Under Article IV of its Articles of Agreement, the IMF is mandated to “oversee the international monetary system in order to ensure its effective operation”. It does this through “firm surveillance over the exchange rate policies of members”³. However, the coverage of surveillance has evolved to include a wider range of macroeconomic and structural policies and in today’s global economy, where economic developments in one country can rapidly spread to another, this surveillance role of the IMF is more important than ever.

2.2 This chapter outlines the IMF surveillance process, then summarises the conclusions of the key surveillance discussions and lending programmes that took place in 2002⁴.

2.3 The IMF conducts surveillance at three levels:

- Global: the world economy at the aggregate level. This is done through the IMF World Economic Outlook and the Global Financial Stability Report;
- Regional: key regional economic areas, such as the Euro-Area;
- Country: the IMF holds “Article IV” consultations with each member country about its economic policies.

³Article IV, Sections 3(a) and 3(6) of the Articles of Agreement of the International Monetary Fund

⁴Chapter 3 considers the UK priorities for reform of the surveillance process

ARTICLE IV COUNTRY SURVEILLANCE

Article IV consultations between the IMF and individual member countries are normally held once a year. The consultations focus on major aspects of macroeconomic and financial sector policies, in particular exchange rate, fiscal and monetary policies and the balance of payments position, including the policy stance and framework. They also cover other policies that affect macroeconomic performance, including where relevant, labour, productivity, enterprise and environmental policies and economic governance.

An Article IV consultation is conducted by a visiting IMF staff team. The team will collect economic and financial information and discuss economic developments and policies with the national authorities. At the end of the mission, the staff prepare a concluding statement. On their return to Washington, they write the Article IV report that summarises much of the detail obtained from the mission and reflects the analysis underlying their views (as expressed in the Concluding Statement). The report is subsequently discussed by the Executive Board. The views of the Executive Board are summarised in Public Information Notices (PINs) attached to the staff report.

In August 2000, following a successful pilot project, the Executive Board adopted a policy of voluntary publication of Article IV staff reports. The UK participated in this pilot project by authorising the publication of the UK's 1999 Article IV report. Since then, the government has continued to publish the UK Article IV reports.

GLOBAL SURVEILLANCE

Overview of the World Economy

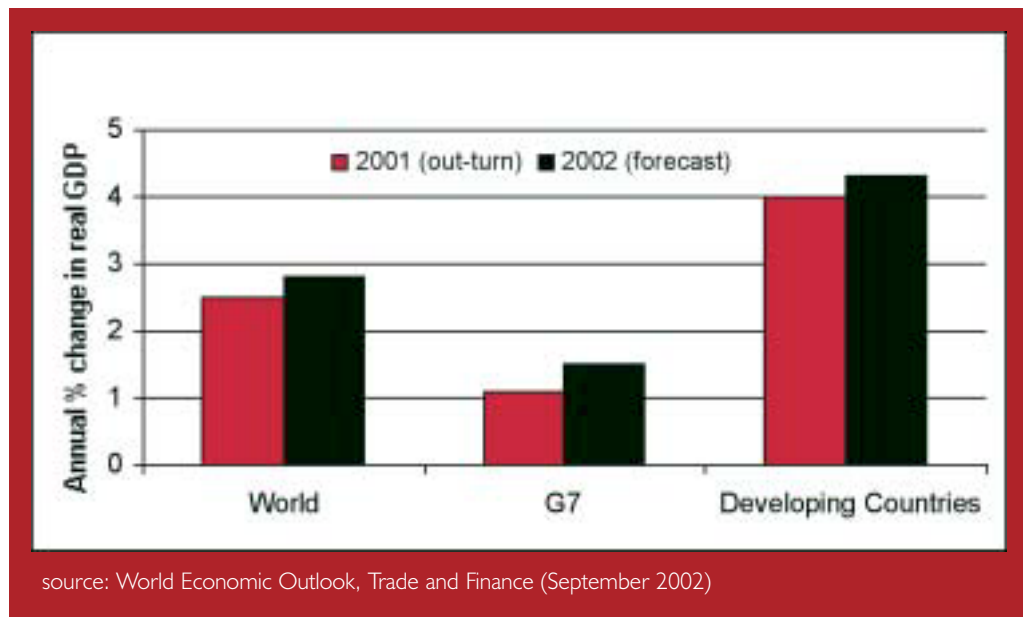
2.4 In 2002, the world economy began to recover from the first synchronised slowdown across the world's major economies in almost three decades. During the first half of 2002, increases in trade and industrial production provided clear evidence that the global recovery was underway. However towards the end of 2002, the outlook weakened again as corporate accounting failures, further declines in equity markets, developments in the Middle East and rising oil prices exacerbated existing uncertainties. As G7 Finance Ministers noted in September 2002, "Economic growth in our countries is continuing, though at a more moderate pace than earlier this year. We recognize that risks remain"⁵.

2.5 Continued volatility in global equity markets and the possibility of renewed rises in oil prices pose a clear risk to the global economic outlook. Heightened investor uncertainty, as a result of any more high profile corporate failures or continued uncertainty in the Middle East, could also delay the global investment recovery.

⁵Statement of G7 Finance Ministers and Central Bank Governors, 27 September 2002. Available at <http://www.fin.gc.ca/activity/G7/g7270902e.html>

2.6 Supportive fiscal and monetary policy should, however, help the global recovery. For example, low interest rates in several countries could stimulate faster than expected household consumption growth.

CHART 2.1 IMF World Economic Outlook



Global Financial Stability

2.7 The Global Financial Stability Report provides timely and comprehensive coverage of financial markets, with a view to identifying potential weaknesses that could lead to crises. In 2002, its reports analysed the deterioration in global financial market conditions.

2.8 A sharp erosion in investor confidence reflected uncertainty, then concern over the strength and durability of the global recovery and geopolitical conditions. Despite this, the international financial system remained resilient; the markets, while unusually volatile, were still orderly and the financial system functioned smoothly.

2.9 With completion of the first annual cycle of GFSR reports, the Board also expressed its satisfaction at the speed with which the GFSR had become a useful tool in monitoring financial market developments and risks.

REGIONAL AND COUNTRY SURVEILLANCE

2.10 The US, Japan, the euro-area and the UK account for nearly 70 per cent of global economic output⁶. Consequently, the IMF's analysis of these economies and its policy advice are of particular relevance in assessing global growth prospects. This section considers the conclusions of these surveillance discussions.

⁶source: World Development Indicators 2001



US Article IV 2.11 After the slowdown in 2001, there was a return to growth in the US economy in 2002.

2.12 The US Article IV Board discussion in July focused on the prospects and policies required for a renewed and durable expansion. While it was felt that activity was rebounding, uncertainties remained regarding both the underlying strength of final domestic demand and the extent to which the rapid productivity growth achieved during the latter half of the 1990s could be sustained. Staff were particularly concerned by the large current account deficit, and the related broader imbalance of global growth. There was also concern that the US fiscal outlook had weakened considerably over the preceding year and that a key step towards addressing these pressures would be to establish a framework that set the clear goal of balancing the budget excluding social security, over the business cycle.

CORPORATE GOVERNANCE

The crises at Enron, WorldCom and elsewhere triggered a renewed focus on corporate governance issues in 2002. The scandals and resulting loss of investor confidence across world markets continue to contribute to international financial uncertainty, and have played a major role in global stock market declines.

Significant doubts have been cast over the effectiveness of existing corporate governance, accounting and auditing arrangements. In addition, the roles and practices of financial analysts and credit rating agencies are being seriously questioned, while the appropriateness of senior executive remuneration packages – in both style and content – have been brought into sharp focus.

National responses in Europe and the US have been rapid and wide-ranging. Initially draft legislation in the US focused primarily on investor protection, but after WorldCom this was strengthened significantly. The Sarbanes-Oxley Act was passed by Congress in July 2002, almost unanimously. It covers the regulation of accounting and auditing, as well as corporate governance and the practices of financial analysts, while commissioning further studies into credit rating agencies. There are also sections covering the punishment for corporate and criminal fraud.

In Europe, the High Level Group of Company Law Experts led by Jaap Winter has produced a report looking into company law broadly but with specific recommendations for corporate governance, from which an action plan is anticipated. Individual nations also have work under way. In the UK, the Treasury and the DTI set-up the Co-ordinating Group on Audit and Accounting Issues with representatives from industry, regulators and government to ensure that there is a co-ordinated and comprehensive work programme to review the UK's regulatory arrangements. The government also set up an independent review of non-

executive directors' remuneration chaired by Derek Higgs. Both reported in early 2003 and government and industry are considering their recommendations. The Financial Services Authority is also looking into the role and practices of financial analysts.

The principal concern for the UK has been to ensure that these issues are addressed through considered and well-targeted measures that are developed in full consultation with stakeholders. The problems exposed by the Enron collapse have global implications. The UK is therefore pushing for global solutions that will not hinder the integration of international capital markets, such as the work being done in the Financial Stability Forum and the moves towards recognised international principles, for example the growing adoption of International Accounting Standards.

Japan's Article IV 2.13 The Japanese economy began to recover in 2002 on the back of stronger external demand (and a weaker yen), but the recovery lost momentum towards the end of the year. Deep-seated structural problems in the banking and corporate sectors remain a drag on growth. The government reaffirmed its commitment to press ahead with structural reforms, so the priority now is implementation.

2.14 Japan's Article IV in July considered some of these implementation issues. Directors stressed that macroeconomic policy needs to remain supportive, to offset the short-term effects of structural reform. Fiscal policy needs to remain broadly neutral in the near term, and further measures taken to improve the composition and hence effectiveness of fiscal spending, but it was also felt that a clear medium-term strategy was needed to tackle the high and rising public debt ratio. Monetary policy must be geared to securing an early end to deflation.

Euro-Area Article IV 2.15 Economic activity in the euro-area continued to disappoint during 2002 as consumer spending and investment remained weak. For the year as a whole growth of just 0.75 per cent is expected. A gradual pick-up in activity is forecast for 2003 in-line with global developments, although at a slower pace than previously expected.

2.16 The Euro Area Article IV in October 2002 noted that there remained plenty of scope to raise the area's potential and reduce vulnerability to shocks through further reforms. Directors stressed the need for reforms to support the reabsorption of labour and further product market integration, particularly in services trade. In this context, new impetus to speeding up financial sector integration through the implementation of the Financial Services Action Plan was welcomed.

SURVEILLANCE OF THE UK ECONOMY

The IMF mission for the UK's 2002 Article IV consultation was conducted from November to December 2002. During the mission, Fund staff met with the Chancellor of the Exchequer, the Governor of the Bank of England, the chairman of the Financial Services Authority, senior officials of the government and the Bank of England and representatives of financial institutions, independent research institutes, business and trade unions.

In February 2003, the Board discussed the UK's Article IV Report, alongside the Financial Sector Assessment Programme (see Chapter 3). Executive Directors noted that the UK had performed well since the previous Article IV consultation. They commended the UK government for "the pursuit of prudent and credible economic policies in the context of a sound medium-term policy framework" and "the strong performance of the UK economy" based on low inflation and sustained output and employment growth. The Directors also noted that while growth decelerated in 2002, the economy has so far weathered the global slowdown relatively well, in part because of the timely easing of monetary and fiscal policies in the context of a well-functioning inflation-targeting framework and a low public debt to GDP ratio.

Looking ahead, the Board noted the prospects for a continued economic recovery, but they also saw risks to this outlook stemming from both external and domestic uncertainties.

Both the Concluding Statement of the IMF Mission and the full UK Article IV Report are available on the HM Treasury and IMF websites respectively.

EMERGING MARKETS OVERVIEW

2.17 The picture for emerging markets during 2002 was mixed. The external environment for the first half of the year was favourable reflecting the recovery in the global economy. Many emerging markets took advantage of the resulting improved credit conditions by front-loading their financing for the year. However, uncertainty increased in the second half of 2002 reflecting fears of the faltering US recovery, greater stock market volatility, growing tensions in the Middle East and increased security concerns over the potential for global terrorism.

2.18 In 2002, access to capital was sharply divided along regional lines. Events in Argentina impacted on Latin America and raised borrowing costs for many countries, but the increased political and economic uncertainty did not lead to more broad-based contagion. In fact, Asia and emerging Europe (particularly investment grade borrowers) continued to attract capital despite worsening conditions in Latin America.

2.19 Table 2.1 below shows the continued decline in total flows of private capital to emerging markets since 2000. This is being driven largely by shrinking FDI flows, but bond issuances are also low compared to their 2000 level. Emerging markets continue to depend on private flows rather than official flows for external financing.

TABLE 2.1 Emerging Markets External Financing (US\$bn)

	Total Private Flows	Equity Investment		Private Creditors		Official Flows
		FDI	Portfolio Investment	Commercial Banks	Non-banks	
1999	153.2	148.9	19.4	-51.5	36.4	12.6
2000	187.6	135.3	14.4	-0.3	38.2	-4.0
2001	126.0	134.6	11.1	-26.4	6.7	14.0
2002	122.9	113.2	10.5	-10.7	9.9	16.6
2003*	150.8	116.4	15.1	-1.0	20.3	19.0

* Institute for International Finance Forecast
source: *Institute for International Finance*

IMF Lending to Emerging Markets

2.20 Although the overall picture for emerging markets was mixed in 2002, a number of economies experienced particular difficulties and required IMF assistance. This was particularly true of Turkey, Brazil, Argentina and Uruguay. Between them, these four economies currently account for 85 per cent of committed Fund resources⁷.

Turkey: Stand-by Arrangement

2.21 A new Stand-By Arrangement (SBA), amounting to SDR12.8 billion (\$17.3 billion) was agreed in February 2002 in support of Turkey's economic programme. This involved further resources to tackle 2002 financing needs and initially had a large, positive impact on market confidence. After the break-up of the ruling coalition in late summer 2002, parliamentary elections were held on 3 November 2002, with the Justice and Development Party (AKP) gaining a majority. The new government remains committed to the IMF programme. Turkey is working to complete the fourth review of its SBA.

Brazil: Stand-by Arrangement

2.22 Despite good economic performance and a sound policy framework, the weakening external environment, the persistence of economic difficulties in Argentina, and uncertainties about the continuity of macroeconomic policy following the presidential elections put substantial pressure on Brazilian financial variables during the summer of 2002. With the *Real* depreciating and bond spreads widening, Brazil's public sector net debt burden increased, making it more and more difficult for Brazil to service its obligations.

⁷source: IMF Survey, January 2003

2.23 In this context, the SBA agreed for Brazil in September 2001 was cancelled. A new \$30 billion SBA was arranged in August 2002, and approved by the IMF Executive board in September. The IMF programme provided a bridge across the election period, helped to preserve macroeconomic stability and contributed towards ensuring the maintenance of sound economic policies. The loan will be disbursed in six credit tranches, subject to satisfactory completion of reviews and observance of relevant performance criteria. Directors noted that there were risks to the success of the programme, and stressed that firm implementation of the authorities' economic plan was essential to ensure debt remained sustainable.

**Argentina:
Stand-by
Arrangement**

2.24 Towards the end of 2001, Argentina defaulted on its sovereign debt. The subsequent floating of the exchange rate (which depreciated rapidly) and emergency policy measures were aimed at restoring stability. The economy, however, contracted by an estimated 12 per cent in 2002, accompanied by a sharp deterioration in poverty indicators.

2.25 The IMF and the Argentine authorities remained engaged in negotiations for a new programme throughout the year. In early 2003 they reached agreement on a transitional economic programme. The aim of this programme is to maintain macroeconomic stability through the election period and lay the foundations for a comprehensive medium-term programme needed to re-establish investor confidence and capital inflows, achieve fiscal and external viability and establish sustainable growth in Argentina.

2.26 The programme provides the funds needed for Argentina to meet payments due to the IMF from January to August 2003 inclusive. Performance criteria relating to fiscal and monetary policy are specified to keep the economy on a stable path and to ensure the next government inherits a stable policy framework. In addition, the IMF will provide technical assistance in a number of areas to help the authorities start preparatory work on a number of structural reforms – including on fiscal co-ordination between federal and provincial governments, broadening the tax base, and banking sector restructuring. The IMF hopes to agree a comprehensive programme with the incoming government after the election in May 2003.

**Uruguay:
Stand-by
Arrangement**

2.27 During 2002, economic conditions in Uruguay deteriorated due to contagion from the Argentine crisis. Consequently, in June the IMF agreed to supplement the country's \$750 million SBA with an additional \$1.5 billion.

2.28 After a temporary suspension of banking activity on 31 July, the IMF announced a further augmentation of around \$500 million in August and re-phased the schedule of disbursements to allow the government of Uruguay to draw around \$800 million immediately. This support was intended to address short-term liquidity needs, and assist the authorities' comprehensive and determined effort to restore confidence in the banking sector.



DEVELOPING COUNTRIES OVERVIEW

2.29 Growth prospects for developing countries in 2002 depended heavily on the extent of the recovery in the industrialised countries, commodity and oil price movements, and sound policy frameworks.

2.30 Nevertheless, the IMF estimates that in 2002, GDP growth in developing countries will be 4.3 per cent, only slightly more than the 4 per cent growth in 2001⁸. On average, developing countries' growth is expected to recover strongly in 2003 and 2004, in the absence of additional adverse shocks to the world economy. However, the rebound in 2003 will be less pronounced in many of the poorer, commodity-dependent economies due to continued weakness in commodity prices. On current trends, these countries will fall short of the growth rates needed to meet the Millennium Development Goal of reducing by half the proportion of people living in extreme poverty by 2015.

2.31 Against the background of this uncertain environment, a combination of policy adjustment in developing countries and additional financing from the international financial institutions, particularly for countries pursuing good policies, helped provide an important safety cushion.

2.32 During 2002, the Executive Board approved ten new Poverty Reduction and Growth Facility (PRGF) arrangements (Albania, Cape Verde, Democratic Republic of Congo, Cote d'Ivoire, The Gambia, Guyana, Nicaragua, Rwanda, Tajikistan, and Uganda). The UK supported all of these programmes. As of January 2003, the Fund had PRGF arrangements with a total of 38 countries⁹. The UK's approach to the role of the IMF in poor countries is set out in Chapter 4. The points made by the UK in relation to Board discussions on the PRGF are summarised in Annex I.

⁸ IMF World Economic Outlook, September 2002

⁹ Albania, Armenia, Azerbaijan, Benin, Cambodia, Cameroon, Cape Verde, Chad, Democratic Rep. Of Congo, Cote d'Ivoire, Djibouti, Ethiopia, The Gambia, Georgia, Guinea, Guinea-Bissau, Guyana, Kenya, Kyrgyz Republic, Lao People's Dem Rep, Lesotho, Madagascar, Malawi, Mali, Moldova, Mongolia, Mozambique, Nicaragua, Niger, Pakistan, Rwanda, Sao Tome and Principe, Sierra Leone, Tajikistan, Tanzania, Uganda, Vietnam, Zambia