

**IMMEDIATE
ATTENTION**

SM/01/315
Supplement 1

October 31, 2001

To: Members of the Executive Board

From: The Secretary

Subject: **Draft Report of the Managing Director to the International Monetary
and Financial Committee on the Fund's Crisis Prevention Initiatives**

Attached for consideration by the Executive Directors is the vulnerability assessment section of the draft report of the Managing Director to the International Monetary and Financial Committee on the Fund's crisis prevention initiatives (SM/01/315, 10/18/01). This section is being circulated as agreed at the Board meeting of October 29, 2001, and comments from Executive Directors are welcomed by the close of business on Thursday, November 1, 2001. A revised version of the report will be circulated to the Executive Board early next week.

Questions may be referred to Ms. Metzgen (ext. 37863) and Mr. Blancher (ext. 36525).

Att: (1)

Other Distribution:
Department Heads

II. IMPLEMENTATION OF THE FUND'S CRISIS PREVENTION INITIATIVES

A. Assessing External Vulnerability

1. **The external crises of the late 1990s were in many ways different from earlier crises and prompted a re-evaluation of traditional methods of vulnerability assessment.** This re-evaluation has reflected the increased role for private capital financing in emerging markets, the interconnectedness of markets across the globe, and the links between external financing difficulties and distress in the financial and corporate sectors. With crisis prevention and the promotion of domestic and international financial stability among its top priorities, the Fund has strengthened its analysis of the vulnerability of member countries to changes in external circumstances and, in particular, to capital market conditions.
2. **On October 22, 2001, the Executive Board took stock of the progress in monitoring members' external vulnerability on a more continuous basis,** particularly for emerging market economies which are often highly sensitive to conditions in international capital markets. Directors welcomed the increased efforts to combine qualitative analysis reflecting individual country circumstances with vulnerability indicators and other quantitative tools, and the improved integration of bilateral and multilateral surveillance activities. They noted that, the use of information on markets and market developments in vulnerability assessments is being further strengthened by the work of the International Capital Markets Department.
3. **Directors observed that the Fund is drawing systematically on a number of independent inputs:**
 - **The latest revisions to the World Economic Outlook.** These are the starting point for any assessment of vulnerabilities, as a key objective is to capture influences from the global economy—most importantly financial market conditions and developments in industrial countries—on emerging market countries, including through the explicit consideration of adverse scenarios;
 - **Early Warning System models.** These models provide a systematic framework for estimating the likelihood of a balance of payments crisis based on a combination of vulnerability indicators. While work is ongoing to improve their performance, they are likely to remain imperfect, somewhat mechanical, signaling tools; as such they need to be qualified by detailed country analysis and used in conjunction with other methods of vulnerability assessment;
 - **Financing requirements.** Where there is a risk that a country's access to global financial markets may become difficult or be interrupted, detailed estimates of its external financing needs and prospective sources and uses of funds are important. The potential for liquidity problems is also reflected in the work on reserve adequacy, which takes into account a country's capital needs through indicators such as the ratio of reserves to short term external debt, and stress-testing of the balance of payments;

- **Market information and contagion risks.** Besides the direct information content of foreign exchange spreads on borrowing costs for individual countries, the analysis of spreads serves to focus attention on changes in market perceptions and as such sharpens the discussion of contagion. The new International Capital Markets Department will be responsible for systematically drawing on market information as well as refining tools to understand markets and market behavior;
- **Financial sector vulnerability assessments.** The Fund's specialized knowledge about the financial sectors of its members is a key input into the Fund's assessment of vulnerabilities. Financial Sector Assessment Programs (FSAPs) help to assess the robustness of the financial sector and the implications of worst case scenarios, as relevant financial sector variables have been subjected to stress tests. For countries that have not yet had FSAPs, the staff remains very actively involved in financial sector monitoring and advice;
- **Area department expertise.** One of the greatest strengths of the Fund is the wealth of information in the hands of its area departments on the countries they monitor continuously. This knowledge is used to provide a broader perspective and judgment on the tools used for vulnerability assessments, including through an appreciation of the feasibility of alternate policy choices and the likely responses of market participants.

4. **The increased focus on vulnerability and appropriate policy responses has further highlighted the importance of addressing gaps and deficiencies in the data required for these purposes.** The Special Data Dissemination Standard already provides an agreed framework for the availability of data on reserves and external debt. Other data needed for vulnerability assessments include those on foreign exchange exposures of the financial sector and the non-financial corporate sectors, and countries' financing needs—including their degree of reliance on rollovers, trade finance, and bond finance. Directors encouraged staff to focus more intensively on these informational needs in order to ensure that data availability improves over time, and stressed that many countries will require technical assistance to achieve this.

5. **Work to reduce external vulnerabilities of member countries has also continued to involve the development of policy guidelines.** Guidelines for Public Debt Management, developed by the Fund and the World Bank, were published in March 2001. Guidelines for Foreign Exchange Reserve Management were also developed in close collaboration with reserve management entities from a broad group of member countries and international institutions, and published in September 2001. In October 2001, the Executive Board considered issues related to reserve adequacy and management, including the implications of the capital account approach to assessing reserve adequacy for reserve management. A next step will be to consider reserve adequacy in the context of a broader approach to external liquidity management, which includes external debt management.

6. **The agenda for further work on vulnerability assessment is broad and evolving,** and Directors discussed a number of potential improvements to the various inputs into the

Fund's vulnerability assessments. The priorities ahead include continuing efforts to better understand market dynamics and the linkages between weaknesses in bank and corporate balance sheets and vulnerabilities, to identify developments in individual countries that may have implications for other members, and to take careful account of the aggregated effects on the global economy of similar policies synchronized across a number of countries.