

**IMMEDIATE
ATTENTION**

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April 10, 2002

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Fund Surveillance and Crisis Prevention and Resolution—Managing
Director's Revised Report to the International Monetary and Financial
Committee**

The attached revised report of the Managing Director to the International Monetary and Financial Committee on Fund surveillance and crisis prevention and resolution reflects the suggestions made by the Executive Directors at Executive Board Meeting 02/39 on April 8, 2002.

In the absence of any reaction from Executive Directors by noon on Monday, April 15, 2002, the report will be forwarded to the IMFC. It is intended that this report will be posted on the Fund's external website following the IMFC meeting.

Questions may be referred to Mr. MacArthur, PDR (ext. 38775) and Ms. Schulze-Ghattas, PDR (ext. 37618).

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Managing Director's Report to the International Monetary and Financial Committee—Fund Surveillance and Crisis Prevention and Resolution

April 10, 2002

1. **A central task facing the Fund is to make its surveillance a more effective vehicle for crisis prevention and the promotion of a global economic environment conducive to sustainable growth.** The objective of this work is neither the unrealistic aim of eliminating all risks of future crises nor an unfulfillable promise to deliver to countries and market participants definitive warnings about future crises. Rather, the Fund's efforts should focus on creating incentives for country authorities and market participants to assess risks appropriately and to base their policies and investment strategies on these assessments. A well-functioning market economy draws its strength and dynamism from a continuous search for better results. This will always lead to some degree of overshooting and correction. Therefore, the Fund needs to encourage governments to adopt policies and institutional reforms to strengthen the resilience of their economies to adverse external developments and financial stress through shock absorbers—appropriate exchange rate regimes, sound fiscal policies, prudent borrowing and debt management strategies, deeper, stronger, and more diversified financial systems and domestic capital markets, but also more effective social safety nets. Equally important are policies to promote sustainable growth and an open trade environment because growth, trade, debt servicing capacity and external viability are inextricably linked.
2. **Effective surveillance and crisis prevention has two key ingredients: it requires sound policy advice and incentives to ensure that this advice has an impact.** Much has been done to improve the Fund's capacity for crisis prevention and the architecture of the international financial system more generally. Within surveillance, a number of initiatives have been launched, including the assessments of vulnerability to crises, strengthened coverage of the financial sector, multilateral surveillance of capital markets, observance of standards and codes, and transparency of the Fund and its member countries. Policies have been strengthened in many countries. The resilience of the global economy and the international financial system in the face of last year's economic slowdown and the events of September 11 demonstrates that these efforts are beginning to bear fruit. But more needs to be done. The Fund must continue to strengthen its analytical capacity to identify sources of vulnerability as they emerge and to develop strategies to reduce vulnerabilities, promote stability, and foster growth. At the same time, there is a need to pay greater attention to the factors that affect the impact of our policy advice. Surveillance can only be an effective tool to promote sustainable growth and financial stability, and to help prevent crises, if the Fund can persuade members to take early action to address emerging problems and imbalances.
3. The Fund's **Contingent Credit Line (CCL)** is designed to provide those members with strong economic policies a precautionary line of defense against balance of payments

problems arising from contagion. The Fund has been working with a number of member countries to explore their possible use of the CCL. For the future, the Fund must continue to ensure that its contingent and precautionary facilities support early policy action by members to correct any vulnerabilities to shocks.

4. **The biennial review of the Fund's surveillance, which the Executive Board discussed on April 4, 2002, took stock of the evolution of surveillance—both the framework within which surveillance takes place and actual conduct of Fund surveillance.** Further discussions on the review of surveillance and on various surveillance-related issues—including the Fund's transparency policy—will continue after the IMFC meeting, but the review thus far has yielded a number of important conclusions. It confirmed that the coverage of surveillance had expanded over the years—from concentrating more narrowly on monetary, fiscal, and exchange rate policies, to a broader purview encompassing external vulnerability assessments, external debt sustainability analyses, financial sector vulnerabilities, and structural and institutional policies—and concluded that this broadened framework constituted a necessary and appropriate adaptation of surveillance to a changing global environment, most notably to the rapid expansion of international capital flows. The review also concluded that Fund surveillance had generally succeeded in embracing the wider coverage without losing focus, with issues covered in individual Article IV consultations generally determined by macroeconomic relevance in country-specific circumstances. The review provided support for the current modalities of multilateral surveillance and recognized the enhancements to the multilateral surveillance of capital markets that had been made possible by the creation of the International Capital Markets Department (ICM). In the context of crisis prevention, member countries have welcomed ICM advice on appropriate debt structures and terms of access to international capital markets—including maturity, currency, pricing, and investor bases—consistent with medium-term sustainability.

5. **Against the background of this overall record with respect to coverage and focus, the biennial review of surveillance identified a number of specific areas where further efforts are needed to ensure that Fund policy advice is sound and persuasive:**

- More candid and comprehensive assessments of exchange arrangements and exchange rates within the framework of macroeconomic policies should become the normal practice throughout the membership.
- The coverage of financial sector issues must be brought up to par with coverage of other areas of surveillance. FSAP participation has translated into an in-depth coverage of financial sector issues. However, in the absence of an FSAP, the quality of financial sector surveillance has been uneven across member countries, and mechanisms must be found to improve this situation.
- To strengthen vulnerability assessments, analysis of debt sustainability needs to be improved, particularly through the use of meaningful stress tests and alternative scenarios. Also, greater attention needs to be paid to the private sector's balance sheet

exposure to interest rate, exchange rate, and general macroeconomic shocks, and to collecting the data required to assess this vulnerability.

- The coverage of institutional issues, such as public sector and corporate governance in certain countries, has sometimes been hampered by a lack of expertise. It should be strengthened. Reports on the Observance of Standards and Codes (ROSCs) and, generally speaking, the work on standards and codes will be essential to meeting this objective.
- Structural issues outside the Fund's traditional areas of expertise are, at times, key to a country's macroeconomic situation and, thus, need to be addressed by the Fund. To tackle such cases, the Fund must make effective use of the expertise of appropriate outside institutions, in particular the World Bank.
- There is some scope for enhancing the focus of surveillance in individual cases and areas. In particular, coverage of trade policies should be strengthened by concentrating on countries whose trade policies either have appreciable global or regional influence or have significant deleterious effects on domestic macroeconomic prospects.
- The results of multilateral surveillance exercises and the Fund's comparative advantage in cross-country analyses should be reflected in bilateral surveillance in a comprehensive and consistent manner. Particular attention should continue to be paid to the systemic impact of the policies of the largest economies in Article IV consultations with these countries.
- The conduct of surveillance in program countries should be considered further with a view to ensuring that Article IV consultations with these countries provide an effective reassessment of economic conditions and policies; this requires a freshness of perspective and appropriate distance from day-to-day program implementation.

The review stressed that, in many instances, the Fund could usefully complement sound advice on economic policy objectives with discussions with country authorities of alternative ways to achieve these objectives. An important component of such discussions would be consideration of social, political, and institutional factors in order to enhance ownership of policy recommendations and increase the likelihood of successful policy implementation.

6. **Efforts to improve the quality of the Fund's policy advice can only translate into effective surveillance and crisis prevention if this advice gets acted upon.** The Fund has traditionally relied on persuasion and peer pressure to get its message across to member countries, and, in this regard, I believe that the gains in transparency in recent years have played an important role. The Fund's Executive Board will address transparency issues again in the coming weeks, and we will be seeking to ensure that we maintain the right balance in the tension between transparency and the Fund's role as a confidential advisor, and that we find ways to enhance incentives for members to follow the Fund's policy advice. At the same

time, we have to be aware that, ultimately, persuasion will remain a key factor in the effectiveness of surveillance. And there is room to enhance our persuasiveness by engaging in a close policy dialogue with the authorities, by reaching out more broadly, for instance to the legislative bodies in member countries, and by ensuring that consultations with members take place at times when the Fund's advice can have the maximum influence on the domestic policy debate. Persuasiveness also requires that the Fund's surveillance is perceived as being evenhanded across the membership, that it is as ambitious in large advanced countries as in emerging market and developing countries.

7. While these efforts to strengthen surveillance should reduce the incidence of crisis over time, it would be unrealistic to expect that all member countries will always be able to avoid crises. **Thus the Fund is working in parallel on ways to strengthen our capacity to assist members to handle crises appropriately.** The Fund must be able to offer effective help to members coping with difficulties in maintaining their access to capital markets, but it should do so in a fashion that strengthens and stabilizes the international financial system as a whole and promotes its healthy development. This work is directed in large measure at providing members and markets with greater clarity and predictability about the decisions the Fund will take in a crisis and the basis for those decisions.

8. The Fund's work program to strengthen the framework for crisis resolution is focusing on four areas:

- Increasing the Fund's capacity to assess the sustainability of a country's debt;
- Clarifying the Fund's access policy;
- Strengthening the tools available for securing the private sector's involvement in the resolution of financial crises;
- Examining a more orderly and transparent legal framework for sovereign debt restructurings, as well as identifying with more clarity the considerations that should guide the availability of Fund financing during and after a restructuring.

9. **Improving the analytical framework that the Fund uses to judge debt sustainability is essential to the Fund's ability to respond appropriately to different crises.** As outlined in the Prague framework, the Fund must strive to distinguish between: those cases where a major debt restructuring, possibly involving a substantial write-down of claims, is called for; those cases where the official sector will need to encourage creditors to reach voluntary agreements to maintain their exposure to help overcome coordination problems; and cases in which it is appropriate for the Fund, in conjunction with others, to provide financing in support of the member's adjustment program to help restore confidence and catalyze the resumption of private capital inflows. This distinction should be based solidly in an assessment of the member's debt sustainability.

10. In **assessing the sustainability of a member's external and fiscal position**, the focus is on the likelihood that it will be able to regain financial and economic viability, and whether some form of debt reprofiling or restructuring is necessary to achieve that objective in the context of a well-designed program of adjustment. Sustainability analysis cannot yield unequivocal results, but the Fund is working to strengthen the analytic basis used to make an inherently difficult judgment. It is envisaged that staff would bring together in a more systematic fashion the elements that go into such a judgment, including the initial stock of actual and contingent liabilities, expected external and internal developments that will affect the debt-servicing burden, the likelihood of more adverse scenarios occurring, and the member's capacity—including its political and institutional capacity—to adjust policies in response to shocks.

11. A second strand in our work program will be to **clarify the policy on access to Fund resources for members facing financial crises**. In this context, it will be important to recognize that a policy on access limits in such cases must be based on the reality that the Fund's resources are inherently limited, while the potential financing needs of a country integrated into global markets can be very large indeed. The policy should specify the circumstances under which the Fund would be prepared to support a member's policies in the event it was facing difficulties. It should also lay out clearly the constraints on and the scope of the support the Fund could make available, taking into account that some members' quotas do not adequately reflect their potential financing needs. In my view, the general direction should be that larger levels of access require stronger justification. A clearer policy on access limits should allow the Fund to provide the scale of financing needed to support members addressing their problems, while at the same time reinforcing incentives for responsible policies and prudent assessment of risk.

12. A third strand of the work program aims to **strengthen the tools available for securing the private sector's involvement in the resolution of financial crises within the context of the existing legal framework**. One aspect of the work explores the use, in cases in which a member's debt burden is judged to be sustainable, of tools that are intended to complement the catalytic approach. The broad conclusion is that there are a number of alternative financing tools that may help manage crises under certain circumstances, but that these need to be examined on a case-by-case basis. In each case the benefits of these financing techniques need to be weighed against potential dangers of unsettling markets that they may involve, as well as their impact on transferring risk from sovereigns to the domestic financial system.

13. Another aspect of the work program looks into **circumstances in which financing requirements are large and prospects for an early return to spontaneous capital market access is poor**. In such cases, notwithstanding the principle that contractual obligations should be honored, there may be a need to reach for more concerted solutions. In such cases, bondholders along with other creditors may need to contribute to the resolution of the crisis. In such cases, the Fund will need to assess the consistency of the repayment terms with the overall macroeconomic framework. While the design of restructuring packages needs to be assessed on a case-by-case basis, it is important to aim for cooperative and widely acceptable

procedures to secure high rates of participation in restructurings and to help pave the way toward an early return to capital market access. In cases in which members maintain open capital account regimes and domestic banks have substantial holdings of claims on the government, restructurings could have substantial ramifications for the domestic economy. Specifically, concerns regarding the solvency or liquidity of the banking system may trigger deposit runs and capital flight that could be difficult to arrest.

14. **In those cases where sustainability considerations indicate the need for the member to restructure its obligations, there should be international support for as rapid a resolution of the problem as possible.** The Fund is working on two aspects of this issue: consideration of an improved framework for sovereign debt restructuring, and Fund support to a member in the process of restructuring its debt (lending into arrears policy).

15. **The current framework for reaching agreement between a sovereign and its creditors on a restructuring of obligations needs to be improved.** The greater integration of capital markets, the increased use of securitized instruments, and the related increase in the diversity and number of creditors has complicated the coordination problems that arise when a member finds it necessary to pursue a restructuring of private claims. In this context, there is broad recognition of the need for better incentives to promote the orderly and timely restructuring of unsustainable sovereign debts so that members with unsustainable debt burdens are more inclined to approach their creditors at an early stage, before delay destroys value and increases the scale of economic disruption. At the same time, care should be taken in the design of a new framework to avoiding creating an inducement for countries to look to default as an easy way of avoiding necessary adjustments.

16. After a preliminary discussion of the issues by the Executive Board in March this year, there seems to be increasing support for thinking about more innovative solutions to the coordination problems inherent in a sovereign debt restructuring. It is now widely accepted that the inclusion of collective action clauses in sovereign debt instruments is highly desirable. In light of this, there is broad support for exploring two broad, complementary, approaches for **improving the legal framework for sovereign debt restructuring**. The first approach would be to establish a statutory framework that would facilitate an agreement between a sovereign debtor and a super-majority of its creditors that would bind all creditors. The second, contractual, approach would seek to achieve similar results by the inclusion of comprehensive restructuring clauses in debt instruments. The Fund will need to carefully consider the relative merits of these approaches in resolving the weaknesses in the current system. In doing so we plan to consult widely with both our members and the private financial community before deciding how best to move forward. My objective is to reach consensus on a broad strategy by the time of the Annual Meetings.

17. In addition, we intend to review our **policy on lending into arrears**. Our aim is to provide greater clarity about the possible extent of Fund financial support, as well as its conditions. In so doing, the Fund would seek to create greater clarity about the relative roles played by the Fund, private creditors and the sovereign debtor during the restructuring process, and to identify the considerations that should guide the availability of Fund

resources during and after a sovereign debt restructuring. This would help the parties to the debt restructuring negotiations arrive at a resolution that achieved the rapid restoration of debt sustainability and the return of the member to a durable growth path.