Report on Implementation of Recommendations Made by the International Financial Institutions Advisory Commission

October 2002

The international financial institutions (IFIs) play a pivotal role in the international community's effort to strengthen the foundations for global growth, to reduce the incidence of crises and promote more orderly resolution when they do occur, and to support increased productivity growth essential to poverty reduction. These challenges are formidable and require continued efforts to find better approaches.

The report prepared in March 2000 by the International Financial Institution Advisory Commission (the Commission), chaired by Dr. Alan Meltzer, provided important insights into how the IFIs might better achieve their objectives. This is the second annual report on progress "to implement such recommendations [made by the Commission] as are deemed feasible and desirable" in the June 2000 U.S. Department of the Treasury (Treasury) response to the Commission's report.[1] This report provides an update on progress since the submission of the first annual report to Congress in October 2001.[2]

INTERNATIONAL MONETARY FUND

The Treasury supports many of the objectives listed in the Meltzer Commission's report on the International Monetary Fund (IMF). To implement these objectives Treasury has focused on five key areas:

- strengthening the IMF's focus on *preventing crises* and *reducing country vulnerability* to crisis;
- *increasing transparency*, both for borrowing countries and the IMF itself, including to support greater accountability for governments and to allow markets to make better risks assessments;
- *streamlining IMF conditionality*;
- *adjusting the terms of IMF lending*, including better recognition of illiquid and insolvent borrowers, and
- *implementing crisis resolution strategies* that reduce the heavy reliance on official financing.

In the last year, further progress has been made toward meeting these objectives.

---

[1] This report is prepared pursuant to section 603(i)(2) of the Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1999 (section 101(d) of Public Law 105-277).

[2] Available on the U.S. Treasury Department's web site: http://www.treas.gov/press/releases/reports/meltzer.pdf.

Preventing Crises and Reducing Vulnerability

Preventing international financial crises is the heart of the IMF's mission. Treasury has strongly supported the substantial efforts the IMF has made in the last year to improve its capacity in this area. These efforts include reinforcing IMF surveillance and focusing IMF programs on the macroeconomic and financial steps necessary to reduce vulnerabilities and bolster sustainable growth.

Addressing Vulnerabilities

Last October, the IMF Board endorsed a new framework that will provide for more systematic analysis of country vulnerabilities to financial crises. The framework provides for more analysis of key "vulnerability indicators," such as reserves and the maturity structure of debt, and will support early attention to key vulnerabilities in the IMF's and countries' crisis prevention efforts. In June the IMF Board also endorsed a new framework for assessing external sustainability in member countries that will reinforce IMF and country understanding of member countries' underlying debt dynamics; such analyses are critical to better anticipating how changes in macroeconomic parameters can affect a country's vulnerability to capital account crises. Ongoing IMF efforts to address vulnerabilities include work on financial sector indicators and on national balance sheet approaches to crisis prevention and resolution. It is especially important in this regard to improve understanding of corporate balance sheets and their implications under stress for a country's financial sector and macroeconomic performance.

At the same time, the IMF is continuing to improve the incorporation of analyses from the Financial Sector Assessment Program (FSAP) into its surveillance and more broadly to incorporate more systematic analyses of the critical issues around financial sector vulnerabilities into surveillance and program work. Likewise, the IMF's Capital Markets Department continues its efforts to strengthen links and facilitate the flow of information between the IMF and the private sector. The above improvements are incorporated into the Fund's new guidelines for conducting surveillance.

Increasing Availability of Country Information

The IMF has continued to assist countries in their efforts to provide economic information for policy making and for analysts and creditors. More readily available national financial data allow vulnerabilities to be identified earlier and policymakers to take corrective actions. The IMF's Special Data Dissemination Standard (SDDS) is the framework which an increasing number of nations follow in publishing this important information. Recently, Costa Rica became the 50th subscriber to the SDDS. In addition to the SDDS, the General Data Dissemination System (GDDS) provides a framework through which countries may improve their statistical systems. Finally, the IMF supplements national efforts to meet the SDDS or the GDDS with technical assistance programs.

Standards and Codes

The IMF also is playing a central role in the broader international efforts to promote the development and application of internationally-accepted standards and codes. Standards and codes contribute to market efficiency and crisis prevention by allowing market participants and country policymakers to compare information on country practices against global benchmarks. 293 Reports on the Observance of Standards and Codes (ROSCs) have been completed by the staffs of the IMF and the World Bank, working in conjunction with domestic authorities. Treasury has consistently supported the IMF's role in these efforts and continues to advocate that more ROSCs to be completed and published. The United States has published self assessments in all areas covered by ROSCs and has participated in the SDDS since its inception.

Countering the Financing of Terrorism

One of the IMF's major contribution to the stability of the international financial system in the past year has been its strong response to the threat caused by flows of funds to support terrorist financing and money laundering. This response recognizes the threat these flows represent to the international financial system and the unique capacity of the IMF to support a concerted international effort in this area. Money laundering and terrorist financing issues are now included in each FSAP and assessments of off-shore financial centers. At the same time, the IMF has approved a one-year pilot program that will to incorporating into the ROSC framework the Financial Action Task Force's (FATF's) 40+8 standards and codes that are designed to reduce money laundering and the flow of terrorist financing. The FATF Plenary will review and endorse the assessment methodology soon, and in the upcoming year the Fund and the World Bank will begin conducting comprehensive assessments under the pilot program. The IMF has also increased its technical assistance for anti-money laundering activities and expanded its research into financial issues that could facilitate terrorist financing.

Transparency and Accountability

The IMF continues to make progress increasing the transparency of its own operations and its dialogue with member countries. Treasury has championed the need for continued advancement of this process; further progress is vitally needed and is critical for the credibility of the IMF and its crisis prevention efforts. In total, 106 member countries have published IMF staff reports on their economies prepared as part of surveillance (Article IV) consultations. Further, summaries of Board discussions of these reports were published for 90% of IMF members in 2000, up from 56% in 1998. 55% of IMF staff reports on use of Fund resources programs were published from January 2001-April 2002, and 93% of letters of intent setting out the borrowing country's economic reform intentions and memoranda of economic and financial policies have been released by borrowing countries between January 2001-August 2002.

It is equally important that the IMF make more information available about its internal activities. Staff papers discussing key policy issues and summaries of Executive Board discussions of these papers are now being released. Importantly, the new Independent Evaluation Office released its first paper, which addressed the problem of prolonged use of IMF resources by certain nations. The United States was a key advocate for establishment of this office, which will provide a source of informed, arms-length analyses that should accelerate reform efforts. The publication of the first report, along with responses from the IMF's management, staff and executive board, represents a welcome step forward.

Finally, the U.S. Treasury strongly supports the IMF's expanded transparency with respect to its financial operations. In recent years, the IMF has significantly increased the volume, quality, and timeliness of information available to the public on its finances. The IMF has published new, more detailed information on its financial structure in its annual financial update. The IMF also provides background and updated data on its financial activities on the internet,[3] including: its current financial position, financial statements, liquidity and sources of financing, SDR (Standard Drawing Rights) valuation and interest rates, rates of charge on IMF loans and the interest rates paid to creditors, and detailed information on its financial relationships with individual countries.

Conditionality

On September 25, the IMF Board approved a new set of guidelines for conditionality.[4] Treasury supported these new guidelines, which codify efforts to streamline conditionality, both in terms of focusing conditions on items that are critical to a program's success and in focusing IMF conditions on its areas of central expertise, including monetary, fiscal, exchange rate, financial sector and debt management policies.[5]

Future IMF conditions will be restricted to those items that are judged to be "critical" to the macroeconomic outcomes of a program. This development addresses concerns that IMF conditionality was too wide ranging and excessively detailed in the past, reducing the effectiveness of IMF programs.

Consistent with its efforts to reduce the conditions the IMF imposes in policy areas outside of its central expertise, the Executive Board of the IMF joined with the Board of the World Bank in endorsing the concept of a designated "lead agency" to facilitate IMF and World Bank cooperation in a country.

The guidelines also call for IMF staff to be more attentive to the need for borrowers to have "ownership" of their reform programs. Treasury strongly agrees on the importance of supporting programs that are backed by reliable domestic ownership. Treasury has simultaneously emphasized the need for the Fund to be more selective in approving programs in countries where ownership and commitment to implementation are weak. Maintaining a strong link between disbursements and measurable results is the best way to ensure the most effective use of resources and to deliver on the promise of aid intended to increase living standards.

---

[3] Available at http://www.imf.org/external/fin.htm
[4] Available at http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.pdf.
[5] The guidelines provide that conditions will normally consist of macroeconomic variables and structural measures that are within the Funds core areas of responsibility. Variables and measures outside the Funds core area of responsibility may also be established as conditions but may require more detailed explanation of their critical importance.

Finally, the guidelines identify modalities for conditionality that will reinforce the strong link that should exist between performance and program disbursement. The guidelines reflect the potential value of requiring specific policy actions prior to Fund endorsement and financing of a country's economic program. Treasury has long argued that prior actions can play a critical role in building market confidence and preventing approval of programs that are likely to fail.

Reform of IMF Lending Facilities

In recent years, the IMF has taken a number of steps to shorten the maturities of its lending programs. As the Meltzer Commission explained, shorter loan terms are more consistent with the IMF's original mandate to make resources available for members that are experiencing a temporary loss of liquidity and they encourage countries to address insolvency problems in an orderly manner. These steps include movement to a repayment structure based upon an expectation of early repayment and a fee structure based upon higher charges for increased access. The IMF's Supplemental Reserve Facility (SRF), which carries premium pricing and short-term repayment terms, is a central vehicle for exceptional access, although the IMF continues to assess the needs for each program on a case-by-case basis.

In shifting to a structure based upon an early repayment expectations, the IMF included provisions for the repayment period to be extended by another year with the formal approval of the Executive Board in cases where the external position of the borrower is not strong enough to make those repayments without "undue hardship or risk." Argentina has requested and received four such extensions in the past year, with Treasury agreeing that Argentina qualified for the extension in each instance.

Involving the Private Sector and Limiting Official Lending

A central criticism made by the Meltzer Commission was that excessive bailouts of investors allows defaulting nations to sustain poor policies. To a great degree, the policies that engendered these criticisms in the past were the result of the absence of a framework for the orderly restructuring of sovereign debts. Without such a mechanism, debt restructuring—on the rare occasions when it is necessary—is unduly delayed and disorderly. This lack of a framework results in unnecessary depletion of the asset value of creditors and the imposition of severe hardships on the citizens of debtor countries.

Creating a more orderly sovereign restructuring process will make it more likely that the private sector plays its role in crisis resolution, while not increasing the probability of sovereign restructuring. The IMF and the U.S. Treasury have worked intensely in the last year to create proposals that will provide for the more orderly workouts of sovereign debt and to clarify official sector policy in this area. Months of discussion among the G-7 Finance Ministers and Deputies culminated in agreement on a G-7 Action Plan for emerging markets in April 2002. The Action Plan supports work on these proposals and has led to significant accomplishments.

In particular, the G-7 has worked with emerging market countries and their creditors to develop a market-oriented approach to the sovereign debt restructuring process. This approach would encourage the use of collective-action clauses that, among other things, would allow a majority of creditors to bind a minority to key financial terms in the event of a restructuring and facilitate on-going engagement between a sovereign and its creditors. At the same time, the Action Plan supported further work by the IMF on a proposed statutory approach to sovereign debt restructuring.

With the creation of a more orderly process for sovereign debt restructuring, the official sector also will be better able to limit official finance. The policy challenge is to move gradually in the direction of less reliance on large official packages, so that investor expectations can adjust smoothly to new official sector policies. In the April Action plan, the G-7 committed to provide exceptional access only when an exception was justified. Progress has been made since April in defining clearer procedures to determine when exceptional access is appropriate and improving the transparency of how these decisions are made. These procedures, which include more rigorous debt sustainability analyses, should help diminish market uncertainty regarding official actions in times of crises and clarify the appropriate role of the private sector.

MULTILATERAL DEVELOPMENT BANKS

The Meltzer Commission emphasized the importance of raising living standards and the quality of life, particularly for people in the poorest countries, and its majority report recommended number of operational and policy reforms to improve the policy performance of the multilateral development banks in this crucial area.

President Bush believes that the United States should and must be a champion of economic growth and development, particularly in those parts of the world where poverty is most acute. The multilateral development banks (MDBs) are important instruments in helping to raise economic growth and prosperity around the world. But while the MDBs have the strong support of the United States, the effectiveness of these institutions in making a difference in the lives of the poor can be substantially improved. Consequently, reform of the MDBs has been one of the highest priorities of the Bush Administration's international economic agenda.

Clearly, there is no simple universal blueprint for overcoming all the country-specific economic and social obstacles that impede sustainable development progress. Yet, the MDBs can do a better job in spurring the economic growth needed to combat poverty if they place greater attention on two aspects of the development agenda that underlie most success stories: (1) the factors that enable people and countries to become more productive; and (2) better measuring, monitoring and managing for development results. From the start of the Administration, we have pursued hallmark reforms in the MDBs in both of these complementary areas. We have also worked to achieve an increase in the proportion of assistance to the poorest countries delivered in the form of grants rather than loans.

Productivity Growth

The MDBs could be more effective in helping countries achieve improved living standards if they prioritized their efforts to address causes of low productivity—such as poor policies, low business investment, and inadequate education and health care—that are now holding countries and people back.

The need for sound policies is fundamental. Sound policies establish the basis for sustainable domestic economic growth. Sound policies encompass outward-oriented engagement with global markets and investment. In every country there is no substitute for honest leadership committed to good and publicly accountable economic management. Progress in meeting the goals of the Millennium Declaration is heavily contingent on improving the quality and productivity of resource use. We therefore have successfully encouraged stepped up efforts by the World Bank (and the IMF) to strengthen public expenditure tracking and fiduciary management and are urging that these efforts be intensified.

It is also crucial to create an environment that promotes vibrant private enterprise and investment. If developing countries are to realize their economic potential, it is essential that they, the MDBs, and their other donor partners move more forcefully to reduce the impediments that are constraining the creation of high productivity jobs by the private sector. In this context, Treasury secured agreement in the IDA replenishment (IDA-13) concluded in July that IDA will pursue a closer partnership with the International Finance Corporation to encourage innovation in support of private sector development and devote significant resources during IDA-13 to such innovative programs.

Treasury also wants to accord priority to human resource development, including investments needed to improve delivery systems for health, education, water, and sanitation. These social sector investments increase individual productivity and have major spillover benefits economy-wide. Conversely, the absence of basic services, such as clean water and sanitation, makes the prospects for economic progress more remote.

The United States is supporting efforts underway by the World Bank and its donor partners to identify best practice approaches that can be replicated elsewhere to help close the gaps—in data, policies, institutional capacity, and financing—that now constrain the expansion of quality education. Although delivery of health services and access to clean water pose different challenges, the importance of coordinated approaches by the MDBs that focus on program quality and the delivery of results cut across these three issues. We also believe it will be difficult to envision substantial progress in any of these areas without major improvements in on-the-ground coordination by the MDBs and other official and private donors.

Better Measuring, Monitoring and Managing for Development Results.

Delivering and measuring development results at all levels should be an MDB development priority. The IDA-13 agreement launches a fundamental shift of focus within the MDBs to measurable results.

The unique outcome of IDA-13 is a contribution structure that allows donors to increase their funding levels if concrete measurable results are achieved. Donors and developing countries will benefit from routinely quantifying development achievements and understanding the reasons for success and failure. This will increase accountability for and learning from development results. In IDA-13, there was agreement to measure progress toward two objectives:

- The first set involves getting the new measurable results system started. This system must be established and other analytical underpinnings of IDA's work expanded. Timely and high quality diagnostic analyses – such as public expenditure reviews, financial accountability assessments, and investment climate assessments – are important tools for identifying the strengths and weaknesses in a country's ability to make the most effective use of IDA resources.

- The second set of results is in the areas of education, health, and private sector development. After careful consideration of both measurability (i.e., whether the data exist in most IDA countries) and relevance (i.e., whether they reflect IDA's productivity growth and poverty reduction mandate), progress will be tracked toward the following goals:

  Education: Increase in aggregate primary school completion rates across IDA countries as well as an increase in the number of countries that have increased their completion rates.

  Health: Increase in measles immunization coverage across IDA countries as well as an increase in the number of countries with 80 percent coverage.

  Private Sector Development: Reductions in both the number of days and the official costs required to start business in IDA countries.

Pursuant to a recently concluded African Development Fund replenishment agreement (AfDF-9), the AfDF will improve its development of quantifiable and monitorable performance indicators for all sectors and rigorously incorporate these in individual operations. The AfDF also will develop a results-based management system for measuring improvements in people's lives.

It is important to keep in mind that the progress secured in IDA-13 and AfDF-9 are just the start of what we want to be a fundamental shift of focus in the MDBs to measurable results. A new measurement system must be created to implement the results approach; it will begin with a small but important set of indicators. And it will evolve over time as the quality of data and evaluation systems in recipient countries is strengthened and as the MDBs, other shareholders, and developing countries realize that the priority given to measuring results can ensure that the lessons – both successes and failures – of development experience result in more effective assistance and less poverty around the world.

More broadly, pursuing a results-based approach in IDA and the other MDBs will require real changes in operating style.

- It means stating in quantitative terms the expected results of individual projects and overall country assistance before providing funding, and

- It means measuring progress towards stated results and assessing the reasons for success and failure. It means structuring projects in a way that steps up or cuts back funding whether results are achieved.

Treasury is urging a sustained and prioritized effort by all of the MDBs to create and integrate results-based operational plan that focuses on key measurable outcomes in every grant and loan, and every country strategy.

Grants

The Meltzer Commission recommended that grants should replace loans in MDB operations in poor countries without capital market access.

As a result of strong U.S. leadership, the IDA-13 agreement provides for a significant expansion in grant funding for the world's poorest countries. Over the next three years, IDA grants will account for between 18 and 21 percent of overall IDA resources. The availability of approximately $4.5 billion in IDA grants should enable:

- almost all of IDA's assistance for education, health, nutrition, potable water and sanitation to countries whose people live on less than a dollar a day to be provided in the form of grants.
- all of IDA's assistance for HIV/AIDS for all IDA-only countries, and up to 25 percent of such assistance to blend countries (those eligible for both IBRD and IDA), to be provided in the form of grants;
- almost all of IDA's assistance for natural disaster reconstruction to be provided in the form of grants; and
- up to 40% of IDA's assistance to post-conflict countries to be provided in the form of grants.

U.S. leadership on grants was also crucial in the recently concluded AfDF-9 replenishment, which will increase the share of AfDF grants from 7.5 percent to between 18 and 21 percent. In extending grants, the AfDF will give priority to investments in education, health, including HIV/AIDS, the provision of water and sanitation, natural disaster prevention and recovery, and post-conflict countries. The AfDF will also continue to provide grants for technical assistance and capacity building.

Treasury views the IDA-13 and AfDF-9 replenishment agreements as significant achievements in terms of meeting the Administration's policy objective of helping poor countries make productive investments without saddling them with ever-larger debt burdens.

G-7 Reform Efforts

Complementing the U.S.-initiated reform agenda, the G-7 Heads of Government at the 2001 Genoa Summit approved six areas for MDB reform. G-7 representatives on the Executive Boards of the MDBs are coordinating practical ways of implementing the G-7 recommendations in each of the institutions.

The six G-7 reform areas may be summarized as follows:

- strengthening *coordination* among the MDBs at the country and institutional levels.
- enhancing *internal MDB governance*, accountability and transparency at the highest standards;
- promoting *good governance* in borrowers—including effective public expenditure management, accountability and anti-corruption efforts—as a core MDB activity;
- reviewing the MDBs' *lending instruments and pricing structures* with consideration given to streamlining instruments and differentiating pricing;
- in the field of *global public goods*, giving priority to fighting infectious diseases, promoting environmental improvement, facilitating trade and supporting financial stability;
- being more proactive in supporting *financial sector reform* in borrowing countries and in building country capacity to meet international codes and standards.

The Presidents of all the MDBs submitted reports to the G-7 countries at the Kananaskis Summit in July on the status of their efforts to implement the Genoa reform agenda. There is broad G-7 agreement that there has been good progress by the MDBs, that more still needs to be done and that progress has not been uniform across the institutions. Implementation of this reform agenda will remain an ongoing priority.

In conclusion, MDB reform has been a priority of the Administration from the outset. Steady progress is being made in achieving the key U.S. objectives within each of the institutions. Treasury is also committed to continue to set high standards for the MDBs in order to make them more effective in raising living standards around the world.

DEBT REDUCTION FOR THE HEAVILY INDEBTED POOR COUNTRIES (HIPCS)

The Meltzer Commission recommended 100 percent debt reduction by the IFIs and by bilateral creditors for the HIPC countries.

The United States and the international community remain committed to implementing the enhanced HIPC Initiative. Twenty-six HIPC countries have now reached their decision points—the point at which creditors commit to providing debt relief—allowing these 26 countries to begin benefiting from HIPC debt relief that will amount to about $41 billion over time. Total debt service savings for these countries will average about $1.3 billion each year over the next five years. Six of the countries (Bolivia, Burkina Faso, Mauritania, Mozambique, Tanzania, and Uganda) have reached their completion points, when debt relief is delivered irrevocably.

Under the enhanced HIPC initiative, creditor countries forgive at least 90 percent of eligible bilateral commercial-term debt. The United States (and some other G-7 countries) forgive 100 percent of all outstanding bilateral debt contracted before the June 1999 Cologne Summit for qualifying HIPCs.

Countries benefiting from HIPC relief are required to establish and implement reforms, including more targeted and effective development strategies. The most important long-term measure of the success of the enhanced HIPC initiative will be the impact of these reforms on productivity and growth.

One hundred percent debt reduction by the World Bank and IMF for either all or a subset of HIPC countries, as some have suggested, would involve substantial additional costs at a time when the current HIPC initiative is not fully financed. Contrary to a number of claims, there are not excess resources readily available at the World Bank (IBRD) and IMF to cover these increased costs; a number of suggested funding mechanisms would deplete World Bank and IMF resources available for developing countries. Apart from the Bank and Fund, resources to pay for additional debt reduction would need to be identified, for example from bilateral donors such as the United States. Finally, providing 100 percent debt reduction for HIPC countries raises equity concerns because other poor and indebted countries, which may have done better jobs of managing their economies and debt obligations, would receive no debt reduction.

BANK FOR INTERNATIONAL SETTLEMENTS

The Meltzer Commission recommended that the BIS continue in its role as a financial standard setter and suggested that the Basel Committee on Bank Supervision align its risk measures more closely with credit and market risk. It also recommended that the BIS become more transparent and efficient by making more information available on its activities and streamlining its organizational structure. Lastly, the Commission recommended that any membership expansion in the BIS be done gradually and deliberately so as to avoid disrupting information exchange between central bankers.

Recent improvements at the BIS continue to broadly coincide with the recommendations of the Meltzer Commission. The Bank for International Settlements (BIS) continues to serve as a primary vehicle for consultation and cooperation among the central banking and regulatory community to address international financial and monetary stability. It also continues to function as a prime counterparty and provider of financial instruments for central banks.

With the active support of the United States, the Basel Committee on Banking Supervision, which operates with a secretariat located at the BIS, reached agreement in July 2002 on the issues to be covered in a new Capital Accord. This new Accord is designed to align bank capital requirements more closely with underlying risks. Rather than relying on a single measure of risk, the new Capital Accord takes a broader, “three-pillared” approach, focusing on a regulatory capital charge, enhanced supervisory review, and greater market discipline on banks. The new Accord is expected to be finalized by December 2003, with implementation to begin by year-end 2006.

The BIS also has continued its efforts to achieve greater inclusiveness by expanding the activities of the Financial Stability Institute, which conducts training seminars for financial supervisors around the world. The BIS also makes use of its Representative Office for Asia and the Pacific in Hong Kong SAR to conduct outreach, and it will soon have a Representative Office for the Americas in Mexico City.

In order to make information about its activities widely available, the BIS maintains a website (www.bis.org). The BIS website contains information about the organization’s history, structure, and activities, including developments on the new Capital Accord. The website also provides access to regular BIS publications and international financial statistics.