

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

*October 2001*

The international financial institutions (IFIs) play a key role in the world economy. These institutions are an important tool for dealing with critical problems facing the international financial system and for working to improve the standard of living of people around the world. However, there is wide recognition that these institutions can and must do a much better job than they have done in the past.

There has been considerable public debate about how to strengthen and reform the international financial institutions in recent years. The report prepared in March 2000 by the International Financial Institution Advisory Commission, chaired by Professor Alan Meltzer, has made an important contribution to this debate and has helped advance the cause of reform.<sup>1</sup> Indeed, some progress has been achieved in the last year.

There is nonetheless an ongoing need for reforms to increase the effectiveness of the international financial institutions. Each of the institutions must focus carefully on the central areas in which it has expertise and experience and be accountable and take responsibility for results.

This report provides an update on progress achieved on reforms to date and lays out the Administration's objectives for reform going forward. The 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). Section 603(i)(2) provides that the President, through the Secretary of the Treasury, shall report annually, "for three years after the termination of the Commission . . . on the steps taken, if any, through relevant international institutions and international fora to implement such recommendations [made by the Commission] as are deemed feasible and desirable" in the June 2000 Treasury response to the Commission's report.<sup>2</sup> This report is in fulfillment of legislative requirements and also provides information additional to what is strictly required by the statute.

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<sup>1</sup> Available on the Internet at <http://www.house.gov/jec/imf/meltzer.htm>.

<sup>2</sup> Available on the U.S. Treasury Department's web site: <http://www.treas.gov/press/releases/docs/response.pdf>.

## **International Monetary Fund**

The Commission's majority report underlined the importance of focusing the International Monetary Fund (IMF) on areas where it has expertise, further enhancing the transparency of IMF operations, improving the IMF's performance in the area of crisis prevention, and sharpening incentives for countries to reduce their vulnerability to crises.

Over the past year, a number of efforts have been pursued or initiated at the IMF to strengthen its effectiveness. This work is taking place against the backdrop of deliberations by IMF management, the Fund's shareholders, and the public.

As discussed further below, the Treasury Department has elaborated priorities for reform of the IMF that emphasize a number of interrelated goals, which are shared by the Managing Director of the IMF. These include sharpening the focus of IMF involvement on areas in which the Fund has expertise and a clear mandate; intensifying the IMF's attention to and improving the IMF's performance in the area of crisis prevention; and increasing transparency and accountability.

These reforms and objectives are also clearly consistent with key aspects of recommendations made by the Commission. The following sections provide an update of progress made in key areas since last year's report to Congress, and further steps that are foreseen.

### *Sharpening the Focus of the IMF*

Over the years, the Fund has taken on more and more activities, some of which overlap with the mandates of the multilateral development banks, such as privatization, public sector management, and social safety nets. While these are relevant issues with important macroeconomic and fiscal consequences, the IMF does not have a comparative advantage in addressing them, and the added effort of attempting to do so arguably diminishes the effectiveness of Fund staff in pursuing more central objectives.

Treasury is therefore pushing for the IMF to sharpen the focus of its involvement. As Secretary O'Neill has stated, the core objectives of the IMF are to (1) promote sound monetary, fiscal, exchange rate, and financial sector policies; (2) carefully monitor economic conditions; and (3) deal with critical problems in the international financial system as soon as they are detected. The strength of the IMF, and its distinguishing feature among the IFIs, is its expertise in these areas. Steps taken this year in a number of areas help move the IMF in this direction, and work will continue going forward.

### *Reform of IMF Lending Facilities*

The effectiveness of the IMF depends importantly on the structure of IMF lending tools and the content of the policy reforms they support. This includes ensuring that IMF lending tools provide incentives for countries to adopt policy reforms, repay the Fund quickly, and rely first and foremost on private finance. Four lending facilities were eliminated and in November 2000 Fund members agreed on a streamlining of its lending tools in order to shift the focus of non-

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concessional lending to short-term emergency finance that is priced to discourage casual use and encourage rapid repayment. Reforms adopted include the following:

- An expectation of early repayment of non-concessional lending.
- Limited use of Extended Arrangements, to reinforce the focus on making resources available only for the short term.
- Surcharges for higher levels of access to discourage excessive reliance on Fund resources, either for a single or consecutive programs.
- Enhancement of the Contingent Credit Line (CCL) by lowering the surcharge and providing countries with greater assurance of their ability to borrow an initial amount; higher standards for qualification help mitigate potential moral hazard concerns related to the greater assurance of the ability to borrow.

Implementation of these reforms will help the IMF use a streamlined set of core non-concessional instruments to concentrate its lending on short-term balance of payments needs and thus contribute to the effort to focus the Fund's work on its areas of expertise.

### *Conditionality*

As part of work to tighten the IMF's focus, the Fund has begun to sharpen and prioritize its approach to conditionality. This means concentrating on lending conditions central to the IMF's areas of expertise – monetary, fiscal, exchange rate, and financial sector policies.

Focusing conditionality is an important priority for Managing Director Köhler. Indeed, the scope of the conditions attached to IMF loans in recent years became very broad. Secretary O'Neill has underscored the importance of reversing this trend – so that IMF conditions are more enforceable, measurable, purposeful and in the interest of the people in recipient countries.

Efforts to focus and prioritize lending conditions are already part of IMF work in individual countries, and progress is already being made in concentrating conditions on areas within the Fund's expertise. The Fund's Executive Board discussed conditionality in March and July 2001, including the preliminary results of efforts to focus conditionality on priority issues. The Board will continue its consideration this fall when it examines the specific modalities for implementing conditions. In addition, the Fund has conducted seminars and sought external input, including through its website, to inform efforts to bring greater focus to Fund conditionality – efforts that are expected to continue throughout the next year.

An important and needed complement to this work on conditionality will be accomplishing greater selectivity in IMF lending. Both IMF management and the Executive Board need to demonstrate a greater willingness to focus support on countries doing the most to help themselves, and to decline to provide financing in cases where a country is not prepared to take the steps required for the program to enjoy a reasonable probability of success. "Ownership" of programs should be genuine and those programs should be of high quality.

*Preventing Crises and Reducing Vulnerability*

Strengthening the IMF's performance in the area of crisis prevention was one of the central themes of the Commission report and is an area of intense focus both for the IMF and the U.S. Treasury. Regrettably, countries come to the IMF all too often for support when their economic situations have deteriorated sharply and often when they have disregarded the Fund's advice. Increased transparency of the IMF's views and a more focused IMF lending role are important components of the Fund's ability to strengthen crisis prevention.

Some encouraging steps have been taken over the past year, but more remains to be done with respect to detecting vulnerabilities and anticipating crises, as well as taking actions to prevent crises.

In order to anticipate crises, policymakers and markets alike must be well informed about the latest developments in countries' economies and financial markets. Providing improved information will enable countries to take corrective actions and investors to gauge risks more accurately. The IMF is uniquely positioned to play a critical role in facilitating the flow of information due to its broad membership and role in reviewing countries' economic performance (through "surveillance"). Fulfilling this role effectively means that the IMF must both practice and advocate greater transparency. The IMF must also take the lead in developing and promoting indicators that can help point to imminent weaknesses – including in the broad macroeconomic context and in financial sectors. In particular, the Treasury Department is calling on the IMF to: further develop indicators of financial vulnerability and feature them prominently in surveillance reports that are clearer and easier to use; make better use of early warning models; strengthen monitoring of financial sector soundness indicators and disseminate this data; and achieve greater transparency by releasing additional reports.

Other IMF activities will also contribute to the crisis prevention effort.

- Standards and codes are a key benchmark for preventive action that both countries and markets should take seriously. The Financial Stability Forum has identified 12 key standards and codes on which countries should focus their efforts. Treasury is working with the IMF to continue and expand efforts to promote implementation, track progress, and communicate status reports effectively. These efforts include Reports on the Observance of Standards and Codes (ROSCs), which summarize the extent to which countries observe certain internationally recognized standards. Seventy-six ROSC modules, each module addressing one of a range of standards and codes, have been published for 31 countries.
- For our part, the United States has released a series of self-assessments relating to compliance with international standards that are available via the web.<sup>3</sup> The release of U.S. self-assessments is part of an international effort to improve transparency globally as a way to promote stronger financial systems and to strengthening crisis prevention capabilities.

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<sup>3</sup> Available on the U.S. Treasury Department's web site: <http://www.treas.gov/standards/>.

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- To carry out its role in crisis prevention effectively, the IMF is working to deepen its understanding of capital markets and their impact on member economies. The new International Capital Markets Department will institutionalize stronger links to increasingly important private capital markets and facilitate the flow of information, thereby improving early warning and crisis prevention capabilities.

Anticipating crises is not enough. Countries must also listen to warning signals and act decisively to correct their policy paths. This emphasis may be having some effect as a number of countries have begun to address policy weaknesses by taking steps such as implementing more flexible exchange rate arrangements and managing public debt more prudently.

As part of the effort to establish clear incentives for early action, the IMF moved in the last year to enhance its Contingent Credit Line (CCL). The CCL was designed to help prevent crises by offering IMF support beyond normal access limits to countries that have taken strong policy measures (i.e., that have met pre-qualification criteria), should external events cause an unexpected disruption in their economies. The steps taken as part of facilities reform to make the CCL a more attractive tool should help contribute to its crisis prevention role. Both countries and markets should view the CCL as a mark of strength – a demonstrated commitment to strong policies that should enhance confidence. With the enhancements to the CCL, countries have expressed increased interest in qualifying for this facility.

Even more needs to be done. Focusing IMF lending on countries that are pursuing or are prepared to pursue strong policies will discourage irresponsible actions by lessening the expectation that Fund resources will be available unless a commitment to reform is demonstrated. The Treasury Department will work to make sure that recent IMF reforms – for example, higher rates for higher levels of borrowing and accelerated repayment schedules – are applied as countries come to the Fund. This will help provide appropriate incentives for strong policies and limited recourse to Fund financing.

### *Transparency and Accountability*

Over the last year, the IMF has continued its efforts to enhance transparency and strengthen accountability. In the IMF there is a presumption that countries will release to the public the documents related to their IMF lending programs. Over the past year, the U.S. has pushed to ensure that this presumption becomes the norm and there have been some encouraging results. For instance:

- Letters of Intent setting out the borrowing country's economic reform intentions and memoranda of economic and financial policies are released about 90 percent of the time by borrowing countries.
- Seventy-three member countries have published IMF staff reports on their economies prepared as part of surveillance (Article IV) consultations. Summaries of Board discussions of these reports were published for more than three-quarters of IMF members in 2000.

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- Publication of Poverty Reduction Strategy Papers (PRSPs), describing the development strategy of low-income countries borrowing from the Fund, is mandatory. Thirty-seven Interim PRSPs and five full PRSPs have been published as of September 25, 2001.
- Documents related to the Heavily Indebted Poor Countries (HIPC) initiative are also released. Decision point documents have been published for 24 countries and completion point documents have been published for five countries as of September 25, 2001.

An increasingly wide range of information about the Fund's internal activities, such as summaries of Executive Board discussions of policy issues, is also released to public. For example, in April 2001 the Fund released for public comment a set of staff papers related to an ongoing review of conditionality in IMF programs and has since held a number of public seminars to seek input. Over the past year the Fund has published information about ongoing policy discussions concerning, for example, the Heavily Indebted Poor Countries Initiative, the IMF's role in governance issues, developing international standards and codes, and combating international money laundering.

In addition, steps have also been taken to increase IMF accountability to shareholders and to the public. Regularly updated information about the IMF's finances, such as data on member countries' financial positions in the Fund and the IMF's liquidity position, is available on the IMF's website. In the past year, the IMF has begun quarterly publication of its Financial Transactions Plan, which details the sources of IMF lending. Also, the IMF's financial statements now conform fully with international accounting standards and clearly identify the key components of the IMF's assets and liabilities.

Earlier this year, the IMF established an independent evaluation office, with a mandate to review a broad range of IMF activities. This office will become operational later this year. It will operate independently of management under the leadership of Montek Singh Ahluwalia and prepare a work program intended to provide for careful examination of policies and programs. Mr. Singh is an economist who has served in top economic policy positions in India.

Enhancing transparency at the IMF and the other international financial institutions is an iterative process through which continued progressive and substantial improvements are made. The U.S. has been the lead promoter of increased transparency and has a good record of securing the required consensus to achieve progressive, substantial gains – but believes more is required, including as it relates to the operations of the Executive Boards. Although some have proposed making the Board of Directors meetings at the IMF, World Bank, and other multilateral development banks open to the public and the media, the Treasury Department does not believe it would be productive to propose that they conduct their operations in public. First, it is important to note that the practice of carrying out governmental functions and decision-making in public settings is not a common practice outside the United States, even in many European countries. Thus, there would be virtually no support for such a broad and sweeping initiative. Second, it is important to be mindful of the market sensitivity of many Board discussions. Third, the IFIs are consensus-based institutions, in which U.S. influence is best exerted through dialogue based on economic and development principles. There is a risk that the impact of U.S. views – and those of other country chairs – would be diminished if other Board members viewed

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them as being designed for public consumption rather than for the purpose of engaging in a serious policy debate. There is also a very real risk that, if Board meetings are made public, many substantive debates will take place in other, less open, fora, possibly without the United States.

Thus, progress has been made, but the IMF can and must do more. Given the importance of greater transparency for crisis prevention, Treasury continues to urge the IMF to improve its performance in this area. For example, more countries should make public the IMF staff reports for their Article IV consultations. Further, while, as noted above, the vast majority (about 90 percent) of countries borrowing from the IMF publish documents setting out program conditions, all such documents should be released.

### **Multilateral Development Banks**

The Commission focused on achieving the long-term goal of reducing poverty, and its majority report recommended a number of operational and policy reforms to improve the performance of the multilateral development banks (MDBs) in this crucial area.

Secretary O'Neill and the G-7 have made strengthening the multilateral development banks and improving their effectiveness in raising the standard of living of people throughout the world a central focus this year. Treasury views increased productivity as the driving force behind increases in income per capita. To **reduce poverty**, there is no alternative to increasing productivity. As long as large segments of a population are stuck in low-productivity employment, prospects for sustained growth and poverty reduction will be limited.

Secretary O'Neill has specifically urged the MDBs to become more focused, to improve their coordination with each other, and to promote productivity by placing greater emphasis on education and aggressively promoting the rule of law, enforceable contracts, a stable government process, and actions to eliminate corruption.

The Treasury Department is therefore pressing the MDBs to:

- concentrate resources on countries that demonstrate their commitment to sound policies that encourage productivity;
- focus on activities that improve the productivity of the economy and/or remove economic constraints that hamper such productivity; and
- enhance the capacity of individuals (e.g., by better quality education and health services) to contribute to countries' economic activities.

The Department also participated with our G-7 counterparts in the preparation of a report on MDB reform that was transmitted to the Heads of State and Government at the Genoa Summit. The process for preparing this report included an open and frank dialogue with MDB Managements and informal consultations with other shareholders.

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Treasury is actively promoting the increased use of International Development Association (IDA) **grants**. Secretary O'Neill highlighted his commitment to more grants in testimony to the Congress and he has raised the issue in his discussions with G-7 Finance Ministers. Treasury is also pressing the issue of grants in the ongoing negotiations of the thirteenth replenishment of the International Development Association (IDA-13) where we have specifically proposed grant funding for Heavily Indebted Poor Countries (HIPC), projects for combating infectious diseases and regional projects. The April 28, 2001 Statement of G-7 Finance Ministers and Central Bank Governors in Washington noted the ongoing discussion on the increased use of grants within IDA-13 and encouraged the World Bank to carefully explore the related financial implications and practical implementation issues. Treasury has also asked the African Development Fund to consider the implications of a limited increase in the grant financing it provides.

Treasury has been successful in generating support for increased IDA grant financing in the G-7. However, there is no G-7 consensus on the scale of such grants (the strongest supporters of the U.S. are thinking in terms of a 10 percent limit) or on which countries and/or projects should be eligible for grants. There is also no consensus among IDA donors on the issue, with many countries still preferring that IDA retain its current, highly concessional credit terms.

On July 17, 2001 President Bush proposed that the World Bank and multilateral development banks dramatically increase the share of their funding provided as grants rather than loans to the world's poorest and least creditworthy (i.e., IDA-only) countries. The President called for up to 50% of the funds provided to these countries to be provided as grants for education, health, nutrition, water supply and sanitation and other human needs. Subsequently, in their July 20, 2001 Statement, the Heads of State and Government of the G-7 countries agreed in Genoa to explore within the context of IDA-13 the increased use of grants for priority social investments, such as education and health.

Treasury will continue to aggressively press the grant issue when IDA-13 replenishment negotiations resume in late October. This issue will also be addressed at the next meeting, in November, of the African Development Fund donors.

Treasury has also encouraged efforts to concentrate international attention on the role of the MDBs in providing **global public goods**, a key issue emphasized in the Commission's report. The issue was on the agenda for ministerial discussion at both the September 25, 2000 and April 30, 2001 meetings of the Development Committee of the World Bank and International Monetary Fund. At these meetings, Ministers:

- (in September) endorsed World Bank involvement in global public goods in the areas of communicable disease, trade integration, financial stability, knowledge and environmental concerns, on the basis of four criteria: clear value-added to the Bank's development objectives; the ability of the Bank to catalyze other resources and partnerships; a significant comparative advantage for the Bank; and an emerging international consensus that global action is required; and
- (in April) welcomed the Bank's commitment to anchor its global public goods activities in its core business and country work, to remain selective and focused on each of these areas, to

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consolidate its cooperation and division of labor with other international partners, and to carry out further analytical work with its development partners on the financing arrangements and governance required for the support of global public goods.

The G-7 MDB reform experts also considered global public goods and recommended that the MDBs prioritize their support on efforts to fight infectious diseases, promote environmental improvement, facilitate trade and support financial stability. The G-7 experts also underscored the importance of ensuring that the MDB's engagement is based on their comparative advantage and effective capacity and in close collaboration with other development partners.

The G-7 report on MDB reform identifies five other areas that merit priority attention for improvement. These recommendations are summarized as follows:

- Better co-ordination among the MDBs: The MDBs should improve their coordination at the country and institutional level and avoid undue overlap in their operations. They should link the timing and substance of their strategies for the same country, and harmonize their operational policies and procedures to the highest appropriate standard.
- Improved internal governance: The MDBs' budget processes must be more transparent and better justified. The institutions need to ensure their operations comply with approved policies and strengthen their efforts to measure and improve development results. Their operations should be transparent, with more open public disclosure of strategy and policy documents. Inspection mechanisms and evaluation departments of the respective banks should report directly to their Boards.
- Strengthened efforts to promote good governance in borrowers: The MDBs should give priority attention to helping borrowers strengthen public sector management, accountability, and anti-corruption measures. Strengthening public expenditure and budget management and improving the promotion and enforcement of safeguard and fiduciary policies in recipient country should be major goals.
- Pricing review: The MDBs should urgently review their lending instruments and pricing policies. The pricing review should take into account the feasibility of price differentiation by instrument, development impact, and stage of borrower development. The on-going review exercise on IDA pricing, including the increased use of IDA grants with the IDA-13 replenishment, is noted. The MDBs should also explore whether there is scope for rationalizing and streamlining their existing instruments to achieve greater coherence and consistency, and avoid price competition.
- Financial Sector Reform: The MDBs have an important role to play in helping developing countries strengthen their financial sectors. The World Bank, when appropriate and operating in closest partnership with the regional MDBs, should play a more proactive role in this area, including in assisting countries to develop the institutional capacity to meet international codes and standards.

### **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 Commission did not address the financial implications for the IFIs of such a policy.

The United States and the international community remain committed to implementing the enhanced HIPC initiative.<sup>4</sup> Twenty-three HIPC countries have now reached their decision points – the point at which creditors commit to providing debt relief – allowing these 23 countries to begin benefiting from debt relief that will amount to about \$34 billion over time. Total debt service savings for these countries will average over \$1 billion each year over the next five years. Two of the countries, Uganda and Bolivia, have reached their completion points, when remaining 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) will forgive 100 percent of all outstanding bilateral debt contracted before the June 1999 Cologne Summit for qualifying HIPCs.

Countries benefiting from HIPC debt 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 instance from bilateral donors such as the U.S. Government. 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 Bank for International Settlements (BIS) continues to promote cooperation among the central banking and regulatory community in the area of financial and monetary stability and on the provision of central bank services and financial instruments. Improvements at the BIS have been broadly in line with the recommendations made by the Meltzer Commission.

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<sup>4</sup> The initial HIPC Initiative was launched in 1996. The enhanced HIPC Initiative, agreed in 1999, provides faster, broader, and deeper debt relief. Specifically, under the enhanced HIPC Initiative, more countries are eligible for greater amounts of debt relief, delivered more quickly.

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The U.S. has actively supported the updating of capital adequacy standards through the Basel Committee on Banking Supervision, which operates with a secretariat located in the BIS building. In June 1999, the Basel Committee released a consultative paper on proposed changes to its 1988 Capital Accord and in January 2001 the Basel Committee issued a second consultative package and received comments. The Basel Committee intends to issue a new proposal in early 2002, followed by a brief comment period, and finalize the revised accord by year-end, with implementation in 2005, a year later than the original implementation period.

The BIS has increased inclusiveness through the growing activities of the Financial Stability Institute, the development of the BIS Representative Office for Asia and the Pacific in Hong Kong SAR, and the decision to establish a Representative Office for the Americas in Mexico City. The BIS also established the Asian Consultative Council in March 2001.

With regard to information disclosure, the redesigned website of the BIS continues to provide a significant amount of information about the organization and its activities, including work on the new Capital Accord.