Strengthening Surveillance and Crisis Prevention

Surveillance lies at the heart of the IMF's efforts to help prevent economic and financial crises. The Fund has taken a variety of measures in recent years to strengthen its surveillance, reflecting the changing global environment, including the increased importance of international capital flows, and drawing on the lessons of international financial crises. These initiatives aim to encourage members to adopt policies and institutional reforms that make their economies more resilient to potentially harmful developments and financial stress, support sustained and balanced global growth, and contribute to a more stable international financial system.

Issues related to economic and financial globalization were the subject of two IMF conferences and an informal Board seminar in FY2003 (see Box 2.1).

During FY2003, the IMF reviewed several of these key measures and took a number of additional steps to enhance its surveillance and contribution to crisis prevention:

- The Board undertook reviews of the IMF's *strategy for enhancing the effectiveness of its surveillance*, and determined ways to carry the agenda forward.
- Management and staff continued to develop a system for *assessing crisis vulnerabilities* in countries that are potentially exposed to capital account shocks. This system enables the staff to pull together, for internal use, information on global economic and market developments, analyses of vulnerabilities and financing scenarios, early warning indicators, financial soundness indicators, information on vulnerabilities in specific sectors, and market intelligence to judge the likelihood of incipient crises and consider policies to forestall them.
- The Board proposed several improvements to assessment exercises under the IMF's *standards and codes initiative* and the joint IMF–World Bank *Financial Sector Assessment Program (FSAP)*.
- Executive Directors broadly supported proposals to enhance *data provision for surveillance purposes*.
- A new analytical framework for *debt sustainability assessments* was adopted in June 2002 and by end-April 2003 was being used in surveillance reports for members with significant capital market access, as well as in reports on members' requests for use of the IMF's general resources.
- In April 2003, the Board endorsed further measures to strengthen *surveillance in program countries*, partly in response to the Independent Evaluation Office's report on the prolonged use of IMF resources. (See Chapter 4 for more details on the IEO report.)
- The IMF took steps to *clarify the signals it conveys to official and private creditors* about the strength of a member's policies.
- The IMF significantly advanced its contribution to *combating money laundering and the financing of terrorism*, including through the start of a 12-month pilot program in October 2002.

Follow-Up to 2002 Biennial Surveillance Review and Steps Forward

The financial year saw two follow-up discussions by the Executive Board of the 2002 Biennial Review of Surveillance. The first, in July 2002, led to several conclusions: endorsement of a new guidance note for staff on surveillance, agreement on a first step toward enhanced assessment of the impact of the IMF's policy advice, and measures to strengthen surveillance in program countries. The second discussion, in March 2003, was a more comprehensive follow-up: the Board revisited the conclusions of earlier reviews, took stock of the range of initiatives already undertaken to strengthen surveillance, and discussed a number of areas where further work would be helpful.

Past reviews, Directors noted, pointed to five key ingredients of effective surveillance:

- timely, comprehensive, and accurate information;
- focused, high-quality analysis;
- openness to different perspectives to minimize the risk of "tunnel vision";
- effective communication of assessments to the authorities and the public; and
- desired impact on members' policy decisions.

They observed that, building on the lessons learned from the Mexican and Asian crises of the 1990s, a range of steps has been taken in recent years to shape

Box 2.1
Research on Globalization

The debate continues on globalization's benefits and costs and about the policies that can best ensure that its net benefits are maximized and shared by all. During the financial year, research on issues directly related to globalization was discussed at three meetings at the IMF.

The IMF held its *Third Annual Research Conference* in November 2002. The theme was *Capital Flows and Global Governance*. The conference provided a forum for economists from the Fund and elsewhere to exchange views on recent research related to globalization and the IMF's work. All research papers presented at the conference can be found at *www.imf.org/external/pubs/ft/staffp/2002/00-00/arc.htm*.

A *Global Linkages Conference* was held in Washington, D.C., in January 2003, to explore how economic linkages across countries have changed in recent years and what implications these changes have for policymakers in advanced and developing economies. The presentations and the discussions are available at *http://web.mit.edu/kjforbes/www/GL-Website/index.htm*.

In March 2003, the Executive Board discussed in an informal seminar a paper by the staff on the *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence*, which was subsequently published on the IMF website. The document is available at *www.imf.org/external/np/res/docs/2003/031703.htm*.

IMF surveillance to better meet these criteria. Nevertheless, there is scope for further progress in these ongoing efforts, including the following:

- improving data provision to the IMF and data dissemination to the public;
- achieving more systematic financial sector surveillance—in particular, through the Financial Sector Assessment Program (FSAP); and
- strengthening assessments of policy frameworks and institutions against internationally recognized standards and codes.

In addition, vulnerability assessments have been significantly bolstered, with better analyses of debt sustainability and capital account developments, and more consideration of market participants' perspectives. Surveillance in program countries is being strengthened by ensuring that economic conditions and policies are reassessed from a fresh perspective. Moreover, regional surveillance is being reinforced by the multilateral surveillance missions to major emerging market financial centers conducted by the International Capital Markets Department to gather market participants' views on the vulnerabilities facing emerging market economies.

Agenda for Further Improvement

Directors were generally of the view that the strengthened architecture of surveillance put in place in recent years remains a sound framework for the conduct of the IMF's surveillance activities. The priority now was to take full advantage of the potential of the present framework by ensuring that progress with implementation was sustained and that the various surveillance outputs were adequately linked. In addition, Directors identified six areas in which further work and reflection would be useful.

First, while a broad consensus has emerged on the types of policies that help to provide buffers against outside shocks, questions remain about the appropriate *calibration of the IMF's policy advice in these areas*. For instance, recent experience in some emerging market countries suggests that prudent debt levels are lower than previously thought, and has focused new attention on the size of risks in highly dollarized economies. The IMF will be working to improve the analytical basis for policy advice in such areas, and to identify criteria for gauging the soundness of policies. However, many Directors saw considerable difficulty in developing such criteria without falling into a one-size-fits-all approach, and cautioned against allowing such criteria to transform Article IV consultations into a rating exercise. They also observed that this approach should apply to the whole membership as relevant.

Second, in order to strengthen policy advice, the IMF will be looking at ways to integrate *insights from cross-country experiences more systematically* into surveillance.

Third, experience in a number of recent crises suggests that whether a country can implement policies that reduce vulnerabilities depends on the robustness of its political institutions and capacity to mobilize political consensus in favor of needed adjustment measures. Given the importance of these political factors—reiterated in the IEO's evaluation of prolonged use of IMF resources—the Board encouraged the staff to enhance its *analysis and reporting of political economy issues*. This effort is to proceed in an evolutionary manner, based on close dialogue with member countries and building on treatment already accorded to such issues in post-conflict cases and in countries facing severe governance issues. Many Directors cautioned, however, that the staff has limited expertise in political analysis and that political economy considerations should not undermine the technical quality of its policy advice.

Fourth, policy initiatives on transparency, global and regional surveillance, and surveillance over systemic effects of members' trade policies have been designed, in part, to *enhance the impact of the IMF's advice to systemically and regionally important countries*—particularly the major industrial countries, whose trade, macroeconomic, and financial policies have major repercussions on other members and the system as a whole. However, in view of the widespread concern that the views of the IMF on such members' policies are still not taken sufficiently into account, Directors saw scope for further efforts to draw attention to the positive and negative effects of systemically and regionally important countries' policies, including the global impact of their trade policies.

Fifth, the IMF must continue to grapple with the *trade-offs between the goals of transparency and candor* in the IMF's policy assessments and prescriptions. Directors agreed that a key challenge is to preserve full candor in the staff's diagnoses and prescriptions to the Board. Subject to that overriding objective, efforts should be made to continue boosting rates of publication of staff reports.

Sixth, Directors supported the ongoing efforts to *enhance the role of surveillance in program countries*, including through a special guidance note to staff that will bring together the various steps taken to help ensure an independent assessment of economic conditions and policies and to present this fresh perspective at a time when it is most beneficial.

Several steps are already planned to move the policy agenda forward, Directors noted. These include the review of the framework for debt sustainability assessments; work on the feasibility and desirability of adapting the Contingent Credit Line (CCL) eligibility framework for possible use in surveillance; the review of progress on financial soundness indicators as well as a seminar discussion on the balance sheet approach to financial crises; the review of the IMF's transparency policy; and implementation of the conclusions of the review on prolonged use of IMF resources.

Building on the Success of the Standards and Codes Initiative and the FSAP

The Executive Board conducted reviews of both the *Standards and Codes Initiative* and the *Financial Sector Assessment Program* in March 2003 (see Box 2.2). These initiatives were significantly enriching IMF surveillance, Directors found, and member countries indicated that they had benefited from participation in the initiatives.

For the standards and codes initiative, Directors agreed that going forward, coverage should be more selective, focusing on the countries and standards expected to have the highest payoff in improving domestic and international financial stability and strengthening institutional capacity. In addition, Reports on the Observance of Standards and Codes (ROSCs) will be expected to focus more sharply on main conclusions and recommendations, with greater attention to follow-up.

In the case of the FSAP, Directors observed that there is scope for streamlining the assessment exercises. In addition, priority should continue to be given to industrial countries and emerging market economies of systemic importance, while maintaining a balanced coverage of countries. The program remained the foundation for strengthened financial sector surveillance, Directors agreed, but it should be complemented with other tools—such as FSAP updates, more participation of specialized financial sector staff in Article IV missions, and off-site monitoring, including through financial soundness indicators—to achieve more continuous surveillance, especially of systemically important countries. To make resources available for these activities, Directors proposed a moderate reduction in the annual number of FSAP assessments and reassessments—while continuing to expect that the entire membership would participate in the program over time—coupled with greater variation in the scope of FSAP assessments according to country circumstances. The proposed greater focus on medium-term and structural issues in low-income countries with small financial systems was welcomed by Directors. It was also noted that for least developed countries with nascent diversified financial systems, the more immediate need might be technical assistance to develop the financial sector, rather than a resource-intensive detailed FSAP.

Data Provision for Surveillance Purposes

The IMF's member countries supply the data that the Fund needs to oversee their economic policies. Members are required to provide such data under the IMF's Articles of Agreement. Crises in emerging market economies since the mid-1990s have made clear the importance of comprehensive, timely, and accurate economic and financial data—including on international reserves, external debt, and capital flows—for assessing countries' external vulnerabilities and as an essential element of surveillance.

To guide members in disseminating their economic and financial data to the public, the IMF created data standards, the Special Data Dissemination Standard (SDDS) and the General Data Dissemination System (GDDS); see Box 2.2. These standards contribute to the pursuit of sound macroeconomic policies and the smooth functioning of financial markets.

In May 2002, the Board met to discuss the *provision of data to the IMF for surveillance purposes*. Directors welcomed recent improvements in members' data provision to the IMF for surveillance purposes. They reaffirmed the IMF's policy on data provision whereby all members are required to provide a minimum set of core data, consistent with their capacity. Beyond this, member countries are expected to supply the data

Box 2.2

The Standards and Codes Initiative and Financial Sector Assessment Program

In 1999–2000, the IMF, with the World Bank, introduced two initiatives as part of the international community's strategy to improve the stability of the global financial system. Under the standards and codes initiative, the Fund and Bank assess member countries' adherence to internationally recognized standards and codes of good economic and financial practices that contribute to sound national and international economies. *Reports on the Observance of Standards and Codes (ROSCs)* are a key output of the initiative. Work under the second initiative, the Financial Sector Assessment Program (FSAP), examines a country's financial sector institutions, policies, and vulnerabilities in a comprehensive manner, including possible systemic risks. These are detailed in a *Financial Sector Stability Assessment* report.

Typically, in both programs, which are interrelated, joint teams of IMF and Bank staff—supported by experts from a range of national agencies and international standard-setting bodies—make at least one in-country visit and work with government authorities and/or the representatives of the private sector. Countries' participation in the programs is voluntary.

Reports on the Observance of Standards and Codes (ROSCs)

A ROSC is an assessment of a country's observance of one of 12 areas and associated standards useful for the operational work of the Fund and Bank. The reports—about 70 percent of which are subsequently published—examine three broad areas: transparency, financial regulation and supervision, and market integrity (including corporate governance, accounting, auditing, and insolvency).

Transparent government operations and policymaking: *Country reports on Data Dissemination, Fiscal Transparency, and Monetary and Financial Policy Transparency.* The underlying assumption is that better-informed publics are more likely to hold their governments accountable for their policies and that investors, armed with better data and a standard against which to evaluate them, are more likely to invest wisely. Key tools are the IMF's statistical initiatives (SDDS and GDDS) and codes of transparency in monetary, financial, and fiscal policies.

Special Data Dissemination Standard (SDDS). Created in 1996, the SDDS is a voluntary standard whose subscribers—countries with market access or seeking it—commit to meeting internationally accepted levels of data coverage, frequency, and timeliness. Subscribers also agree to issue calendars on data releases and follow good practices with regard to data quality and integrity. Information on subscriber data dissemination practices is posted on the IMF's website on the Data Standards Bulletin Board, which is linked to subscriber websites.

General Data Dissemination System (GDDS). For countries that do not have market access but are eager to improve the quality of their national statistical systems, the GDDS offers a "how to" manual. Voluntary participation allows countries to set their own pace but provides a detailed framework that promotes the use of widely accepted methodological principles, the adoption of rigorous compilation practices, and ways in which the professionalism of national systems can be enhanced. Participating countries post their detailed plans for improvement on the Data Standards Bulletin Board, thus permitting both domestic and international observers to view their progress.

Financial sector standards: *Country reports on Banking Supervision, Securi-*

appropriate to their individual characteristics and circumstances.

Directors broadly supported IMF staff proposals to enhance the provision of data needed by the Fund for surveillance purposes. Highlights of the discussion included:

Issues regarding moving to weekly dissemination of data on international reserves under the SDDS. Frequent and timely disclosure of reserves data to the public is emerging as a best practice for many countries, Directors remarked. However, increasing frequency and timeliness in the data requirements of the SDDS is not now necessary, most Directors considered, noting also that moving to weekly data would raise technical and resource constraints for most subscribers and could deter new subscribers. Directors will have an opportunity to return to this issue later in 2003.

Improving provision of fiscal data. Directors stressed the critical importance of the IMF's being provided with adequate fiscal data, and asked the staff to continue working on improving the provision of these data. They welcomed the recent completion of the *Government Finance Statistics Manual*, which represents a major advance in the development of an analytical framework for fiscal data, and they supported giving IMF technical assistance to countries to help them adopt the practices set out in the new manual.

Identifying gaps in data for vulnerability assessments and national policymaking. Recent improvements in Article IV report discussions of countries' vulnerabilities, particularly for countries with access to international capital markets, were welcomed by the Board. Nevertheless, data deficiencies in many cases continued to hamper vulnerability analysis, and most Directors agreed that staff reports should more clearly identify gaps in data and technical assistance priorities during Article IV consultations and discuss progress in compiling data needed for vulnerability assessments, as relevant.

ties Regulation, Insurance Supervision, Payments Systems, and Combating of Money Laundering and Terrorist Financing. The IMF and the World Bank each year undertake at members' requests a certain number of financial system "health checkups" under the Financial Sector Assessment Program (see below). As part of this checkup, staff prepare detailed assessments of the country's observance of relevant financial sector standards and codes such as the Basel Core Principles for Effective Banking Supervision; summaries of these assessments may be issued as individual ROSCs as well as included in a comprehensive *Financial Sector Stability Assessment* report on the country.

Market-integrity standards for the corporate sector: *Country reports and assessments on Corporate Governance, Accounting and Auditing, and Insolvency and Creditor Rights.* With the private sector serving as the engine of growth in most economies, the health of the corporate sector is a critical concern. The World Bank typically takes the lead in assessing the quality of corporate governance, the adequacy of accounting and auditing standards, and the state of insolvency procedures and creditor rights.

The standards initiative has attracted growing participation from members and attention from financial market participants and ratings agencies. By end-April 2003, over 388 ROSCs had been prepared for 91 countries. Most systemically important countries are participating in ROSCs, though country coverage of the assessments remains uneven across regions.

Financial Sector Assessment Program (FSAP)

The FSAP is a comprehensive health checkup of a country's financial systems. Financial systems comprise the whole range of financial institutions, such as banks, mutual funds, and insurance companies, as well as the financial markets themselves—that is, securities, foreign exchange, and money markets. Also included are the payments system and the regulatory, supervisory, and legal frameworks that underlie the financial institutions and markets.

The Checkup. FSAP teams (IMF and Bank staff and experts from central banks, national supervisory agencies, and international standard-setting bodies) seek to alert member countries to likely vulnerabilities in their financial sector and to help the IMF and the Bank—and the international community—formulate the appropriate assistance. Teams use a variety of analytical tools (including stress tests and financial soundness indicators) to review financial sectors, evaluate how risks are managed, weigh possible technical assistance needs, and help countries prioritize policy responses. The FSAP assessment is an important input to IMF surveillance. By end-April 2003, reports under the program had been completed for 48 countries or regions, another 22 were under way, and a further 31 countries had committed to future participation.

Offshore Financial Centers

The IMF uses many of the diagnostic tools developed for the FSAP in its work on offshore financial centers. This work helps members to identify gaps and reduce potential vulnerabilities in their financial systems and improves the statistical coverage of the activities of offshore financial centers. Assessments of offshore financial centers evaluate financial regulation and supervision in jurisdictions with significant offshore financial activity to help safeguard the stability and integrity of their financial systems.

The Board noted that the cost implications of these enhancements for member countries as well as for the IMF will require careful prioritization and sequencing. They stressed that efforts to increase the frequency of data provision should not come at the expense of quality.

Signaling Assessments of Members' Policies

The IMF's interactions with member countries can have an important signaling function. Most of these interactions take place in the context of IMF surveillance and the IMF's financial support of policy programs. However, on occasion the IMF has responded to requests from member countries for special monitoring that goes beyond surveillance but does not involve an IMF financial arrangement. Some of these monitoring mechanisms were specifically intended to provide signals to official or private creditors. In recent years, such monitoring has mainly taken the form of staff-monitored programs (SMPs), under which no funds are lent but IMF staff follow a member's economic program and meet regularly with the country's authorities to discuss economic developments and policies.

During the discussion of the 2002 Biennial Review of the IMF's Surveillance, Directors expressed concerns about certain aspects of these programs. A follow-up discussion took place in January 2003 based on a paper entitled *Signaling Assessments of Members' Policies.* Experience with another signaling mechanism—assessments of members' policies provided in response to ad hoc requests from various official creditors or donors—was also discussed.

Concerns about SMPs relate mainly to SMPs that are used to convey signals on a member's policies to official and/or private creditors, Directors agreed. Given the close formal resemblance to IMF-supported programs, these "signaling" SMPs risk being misinterpreted as carrying the IMF's seal of approval. Moreover, relatively lax standards for reporting on performance have allowed members to use the positive signal of initiating an SMP without adequate follow-up on implementation.

In light of these concerns, Directors felt that the existing framework for SMPs is not well suited to situations where members see a need for monitoring by IMF staff to provide assessments of their economic policies to official and/or private creditors. Consequently, they supported a proposal to discontinue such "signaling" SMPs. However, Directors concluded that the SMP framework remains suitable for circumstances where members need to establish a policy track record based on strong ownership before moving to an IMF arrangement or after an arrangement has gone off track.

Views differed, however, on establishing a new mechanism for this purpose. Given their differences on the matter, Directors agreed that, for the time being, the IMF will use existing mechanisms, including the Article IV consultation process and precautionary arrangements, for signaling purposes. If later it becomes evident that there is a demand for a more specific signaling mechanism, the staff will come back to the Board with a new proposal.

On the future role of SMPs, Directors were of the view that, in cases where SMPs are used to build a policy track record toward an IMF arrangement, the risk of misinterpretation is relatively low. In these cases, Directors concluded, the SMP framework remains suitable.

IMF staff also provide assessments of members' macroeconomic conditions and policies in response to various ad hoc requests from other international financial institutions, creditors, or donors. While recognizing the need for flexibility in meeting such demands, Directors nevertheless saw merit in general guidelines for the preparation of these assessments. They stressed that these assessments should be sufficiently nuanced to take account of different country circumstances, but written clearly so that the boards of other international financial institutions or other donors would be able to distinguish between countries with strong macroeconomic policies and those without. The assessments should also provide a brief history of the IMF's relationship with the member country.

Review of the Contingent Credit Line

The IMF designed and introduced its Contingent Credit Line (CCL) in 1999 as a way to enhance incentives for sound policies and provide a better safety net for good performers. It offers precautionary short-term financing under a Stand-By Arrangement primarily to help a member overcome the balance of payments financing need arising from a sudden and disruptive loss of market confidence due to contagion, and largely generated by circumstances beyond the member's control. At the end of FY2003, Directors were engaged in a review of the CCL, addressing reasons why it had not been used to date, especially:

- Concerns by members that a CCL request could be viewed as a sign of weak, rather than strong, policies;
- The possibility that a country's withdrawal from the CCL (or a determination that it no longer met the requirements) might trigger adverse market reactions; and
- An impression that the CCL might not provide greater assurances of timely financing than other IMF facilities and policies.

Besides its consultations with members and Directors, the staff has engaged in extensive outreach with market participants on these and other issues related to the CCL. The Board expects to continue its discussions in the period prior to the scheduled expiration of the facility in November 2003. In the interim, it has asked the staff to explore ways in which it might be possible to use strengthened IMF surveillance and precautionary arrangements to achieve the goals of the CCL in helping member countries with sound policies to confront the challenges of globally integrated capital markets.

Improving Sustainability Analysis

Assessments of the sustainability of a country's external and public debt are a key element in the IMF's work with many member countries. Judgments about debt sustainability—whether the debt can be serviced without an unrealistically large correction to the balance of income and expenditure—underpin the IMF's decisions in program contexts, in particular by helping to determine when financing is appropriate and, if so, the appropriate amount of financing to provide. These judgments become critical—and in many cases, particularly finely balanced—in cases of emerging market countries that are highly integrated into global capital markets and may have large financing needs.

In June 2002 the Board discussed and endorsed a new framework for judging debt sustainability. The new framework provides a reality check on the baseline projections on the basis of which sustainability is assessed, by clarifying the underlying assumptions regarding key variables including growth, real interest rates, exchange rates, and primary fiscal or external imbalances, and by highlighting their implications. It introduces a set of standardized parameters for stress-testing the program baseline, to identify the extent to which sustainability hinges on the assumption of a macroeconomic outcome more favorable than experienced in the past and to help ensure the robustness of the program in the face of plausible shocks.

In their discussion, Directors noted that assessments of sustainability are necessarily based on judgment, given that they depend upon a complex assessment of the interrelationships among several factors—including macroeconomic developments, political and social constraints on adjustment, and the availability and cost of private and official financing. The new framework helps strengthen the analytical basis for making these judgments. It does not provide a mechanistic approach, which would be inappropriate given the wide variation in the debt-bearing and adjustment capacities of different economies over time. Rather, it is a framework for informing these judgments and expressing them in a transparent manner. As greater experience is gained, efforts will continue on further refining the framework.

Combating Money Laundering and the Financing of Terrorism

In July 2002, the Board discussed proposals to advance the IMF's contribution to international efforts to combat money laundering and the financing of terrorism (AML/CFT). The IMF had begun a new chapter in its work on this subject, Directors noted, by taking two key steps:

- conditionally adding the Financial Action Task Force (FATF) 40 Recommendations and the 8 Special Recommendations (FATF 40+8) to the list of areas and associated standards and codes useful to the operational work of the IMF (see Box 2.3); and
- endorsing a 12-month *pilot program* of AML/CFT assessments and accompanying ROSCs that would involve participation of the IMF and the World Bank, the FATF, and FATF-Style Regional Bodies (FSRBs).

Governing Principles

In moving forward, Directors emphasized that four key principles should guide the IMF's role in AML/CFT assessments and accompanying reports:

- the IMF staff's involvement in assessing non-prudentially regulated financial sector activities should be confined to those that are macroeconomically relevant and pose a significant risk of money laundering or terrorism financing;
- all assessment procedures should be transparent and consistent with the mandate and core expertise of the different institutions involved, and compatible with the uniform, voluntary, and cooperative nature of the ROSC exercise;
- the assessments should be followed up with technical assistance, if requested by a member, to build its institutional capacity and develop its financial sectors; and
- the assessments would be conducted in accordance with the comprehensive and integrated methodology being developed jointly by IMF and World Bank staff and the FATF.

Box 2.3

Money Laundering and the FATF

Money laundering is the hiding or hidden movement of assets resulting from criminal activity to muddy the connection between the crime and the assets. In turn, this laundered money is sometimes used to finance terrorism.

The harmful effects of money laundering on countries could include a range of severe macroeconomic consequences, such as unpredictable changes in money demand, risks to the soundness of financial institutions, and contamination effects on legal financial transactions. And money laundering can inhibit foreign direct investment if a country's commercial and financial sectors are perceived as being under the influence of organized crime. From a wider perspective, the financing of terrorism threatens the stability of individual countries and of the international financial system. Because financial market integrity is closely linked to financial stability, setting out guidelines for financial sector supervision is an important role for the IMF, which has expertise in assessing and providing technical assistance in financial sectors and overseeing members' exchange systems.

Financial Action Task Force

The Financial Action Task Force on Money Laundering (FATF) is an intergovernmental body established by the G-7 summit in Paris in 1989 to develop and promote policies, at national and international levels, against money laundering. The task force monitors its members' progress in carrying out anti-money-laundering measures, reviews money-laundering techniques and countermeasures, and promotes the global adoption of anti-money-laundering measures, collaborating with other international bodies. In April 1990 the task force issued a set of "40 Recommendations," which provide a comprehensive blueprint of the actions needed to fight money laundering. After the terrorist attacks of September 11, 2001, the scope of the FATF was expanded to include terrorist financing. At a Plenary on the Financing of Terrorism, the task force issued 8 Special Recommendations on Terrorism Financing to supplement the original 40. The recommendations are now referred to as the FATF 40+8.

The IMF's Executive Board agreed in April 2001 that the FATF 40 Recommendations be recognized as the appropriate standard for combating money laundering and that work should be conducted to determine how the Recommendations could be made operational in the IMF's work. In July 2002 Executive Directors conditionally approved adding the FATF 40+8 to the IMF list of standards and codes (see text); they were formally added in November 2002.

Pilot Program

A 12-month pilot program of AML/CFT assessments was initiated in October 2002, with participation of the IMF, World Bank, FATF, and many of the FSRBs. The Fund and the Bank are undertaking the assessments of the FATF 40+8 and accompanying ROSCs in the context of the Fund/Bank Financial Sector Assessment Program and the Fund's Offshore Financial Center assessments. They are following the AML/CFT assessment methodology endorsed by the FATF in October 2002 and also approved by the IMF Executive Board as part of the pilot project's launch. (This methodology was reviewed by the Board in July 2002.) About 50 assessments using the methodology could be undertaken under the pilot program, including up to 8 by the FATF, 12 by the FSRBs, and at least 36 by the IMF and the World Bank.

The FSRBs are generally cooperating in the pilot program, although there is still some uncertainty about how many assessments they will undertake. Three regional bodies have endorsed the methodology, and two others are expected to do so shortly. The Caribbean FATF, while not fully endorsing the methodology, has acknowledged that it will be used in assessments of member countries during the pilot project in IMF/World Bank assessments.

The assessments are identifying weaknesses in AML/CFT regimes, and technical assistance has been significantly stepped up in response. Areas of weakness include legislative drafting and review, especially in combating the financing of terrorism, and the effectiveness of supervisory arrangements. The IMF and the World Bank have completed, initiated, or agreed to 52 AML/CFT technical assistance programs, comprising direct technical assistance to 40 jurisdictions and 12 regional technical assistance projects. In March 2003, they published a Joint Interim Progress Report. The participating parties will undertake a full review of the pilot program early in 2004.