- The other set of proxies includes an effective exchange rate and a foreign price variable based on constant 2004 sector-specific weights. This accounts better for differences in trade structure across sectors (at least in 2004), but ignores the changing importance of different trading partners over time. Again, Figure 5 illustrates that this omission can be important.

4. The pass-through coefficients estimated using the "broad" and "sectoral" explanatory variables were found to be quite closely related. In line with intuition, sectoral-based estimates are significantly smaller, particularly in the earlier period; and the broad-based coefficient estimates vary across a broader range for the various sectors.

5. China's share in imports by end-use category was calculated based on Bureau of Census data (for 2000-04). For 1993, shares reported by Kamin and others (2004) were used.

Data for country estimates

6. Data cover 17 advanced economies: Australia, Austria, Canada, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, United Kingdom, United States.

7. Import prices are overall import deflators from the OECD Analytical Database. Domestic prices are represented by GDP deflators (from the OECD Analytical Database), while foreign prices are import-weighted CPIs of trading partners (from the WEO). Nominal and real effective exchange rates are from the International Financial Statistics.

8. Structural change variables—the change in China's share in total imports and the indicator of change in the trade structure—are constructed based on information from the Direction of Trade Statistics. The structural change indicator is based on the following breakdown of total imports:

- Industrial countries: Canada, Australia, Japan, New Zealand, Austria, Belgium (Belgium-Luxembourg), Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States
- Africa
- Asia: China, P.R., India, Indonesia, Korea, Malaysia, Other
- Emerging Europe
- Middle East
- Western Hemisphere: Argentina, Brazil, Mexico, Other
- Other

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IV. A Global View of the U.S. Investment Position[28]

1. ***The rapid increase in the United States' net foreign liabilities has raised questions about foreign investors' willingness to continue to hold or acquire U.S. assets***. Federal Reserve Board officials, among others, have noted that the decline in the U.S. net international investment position (NIIP) is not sustainable over a longer time period (Ferguson, 2005, and Greenspan, 2005). This view is partly related to concerns that global investment portfolios may by now contain excessive holdings of U.S. assets, and that the financing of the current account deficit has recently shifted from equity to debt instruments. Both trends are seen as potential triggers of a disorderly exchange rate adjustment that could have harmful effects on financial markets and real activity (Cline, 2005, and Obstfeld and Rogoff, 2004).

2. ***The paper analyzes various indicators of the U.S. NIIP from a portfolio perspective***. It examines whether investment portfolios have become more or less internationally diversified over time, and whether the increase in foreign claims on the United States can be explained by the growth of U.S. financial markets or a decline in home bias. The share of foreign portfolio exposure to U.S. assets is compared to the benchmark share of U.S. assets in the world portfolio. The U.S. NIIP is also compared with that of other countries, including a breakdown by investment category and analysis of recent changes.

A. Measurement of Global Portfolio Shares

3. ***When measuring the degree of home bias in large countries, the size of domestic financial markets needs to be taken into account***. The analysis starts from the assumption that, in order to maximize international risk sharing, the share of an investor's portfolio dedicated to claims on a particular country will equal the country's weight in the outstanding global financial stock.[29] However, it is a well-documented fact that investors favor their domestic markets—this is termed "home bias".[30] A standard measure of home bias that accounts for the size of the domestic financial market relative to the rest of the world is:

$$\text{Home Bias} = \frac{A^*}{D} \Big/ \frac{W - D}{W} \tag{1}$$

where A^* represents domestic holdings of foreign assets, D is the size of the domestic market, and W is the size of the world financial market. The numerator measures the actual share of foreign assets in the portfolio, while the denominator measures what this ratio would be in a fully diversified world. A value of zero indicates no holdings of foreign assets, while a value of one indicates that the country's portfolio is perfectly diversified from a geographic

[28] Prepared by Andrew Swiston.

[29] See Karolyi and Stulz (2002) for a model and survey of the literature.

[30] Bertaut and Kole (2004) and Sorenson and others (2005) present recent data on home bias.

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perspective. For small countries, the denominator in the above equation is close to one, and the results of the formula are close to those obtained by taking foreign assets as a share of investors' portfolios. For large countries, however, the denominator is lower, and the difference between the simple share of foreign assets in investors' portfolios and the above formula is larger. This implies that investors in countries with large financial markets—especially the United States—would be expected to hold a lower share of foreign assets and a higher share of domestic assets, reflecting the country's greater weight in the global financial universe.

4. ***The paper analyzes the implications of home bias for NIIPs***. Replacing A^* in (1) with L^*, for foreign holdings of domestic assets, gives a measure of the degree of home bias displayed by foreign investors toward a particular country:

$$\text{Foreign Investors' Bias} = \frac{L^*}{D} \Big/ \frac{W - D}{W} \tag{2}$$

This formula describes foreign investors' bias from the perspective of the country issuing the liabilities in question. Combining (1) and (2), the overall internationalization of a country's financial market, including both assets and liabilities, can be measured as:

$$\text{Internationalization} = \frac{\frac{1}{2}(A^* + L^*)}{D} \Big/ \frac{W - D}{W} * 100 \tag{3}$$

Similarly, the difference between (1) and (2) provides a measure of a country's indebtedness scaled by the size of the domestic market:

$$\text{Indebtedness} = \frac{A^* - L^*}{D} \Big/ \frac{W - D}{W} * 100 \tag{4}$$

5. ***Scaling the NIIP by the size of the domestic market facilitates an examination of indebtedness based on portfolio shares***. The NIIP is typically stated as a ratio to GDP, combining a stock concept and a flow concept and focusing on a country's ability to service its debt. Determining whether a negative NIIP is large relative to the domestic market reveals whether the already high exposure of foreign investors to domestic assets might constrain a further rise in indebtedness.

6. ***Data on international investment holdings and domestic financial market size are used to obtain measures for portfolio internationalization and net investment positions***, based on Equations (3) and (4).[31] The size of domestic financial markets—taken to be equal to the stock of financial instruments outstanding—is estimated for 45 countries. However,

[31] The data used for this paper are described in the appendix.

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data limitations restrict the analysis of foreign holdings of domestic financial instruments to 22 advanced economies.

7. ***Reflecting diverse and complex data sources, the results of the following analysis are necessarily subject to a number of caveats***. Although the data are obtained from cross-country sources with standardized definitions, some important country-specific features may not have been captured and other problems remain:

- The definition of domestic equity outstanding may not include the market value of issuance abroad by domestic corporations; data on financial stocks are not adjusted for derivatives or other complex instruments; and country surveys on international holdings cannot always ascertain the final ownership of a financial instrument, reflecting limits on data for custodial holdings.[32]
- Data on international holdings tend to understate assets compared to liabilities, often resulting in an upward bias for net international indebtedness (Bertaut and Griever, 2004). This dataset confirms the bias toward net indebtedness.
- Because the rate of return the United States earns on foreign claims exceeds the rate it pays on claims held by foreigners, the indebtedness concept overstates the economic burden of the United States' negative NIIP (Cline, 2005).
- Valuation changes pose a further complication in analyzing external imbalances and NIIPs, as they weaken the link between a country's current account balance and the change in its NIIP (see Box 1).

B. Trends in Portfolio Internationalization

8. ***Possibilities for increased holdings of international assets have multiplied due to rapid financial deepening in the 1990s*** (Figure 1). In industrial countries, financial markets have deepened at a remarkable pace, with stocks of debt, equity, and loans expanding from around 300 percent of aggregate GDP in 1990 to around 450 percent in 2003, interrupted only temporarily by the bursting of the global equity market bubble. Despite the similarity in overall market size, the United States relies more heavily on debt and equity financing, and less on bank financing, reflecting the larger role of U.S. securities markets in financial intermediation.

9. ***When adjusting for the size of the domestic financial market, the bias exhibited by foreign investors against U.S. assets and U.S. investors against foreign assets is slightly larger than for other countries***. As shown in Figure 2, this is true for all investment types, with the overall gap widening recently. Countries with highly internationalized portfolios include centers of global finance (the United Kingdom and Switzerland), countries that

[32] See Griever, Lee, and Warnock (2001) for an in-depth examination of U.S. data on international financial holdings.

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Box 1. Valuation Changes and the International Investment Position

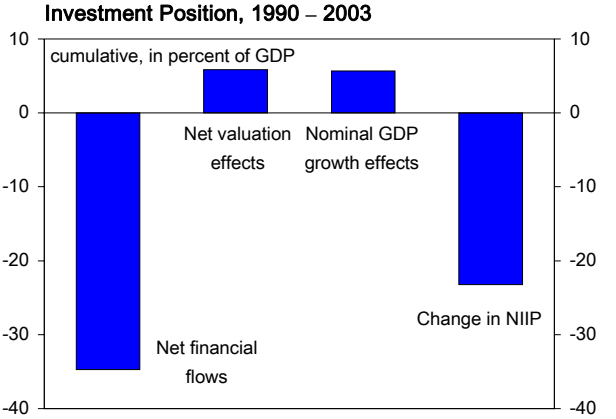
This box examines the effects of valuation changes on the U.S. NIIP. The change in a country's NIIP as a ratio to GDP can be calculated as:

$$\Delta niip_t \approx -fa_t + vc_t - NIIP_{t-1} * g_t$$

where fa_t is the financial account balance as a share of GDP (which is approximately the inverse of the current account balance), vc_t is the sum of valuation changes as a share of GDP, and g_t is the growth rate of nominal GDP. BEA (2005) further decomposes valuation changes since 1990 into changes in the price of assets, exchange rate changes, and other valuation changes.

Since 1990, net valuation changes have eased the impact of financial flows on the NIIP (Figure). This is more than accounted for by large positive gains in 2002 and 2003. Valuation changes in those two years improved the NIIP by 7.2 percent of GDP, offsetting a large proportion of the 10.4 percent of GDP deficit in financial flows in 2002 and 2003. This is consistent with the findings of Gourinchas and Rey (2005), that valuation changes on the U.S. NIIP have tended to have a stabilizing effect on external imbalances.

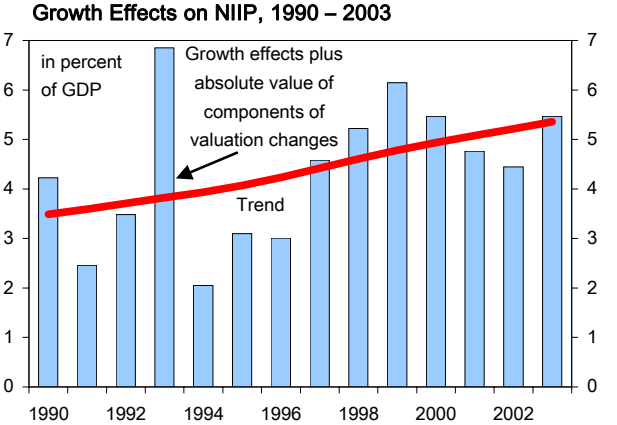
United States: Change in the Net International Investment Position, 1990 – 2003



The gains in 2002 and 2003 reversed small earlier losses, as the cumulative effect on the NIIP of valuation changes from 1990–2001 was a loss of about 1 percent of GDP (net valuation changes were also negative in the 1980s). Additionally, year-to-year persistence in valuation changes is low, with essentially no correlation between the change in one year and the next, implying that valuation changes have not been systematic.

The importance of valuation changes in determining the NIIP has been increasing as gross positions rise (Figure)**.** Without valuation changes, the expected correlation between a country's current account balance and the change in its NIIP is 1, but in this dataset the correlation is only 0.1 (the correlation for the United States is also 0.1). Differences in the performance of domestic and foreign equity markets and movements in the exchange rate affect gross foreign assets in a different way than gross foreign liabilities, driving overall net valuation changes. For example, because U.S. foreign assets are mostly denominated in foreign currency and U.S. foreign liabilities in domestic currency, a depreciation of the dollar will boost the dollar value of U.S. asset holdings without changing the dollar value of U.S. liabilities, leading to an improvement in the NIIP. Tille (2003), for instance, shows that, even when the NIIP is balanced, a given change in the exchange rate will result in a larger change in the U.S. NIIP when gross positions are larger.

United States: Impact of Valuation Changes and Growth Effects on NIIP, 1990 – 2003



[1]Although cumulative valuation changes resulting from asset prices and exchange rates were negative, other valuation changes were consistently positive throughout the period.

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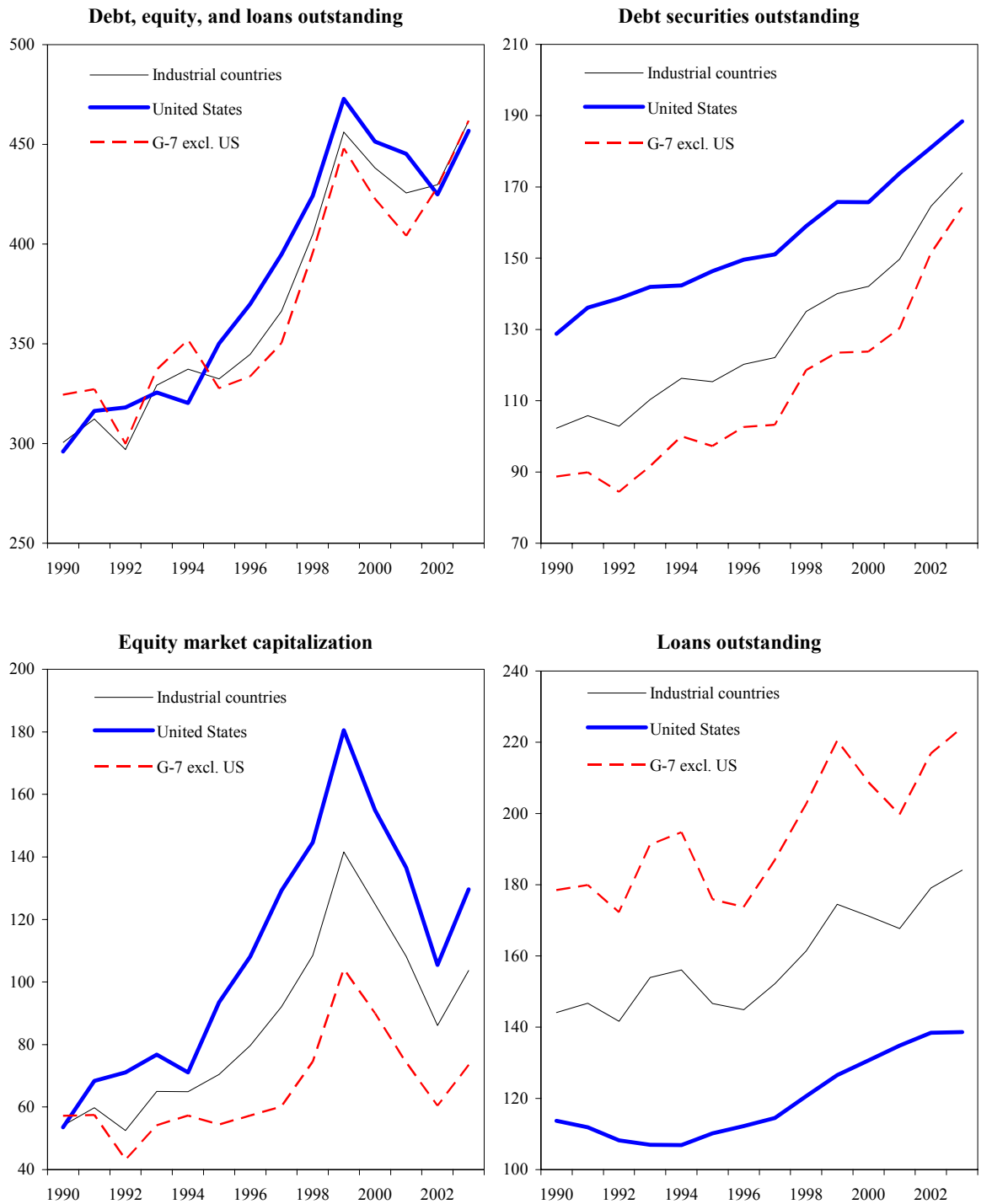
Figure 1. Industrial Countries: Financial Deepening, 1990 – 2003
(In percent of GDP in U.S. dollars)



Source: Fund staff calculations.

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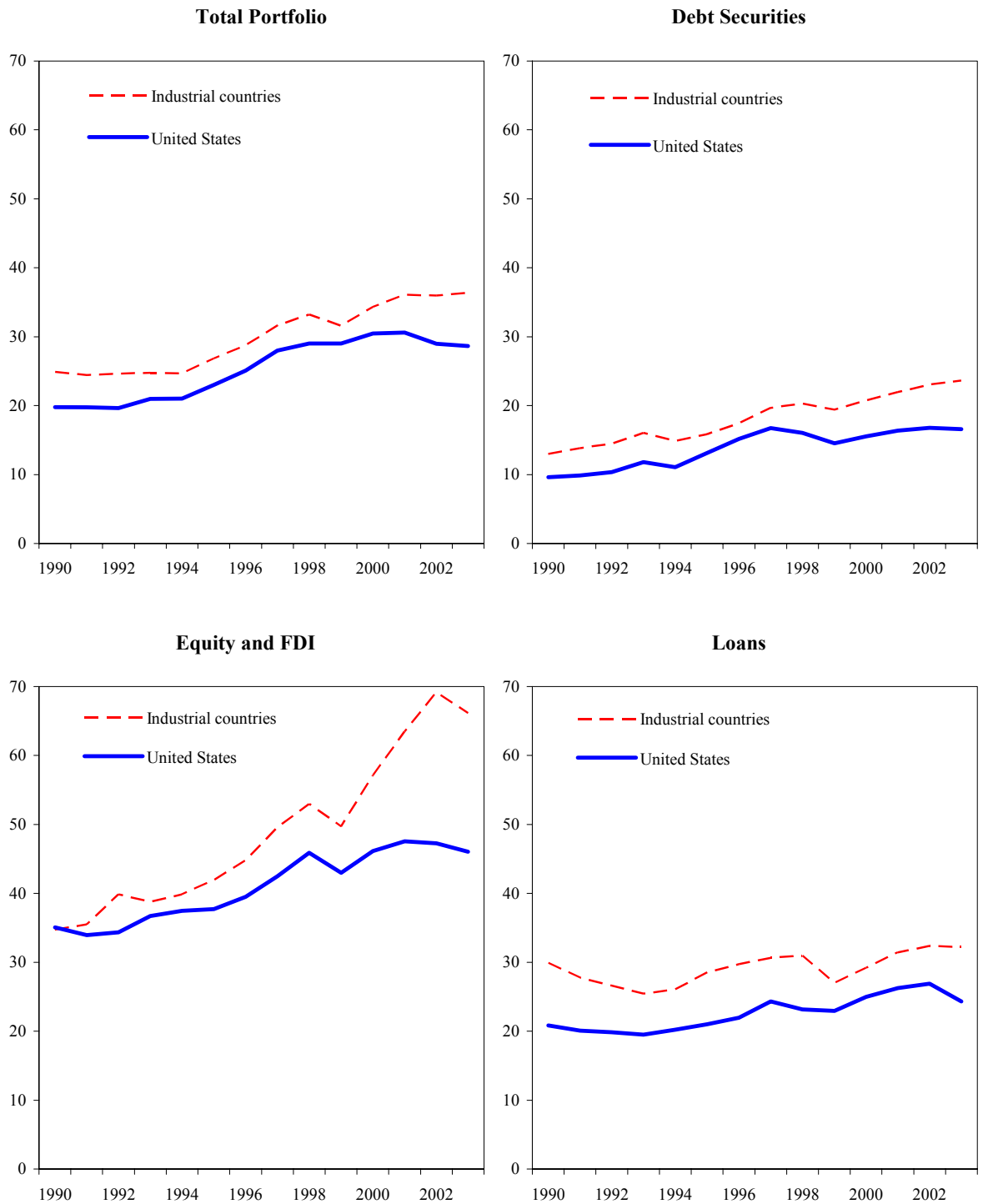
Figure 2. Internationalization of Assets and Liabilities, 1990 – 2003



Source: Fund staff calculations.

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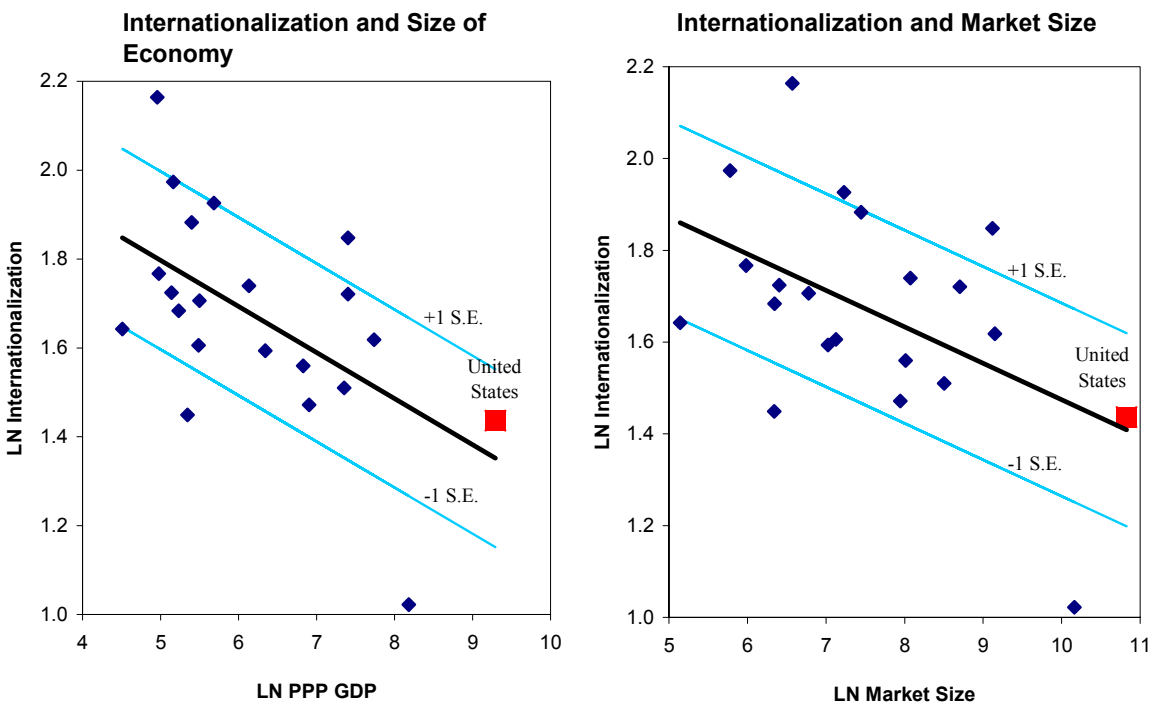
Figure 3. Internationalization and Country Size, 2003



Source: Fund staff calculations.

receive large foreign investments (Ireland), and Norway, whose international holdings grew rapidly as a result of its accumulating oil wealth.

10. ***However, after adjusting for the size of the economy or of outstanding financial instruments, the internationalization of U.S. portfolio holdings is close to what would be predicted***. The benefits of geographic portfolio diversification are lower for investors in an economy with more diverse activities and a greater variety of investment opportunities.[33] Figure 3 shows that—using the size of the economy or depth of financial markets as proxies for economic diversity in simple linear regressions—these factors explain the lower degree of internationalization of the U.S. financial market.[34]

11. ***Notwithstanding a rise in portfolio internationalization, rapid growth in global financial markets has been a larger contributor to the increase in foreign asset holdings***.

[33] Errunza and others (1999) show that the benefits of international diversification can be emulated by holding equity in domestically-based multinational corporations. To the extent that this type of firm is more prevalent on U.S. equity markets than those in other countries, this would further reduce U.S. investors' need for geographic portfolio diversification relative to investors of other countries.

[34] The results hold true even in regressions excluding the United States and Japan.

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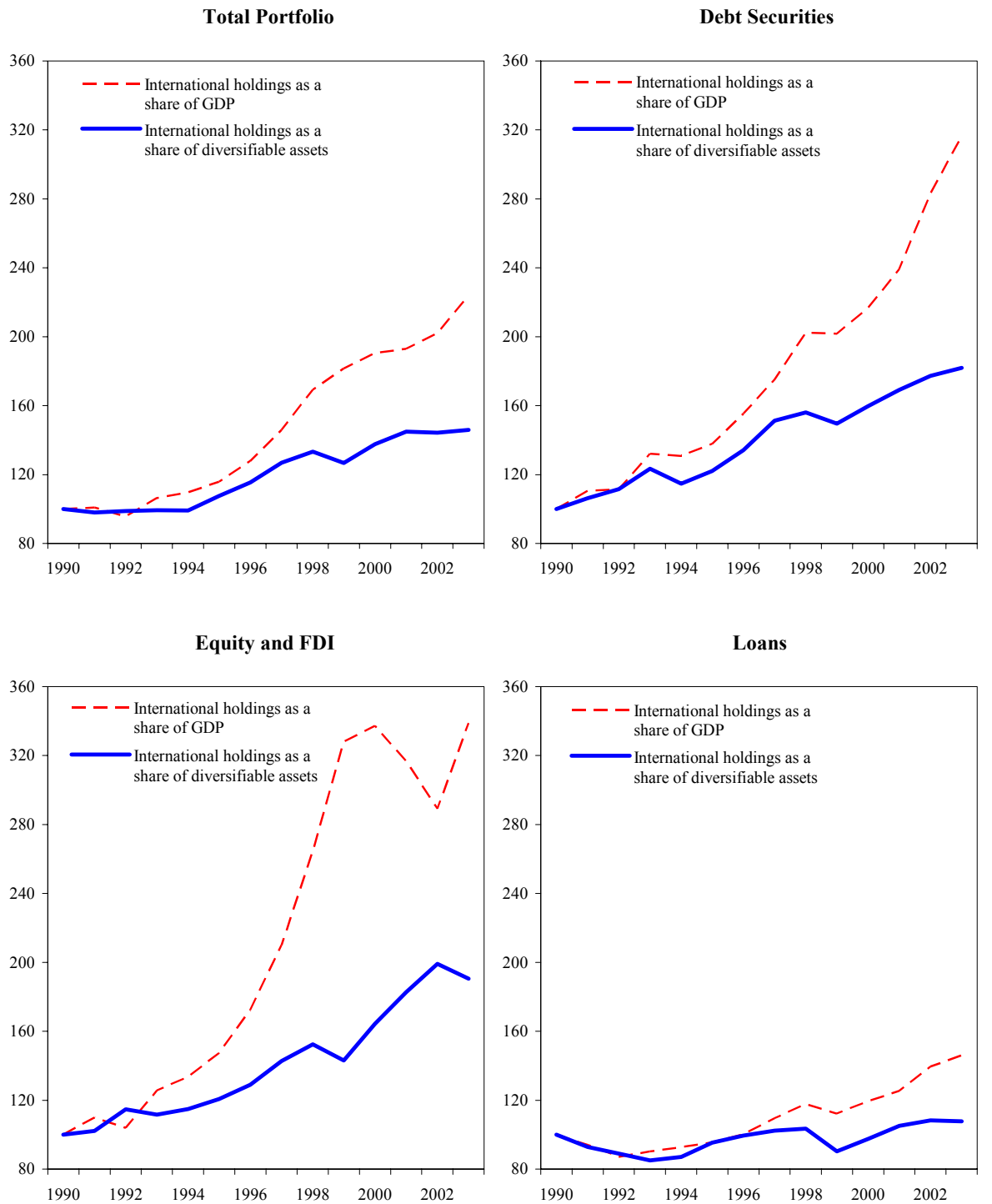
Figure 4. Industrial Countries: Internationalization of Assets and Liabilities, 1990 – 2003
(1990 = 100)



Source: Fund staff calculations.

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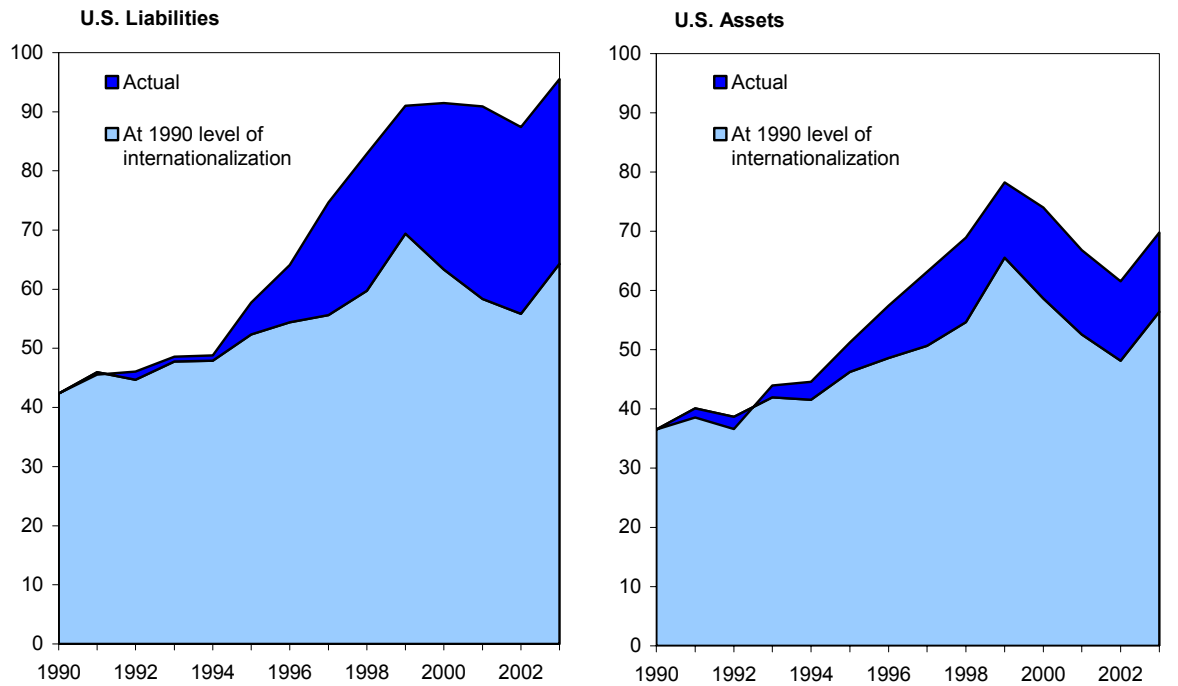
Figure 5. United States: Foreign Liabilities and Assets, 1990 – 2003
(In percent of GDP)



Sources: Bureau of Economic Analysis; and Fund staff calculations.

Figure 4 (on the previous page) shows that holdings of foreign assets more than doubled as a share of GDP since the early 1990s. Portfolio internationalization also increased, but reached only one-and-a-half time the level it had in 1990, implying that growing domestic markets were responsible for a larger share of the growth in foreign holdings than the decline in home bias. The fastest-growing markets, in debt securities and equity, were also the markets becoming more internationalized during the period, perhaps adding to the perception that investors shifted a large proportion of their portfolios abroad.

12. ***However, the United States appears to have particularly benefited from a worldwide decline in the home bias to finance rising liabilities***. Figure 5 decomposes the changes in U.S. holdings of foreign assets and foreign holdings of U.S. assets. On the liabilities side, growth in U.S. markets would have caused foreign holdings to increase from 42 percent of GDP to 64 percent of GDP since 1990. The increased propensity of foreign investors to hold U.S. assets added another 31 percent of GDP to U.S. liabilities, with about half the increase in debt securities. By contrast, the internationalization of U.S. asset portfolios has increased less strongly. Growth in foreign markets would have caused U.S. holdings to increase from 37 percent of GDP to 56 percent of GDP, with a fall in the home bias of U.S. investors contributing an additional 13 percent of GDP, mainly in equity and FDI.

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C. The U.S. International Investment Position

13. ***Global asset portfolios appear not to be significantly overweight in U.S. assets, relative to the United States' benchmark share in an internationally diversified portfolio***. The benchmark share is constructed taking into account the assets that investors in each country would maintain in domestic financial instruments. All other financial instruments are considered to be "diversifiable", in that they would be owned by foreign investors in a world of complete geographic diversification. Given the degree of home bias shown in Figure 2, actual foreign portfolios are much smaller in size than "diversifiable" assets. Figure 6 examines whether, given this home bias, claims on the U.S. occupy a larger share of foreign portfolios than the benchmark the U.S. share of diversifiable assets is outstanding. By this metric, non-U.S. portfolios are underweight in U.S. equity/FDI and loans, and marketweight in U.S. debt securities. U.S. equity and FDI as a share of foreign portfolios peaked during the stock market boom in the late 1990s but has since fallen from slightly overweight to well underweight, while the portfolio share of U.S. loans increased steadily until falling back in the last two years. The share of foreign portfolios dedicated to U.S. debt securities peaked in 1997 and 2001 before declining more recently. These numbers give little indication that foreign absorption capacity of claims on the U.S. would be constrained in the near future.[35]

14. ***The U.S. NIIP is comparable to that of many other industrial countries, but appears unusually large given the tendency for larger countries to have lower absolute NIIPs*** (Figures 7 and 8). For small open economies, net foreign assets or liabilities can often be large relative to the size of their domestic financial markets. For example, Australia and New Zealand report high levels of net indebtedness, amounting to over 30 percent of the outstanding stock of domestic investments. However, larger countries such as the G-7 generally maintain NIIPs—either positive or negative—closer to balance, given that it is more difficult for countries with large financial markets to run up a large NIIP relative to market size. This negative relationship is depicted in the downward sloping line in Figure 8. The figure suggests that the absolute size of the U.S. NIIP is much larger than expected—although less so when accounting for foreign reserve holdings. This result holds even if the United States and Japan are excluded from the regressions.

15. ***The U.S. NIIP has deteriorated since 1990***. The NIIP has moved from a negative position of 3 percent of U.S. market value to 9 percent in 2003, and appears poised to fall further due to continued current account deficits. Most other industrial countries' positions improved during this period, with only Germany, Greece, and the Netherlands also having a worsening NIIP.

[35] This measure may understate the share of U.S. equities that are truly "diversifiable", as Bertaut and Kole (2004) and Dahlquist and others (2003) find that the share of U.S. equities in the global portfolio available to most investors is even higher when using float-adjusted market capitalization (equity not held by controlling shareholders).

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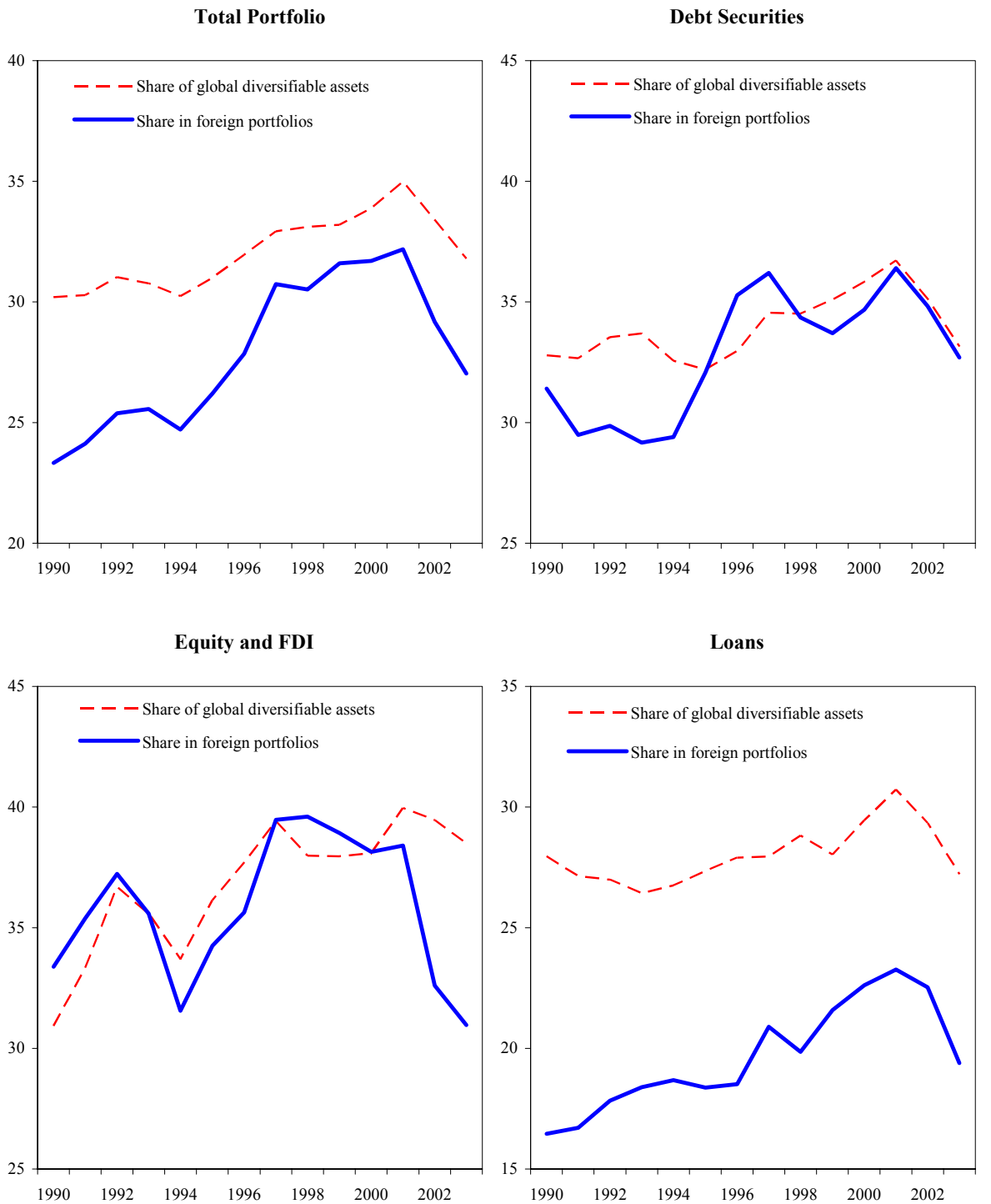
Figure 6. Share of U.S. Assets in Foreign Portfolios, 1990 – 2003



Source: Fund staff calculations.

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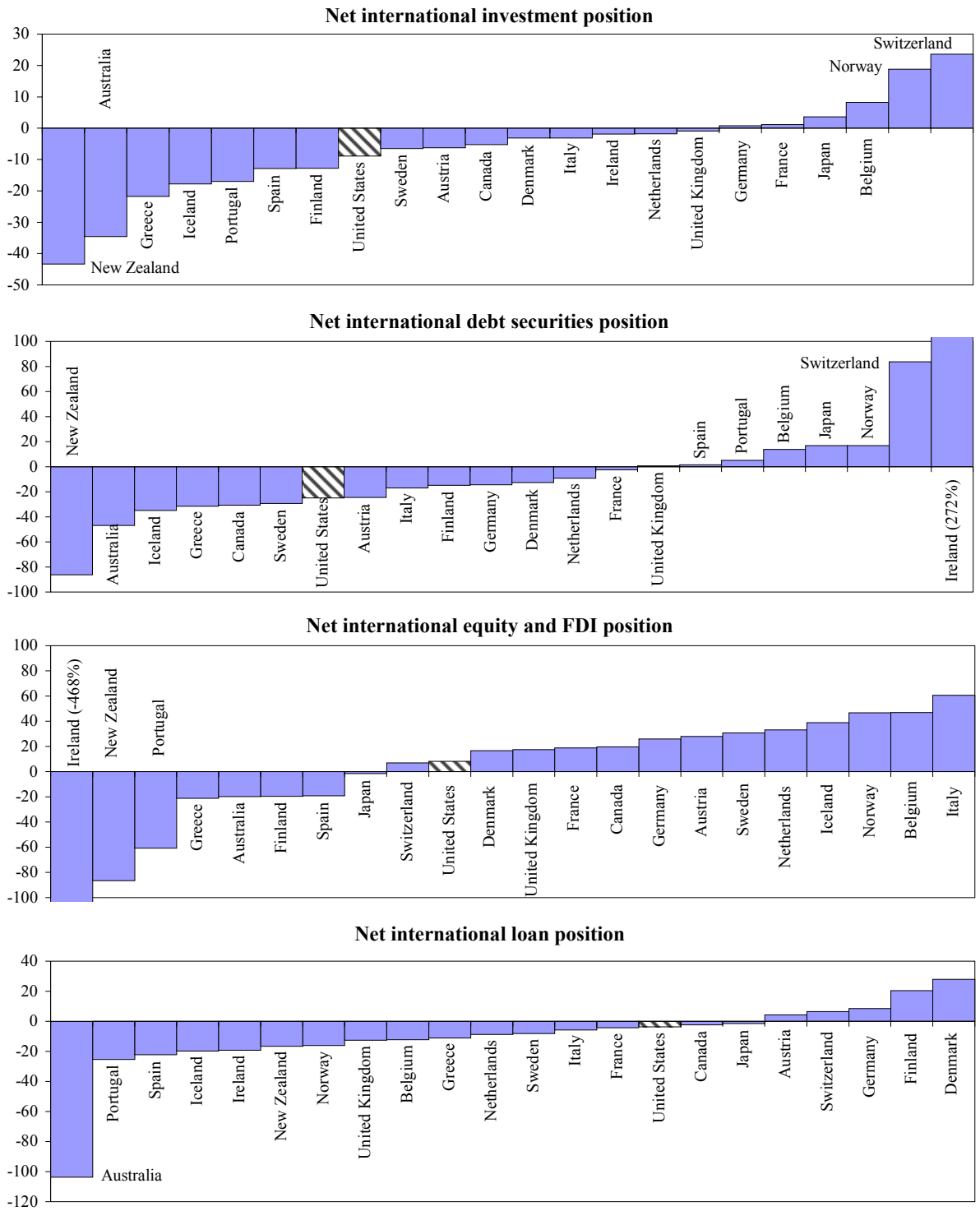
Figure 7. Industrial Countries, Net International Position by Type of Investment, 2003
(In percent of diversifiable assets)



Source: Fund staff calculations.

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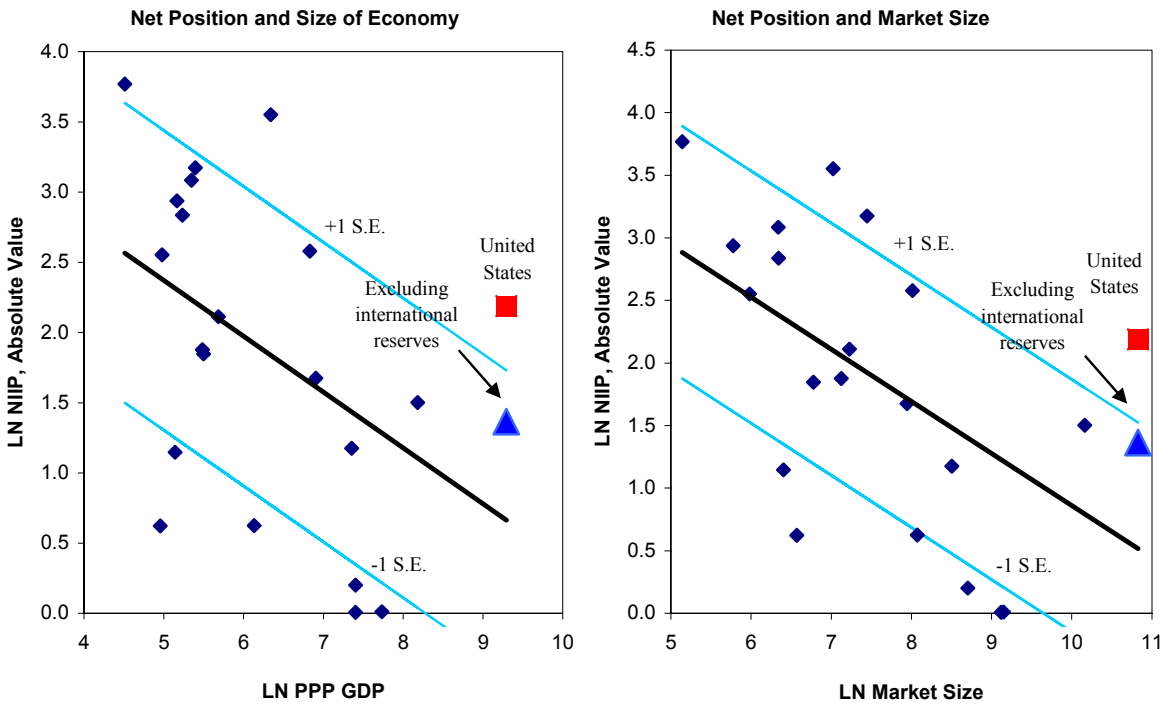
Figure 8. Absolute Net International Investment Position and Country Size, 2003



Source: Fund staff calculations.

16. ***In particular, the U.S. position in debt securities is weaker than in other investment classes, and is deteriorating*** (Figure 9). Both the net equity and FDI position, which is slightly positive, and the net loan position, which is slightly negative, are near the average for industrial countries (see Figure 7). However, the net debt securities position has fallen to 25 percent of the outstanding market from 13 percent in 1990. This is significantly larger than the industrial country average of 11 percent. The decline appears to have been driven mainly by an influx of foreign investors into U.S. debt securities, as the position would have been broadly stable if the degree of home bias had remained at 1990 levels (Figure 10).[36]

17. ***The U.S. dollar's reserve currency status accounts for some of the negative U.S. debt securities position, but the recent deterioration has mainly been in non-reserve items***. At end-2003, Treasuries held as international reserves accounted for over 20 percent of all Treasuries held by the public, and 8 percent of agency bonds were also held as reserves (up from 11 percent and 1 percent, respectively, in 1990). Excluding reserves, the U.S. had a net debt securities position of -6 percent of the outstanding market in 1990 and -16 percent in

[36] The only variation in the lines labeled "At 1990 level of internationalization" is due to the changing weights of each asset class in U.S. and global financial stocks.

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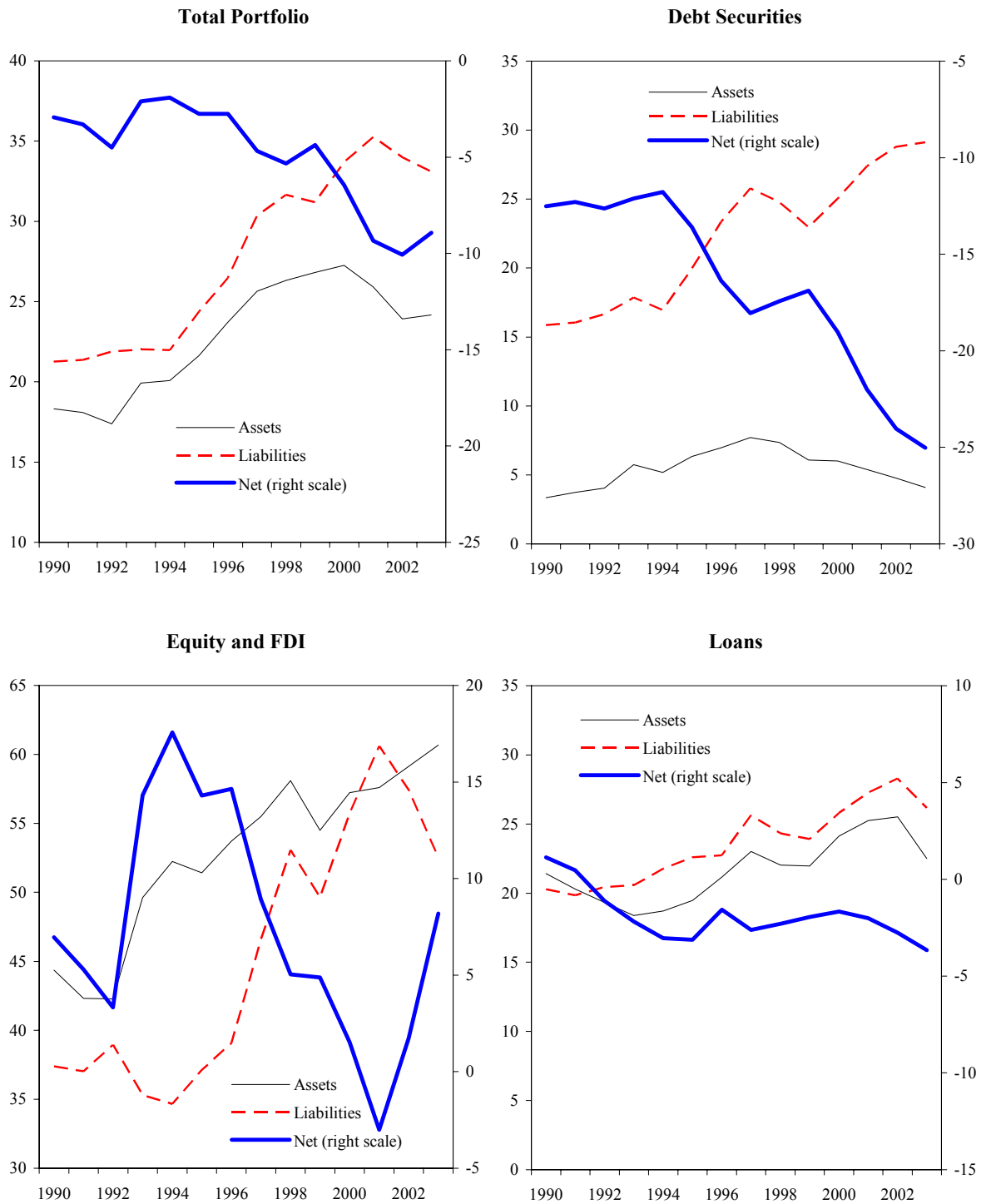
Figure 9. United States, International Asset and Liabilities Positions, 1990 – 2003
(In percent of diversifiable assets)



Source: Fund staff calculations.

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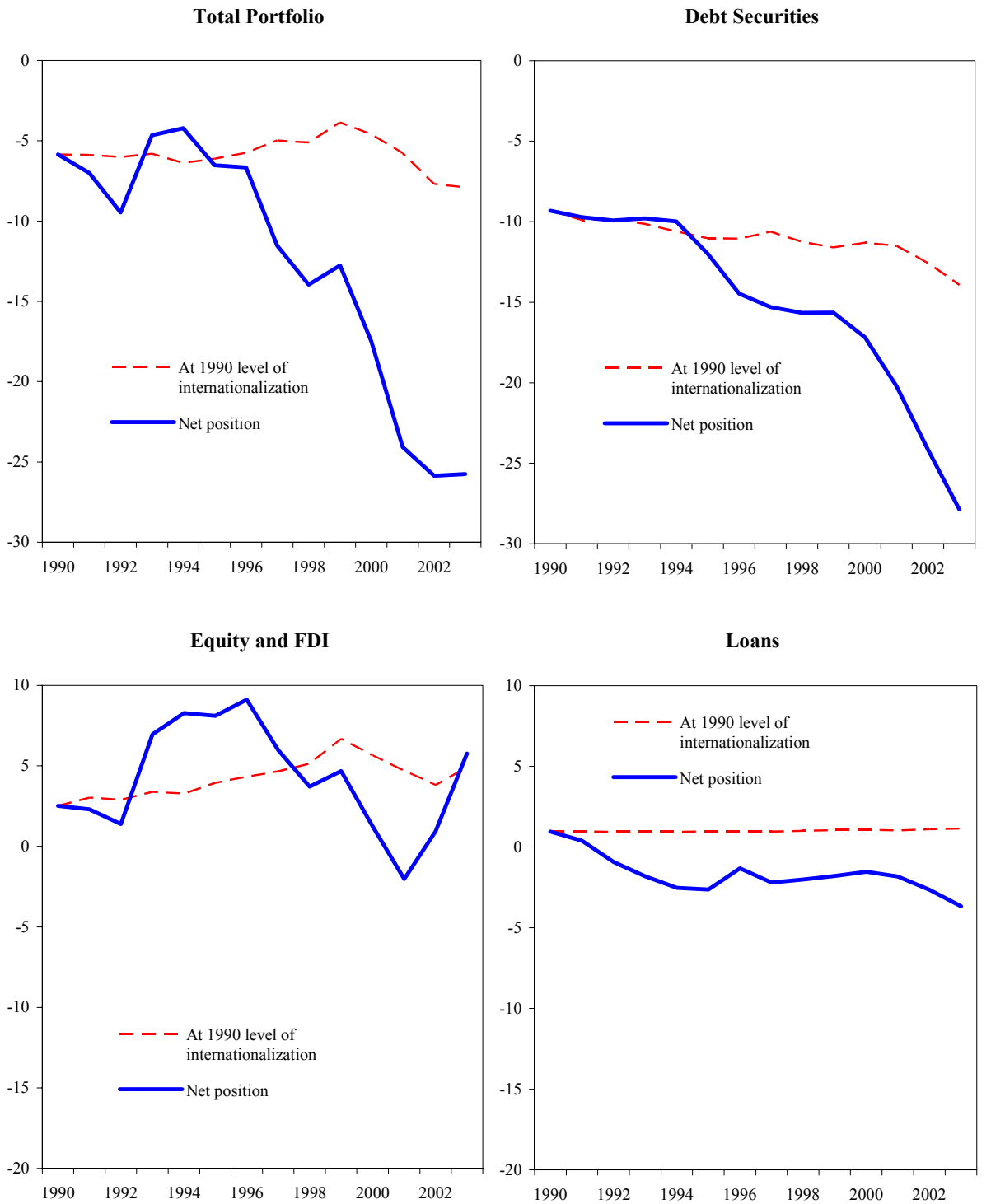
Figure 10. United States, Net International Positions, 1990 – 2003
(In percent of GDP)



Sources: Bureau of Economic Analysis; and Fund staff calculations.

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2003. Debt securities excluding reserves thus accounted for 10 percentage points of the 12 point deterioration in the net debt securities position over the period, while reserves only accounted for 2 percentage points.

D. Conclusions

18. ***The U.S. has experienced the same trends toward financial deepening and internationalization of portfolios as other industrial countries***. U.S. markets remain less internationalized than other countries, even adjusting for the U.S.'s large share of the global market. The difference can be explained by the United States' greater variety of economic activities—it is not as necessary for U.S. investors to diversify their portfolios by investing abroad as it would be for investors in a country with a smaller assortment of economic activity.

19. ***Global portfolio data gives mixed signals regarding foreigners' exposure to U.S. assets, and the decline in the U.S. net debt position could be a cause for concern***. On the positive side, an examination of foreign portfolios confirms that they contain about the expected proportion of U.S. assets, and measures for U.S. indebtedness rank near the middle of industrial countries in most asset classes. That said, the U.S. NIIP is weaker than would be expected given the size of the U.S. economy and financial markets, even if international reserves are included in the analysis, and its net debt securities position is particularly large. The overall NIIP and the net debt securities position are also deteriorating rapidly, and the large current account deficit implies that foreign claims on the United States will continue to mount.

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Data

- **Domestic equity market capitalization:** for most countries, from the World Federation of Exchanges, which standardizes across countries and excludes the capitalization of foreign companies listed on an exchange; the value of mutual funds and similar shares; and options, futures, and derivatives. Additional data sources are: Datastream; the IMF's *Global Financial Stability Report*; Meridian's *World Stock Exchange Fact Book*; and Standard and Poor's *Emerging Stock Markets Fact Book*.

- **Debt securities outstanding:** from the *Quarterly Review* of the Bank of International Settlements, Tables 12A and 16A.

- **Domestic stock of loans outstanding:** where available, from the OECD's *National Accounts Volume IIIB*, spliced with data from the IMF's *International Financial Statistics* (IFS) for missing observations in the former dataset. Data for non-OECD members were taken mainly from the IMF's *Money and Banking Database*, which is based on raw data used in the IFS. Additional data were taken from IFS and, for Chile, China, the Czech Republic, Hong Kong SAR, Peru, and Taiwan Province of China, from published national sources. Data were converted to U.S. dollars using exchange rates from IFS.

- **Foreign holdings of financial instruments:** Data on the international holdings of financial instruments were kindly provided by Philip Lane and Gian Maria Milesi-Ferretti (see Lane and Milesi-Ferretti, 2005a). These combine official data on international investment positions with estimates of external assets and liabilities based on balance of payments flows and various other sources, with appropriate valuation adjustments based on equity price fluctuations and exchange rate changes. For a description of the methodology see Lane and Milesi-Ferretti (2001).

Table 1. List of Countries 1/

Argentina	*Greece*	Philippines
Australia	Hungary	Poland
Austria	*Iceland*	*Portugal*
Belgium	India	Russia
Brazil	Indonesia	Singapore
Canada	*Ireland*	Slovak Republic
Chile	*Italy*	South Africa
China,P.R.: Mainland	*Japan*	*Spain*
China,P.R.:Hong Kong, SAR	Korea	*Sweden*
Colombia	Malaysia	*Switzerland*
Czech Republic	Mexico	Taiwan Province of China
Denmark	*Netherlands*	Thailand
Finland	*New Zealand*	Turkey
France	*Norway*	*United Kingdom*
Germany	Peru	*United States*

1/ Italics indicate countries for which international holdings data were analyzed. Non-italicized countries were only included in the totals for global financial stocks.

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3. ***A key assumption of GFM is that fiscal policy ensures the sustainability of changes in the government debt-to-GDP ratio***. The debt ratio is stabilized by adjusting tax rates to generate sufficient revenue. This rules out partial default on government debt, and it also rules out fiscal dominance over monetary policy, implying that inflation will not be used as a tool of discretionary fiscal revenue generation.

4. ***The model was calibrated to reflect the macroeconomic features of the four regions***. Given the size of the U.S. economy, its policies have a significant impact on world real interest rates. The initial shares in GDP of consumption, investment, government spending, exports, and imports correspond to recent historical averages in each of the four regions. Exports and imports are, in addition, consistent with a trade matrix between the four regions based on recent historical data. In the current version of the model, the available fiscal instruments comprise labor income taxes (our baseline experiments are based on this), capital income taxes, lump-sum transfers, and government spending.[45]

5. ***For a large country such as the United States, the key transmission channel of a fiscal consolidation is the induced change in the world real interest rate***.[46] A fiscal consolidation increases national saving, as there is an incomplete private-sector offset to an improvement in the fiscal deficit. To help re-equilibrate savings and investment, the domestic interest rate falls. With perfect international financial integration, the reduction in U.S. and foreign real interest rates is the same in the long run and investment opportunities expand by similar percentages. Ignoring supply-side effects, the portion of domestic excess saving that goes to domestic investment depends on the size of the domestic economy in the world—about one third in the case of the United States. The remainder finances foreign investment and is reflected in a significant improvement in the current account. If capital markets are less than fully integrated, the fall in domestic real interest rates is larger than those elsewhere and the benefit to foreign investment and the current account is smaller.

6. ***A number of key behavioral parameters are set equal across the four economies***. These include the key coefficients for household utility and firm production functions (except for small data-derived variations in the labor and import shares of production). Wealth effects of tax policies are ensured by assuming an average 10-year planning horizon for households in each region, as well as a 25 percent share of rule-of-thumb consumers (50 percent for Emerging Asia) who consume their after-tax income each period.

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[45] Rather than try to model the complexities of actual tax systems, it is assumed that taxes are levied on the relevant base as a single marginal rate, so there is no difference between average and marginal tax rates.

[46] Thus far, real interest rates have not been significantly higher in the United States than elsewhere in response to large current account deficits, but we anticipate that this would likely happen if we were to see concerns about a large and abrupt depreciation of the U.S. dollar that might be caused by a loss in appetite for U.S. assets (Faruqee and others, 2005).

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PART III: POLICY ISSUES

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VI. Should the Fed Adopt an Explicit Inflation Objective?[47]

A. Introduction and Summary

1. ***This paper considers whether the Federal Reserve should adopt an explicit inflation objective and, if so, what this might involve***. The Fed has established a highly successful record in maintaining price stability and has steadily enhanced the transparency of monetary policy in recent years. At the same time, it is one of the few remaining central banks among industrial countries that do not have a quantitative price objective.

2. ***The potential benefits of a numerical price-stability objective are a recurrent issue of debate by the Fed and private researchers***. The Federal Open Market Committee (FOMC) has discussed the application of inflation targets in the United States—most recently in February 2005—and Fed Governors have also raised the subject in their speeches. Most academic research has come out in favor of an explicit inflation objective.[48]

3. ***This paper takes the view that the adoption of an explicit inflation objective could enhance the effectiveness of monetary policy.*** An explicit inflation objective would help anchor long-term inflation expectations by reducing uncertainty regarding the Fed's longer-term policy objective while further enhancing the transparency of its near-term policy stance. At the same time, the international experience does not suggest that this would significantly impair the Fed's flexibility with respect to its other policy objectives.

B. The Fed's Monetary Policy Framework

Legal mandate and accountability

4. ***According to the 1977 Federal Reserve Act, the objectives of the Fed are to promote maximum employment, stable prices, and moderate long-term interest rates***. The last objective is widely interpreted as intended to support the first two goals, giving the Federal Reserve a "dual mandate" of maximum employment and stable prices (Ferguson, 2005). However, over the past decade Fed officials have often explained that reaching the employment objective is only possible if price stability is maintained, in effect elevating price stability as the principal policy priority. In addition, the Fed, like other central banks, sometimes takes financial stability considerations into account when circumstances warrant.

5. ***Accountability for the Fed is informal in the context of a high degree of independence***. The Chairman is mandated to testify on Capitol Hill twice a year. However, the Fed enjoys substantial latitude both in how it interprets its mandate, and in its

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[47] Prepared by Turgut Kisinbay, Scott Roger, and Mark Stone (all MFD).

[48] See Bernanke and others (1999), Cecchetti and O'Sullivan (forthc.), Goodfriend (2003), Mishkin (1999), Stone (2003), Truman (2003), and Friedman (2004). Fed speeches include Bernanke (2003a), Ferguson (2003), Gramlich (2005), Greenspan (2004), Kohn (2003a,b), Meyer (2001), Santomero (2004), and Yellen (2005).

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accountability to the public, partly because the latter is more difficult to formalize in the United States than in many other countries. An important difference between the Fed and central banks operating in parliamentary systems is that the checks and balances of the U.S. system mean that the Fed does not deal with a party in control that speaks with one voice (Kohn, 2003a).

Communication

6. ***Press statements and FOMC minutes are the Fed's main short-term communication channels***. A statement is issued immediately following each of the eight FOMC meetings per year. Recently, the statement has included a short explanation of any decisions that were taken, a view on inflation, a succinct assessment of the balance of risks, and a view regarding the likely direction of future FOMC actions. In addition, a fairly detailed minute of each meeting (around 3,500 words) is released with a three-week lag, which also attracts considerable market attention.

7. ***The twice-yearly Monetary Policy Report (MPR) to Congress reviews economic and monetary policy developments***. The MPR includes a detailed discussion of the rationale for and reaction to the policy decisions made at the most recent FOMC meetings. It also includes the range and "central tendency" of FOMC members' two-year forecasts of nominal and real GDP, the personal consumption expenditure deflator excluding food and energy (core PCE), and the unemployment rate.

8. ***Communication is further enhanced through speeches and testimonies by FOMC members***. These speeches—that occur frequently compared with most other central banks—convey a diversity of views on both monetary policy and other issues, such as demographic challenges, fiscal developments, or financial market issues.[49] They provide a flavor of the Fed's internal discussions on a broad range of topics, and serve as a useful basis for the analysis of monetary policy decisions.

9. ***The Fed has increased policy transparency in recent years*** (Table 1). Explanations of policy views and intentions have become more regular and frequent, more information is conveyed on the views of FOMC members, and publication lags for FOMC minutes have been shortened.

Comparisons with other industrial countries

10. ***All but one industrial country central banks have either an explicit or implicit price stability anchor***. Counting the ECB as the central bank for the euro area, the monetary regimes of the 12 industrial country central banks are as follows:

[49] During the first five months of 2005, FOMC members gave about 70 speeches according to websites of the Federal Reserve System.

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Table 1: Recent Changes in FOMC Transparency

Date	Action
1992 to 2000	Gradually shifted policy actions to regularly scheduled meeting dates.
1993-March	Began releasing minutes of FOMC meetings (with lag).
1993-November	Began releasing transcripts of FOMC meetings (with 5 year lag).
1994-March	Began explicitly announcing changes in federal funds rate target and rationale for policy action.
1994-August	Began describing state of economy and more detailed rationale for policy action after FOMC decisions--August 1994
1994 to 2003	Gradually shifted to longer, more descriptive press releases after FOMC decisions.
2002-March	Began releasing votes of individual Committee members and preferred policy choices of any dissenters.
2005-January	Shortened lag of release of minutes of regularly scheduled meetings to three weeks after the date of the policy decision.

Sources: Swanson (2004); and Board of Governers of Federal Reserve website.

- Central banks in Australia, Canada, Iceland, New Zealand, Norway, Sweden, and the United Kingdom practice full-fledged inflation targeting (FFIT), defined as an institutionalized commitment to a quantitative inflation target, accompanied by a high degree of transparency and often formal accountability (Bernanke and others, 1999; Truman, 2003).[50]
- Price stability frameworks in the Euro area, Japan, Switzerland, and the United States are less explicitly defined than in FFIT countries (Carare and Stone, forthcoming). The ECB and the Swiss National Bank operate under explicit inflation objectives, but do not have the formal commitment modalities of FFIT countries. Japan, a special case, currently has an anti-deflation objective. All of these countries have what can be termed an "implicit" price stability anchor.[51]
- Finally, Denmark has an exchange rate peg.

11. ***In many respects, the Fed is highly transparent*** (Table 2). However, as the United States is one of the few industrial countries that does not quantify its inflation objective, the

[50] FFIT countries all publish detailed inflation reports. Most of them are formally accountable through requirements to publicly explain breaches of the inflation target, formal relations of the decision-making body with the government, and in some cases the possibility of a government override (Roger and Stone, 2005).

[51] Implicit price stability anchor countries tend to be larger and have more developed financial systems compared to FFIT countries, and they have a history of lower and more stable inflation (Stone, 2003). The Fund's detailed Monetary and Financial Policy Transparency Code assessments give implicit price stability anchors relatively high scores for transparency, but less than for FFIT countries (Roger and Stone, 2005).

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Table 2. Transparency Practices of Industrial Country Central Banks

Country	Decision making body	Frequency of Meetings	Votes Disclosed?	Lag of disclosure of minutes
Australia	Reserve Bank Board	11 times a year	no	Not disclosed
Canada	Governing Council	8 times a year	no	Not disclosed
European Central Bank	Governing Council	Monthly	no	Not disclosed
Iceland	Board of Governors	Once a month on average	no	Not disclosed
Japan	Policy Board	Monthly	yes	1 or 2 months
New Zealand	Reserve Bank Governor	8 times a year	n.a.	Not disclosed
Norway	Executive Board	every six week	no	Not disclosed
Sweden	Executive Board	8 times a year	yes	2 weeks
Switzerland	Governing Board	Quarterly	no	Not disclosed
United Kingdom	MPC	Monthly	yes	2 weeks
United States	FOMC	8 times a year	yes	3 weeks

forward-looking policy discussion is less detailed than in other countries, almost all of which publish an inflation report (Wyplosz and others, 2003). The Fed also has fewer formal institutional elements in support of monetary policy accountability compared with other industrial countries (Table 3).

C. Adopting an Explicit Inflation Objective: The Pros and Cons

12. ***Given the Fed's successful track record, there are relatively few imperatives for changing its monetary policy framework***. For example, Greenspan (2004) has argued that a rules-based policy such as a strict inflation target would be an imperfect substitute for the risk-management paradigm the Fed has followed in recent years. In his view, some FFIT regimes have not yet had to balance risks to inflation and growth of a sufficient magnitude in order to constitute a real "test." Kohn (2003a) believes that even flexible inflation targeting is "ill-adapted" to the Fed's risk management paradigm. While he acknowledges that a flexible inflation targeting framework leaves room for deviations from the inflation target, he is skeptical that deviations can occur in practice.

13. ***However, others have argued that an explicit inflation objective should be seen as a refinement of the existing framework, aimed at enhancing transparency***. Academic research suggests that improvements in transparency on the part of the Fed has made monetary policy more predictable (Swanson, 2004; Lange and others, forthcoming), improving economic decision-making and thus benefiting the real economy. Building on these results, a number of commentators argue that clarifying the Fed's inflation objectives would further enhance transparency.

Anchoring inflation expectations

14. ***Despite the Fed's clear commitment to price stability, Fed officials have offered different interpretations of what this means***. Chairman Greenspan has said that "price stability is best thought of as an environment in which inflation is so low and stable over time

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Table 3. Industrial Countries, Accountability Aspects of Monetary Framework

Country	Target Set	Relation of Decision Making Body with Government	Government Override Provision	Conflict Made Public	Accountability for Ttarget Breach
United States	None	The FRB is not subject to formal oversight but the Chairman is subject to public questioning by members of Congress during his semi-annual appearance.	None	No	N/A
Australia	Jointly through an agreement between Treasurer and Governor - designate	Required to inform government from time to time on monetary and banking policies which is done through monthly meetings between Gov/Dy Gov and Treasurer, plus annual report to Treasury and Parliament. Govt reserves right to comment on monetary policy but will not make announcement of policy adjustment or stances	Yes. After board presents a statement expressing difference of opinion and government accepts responsibility.	Yes	None
Canada	Jointly through an agreement for five years	Minister and Governor will consult regularly on monetary policy and on its relation to general economic policy.	Yes, government directive	Yes (Canada Gazette)	Explanation in monetary policy report on reasons for breach, measures and timeframe to meet target.
Iceland	Joint central bank sets target but with the consent of the Prime Minister provisioned for in the central bank act. Target breaches to be explained to the government publicly.	Internal rules on preparation of, arguments for and presentation of monetary policy decisions by Board of Governors is approved by the Supervisory board (7 member board of political appointees with proportional representation). Supervisory board also looks at bank organization, operating budget, internal audit; accountable to PM (not minister), governors can attend supervisory board meetings but must leave if the board so decides.	No	No	Public report to government explaining the target breach and measures to meet target.
New Zealand	Jointly, through a Policy Targets Agreement which is set for governor's term for 5 years which can be revised by mutual consent	Shall consult and give advice to the government; submit policy statements to the minister and Parliament periodically (not exceeding six months). Governor's performance is reviewed by the Board of Directors. Minister has power to fix exchange rates and if this is inconsistent with the policy targets, governor may advise in writing for new policy targets. If the direction on foreign exchange is inconsistent with the monetary policy objective, the governor can advise, in writing, that direction will not be effected.	Yes; the Governor-General, on the advice of the Minister, can direct the Bank to formulate and implement monetary policy for any economic objective, other than price stability.	Yes (in gazette and House of Representatives)	Explanation through a policy statement reasons for deviation from medium term target, and measures to remain consistent with target.

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Table 3. Industrial Countries, Accountability Aspects of Monetary Framework (concluded)

Country	Target Set	Relation of Decision Making Body with Government	Government Override Provision	Conflict Made Public	Accountability for Ttarget Breach
Norway	Government (stipulated in the regulation and submitted to Storting)	Bank is owned by the state; before the Bank makes a decision of special importance, the matter is submitted to the ministry. Governor and Deputy Governor obliged to attend Supervisory Council meetings. Budget approved by Supervisory Council (15 member committee elected by Storting) and forwarded to the ministry; Supervisory Council issues a statement on the minutes of the Exec. Board meeting, which is forwarded to the ministry, King and Storting.	Yes. The Council of State may adopt resolutions regarding the operations of the Bank in the form of general rules or instructions. The Bank shall be given the opportunity to state its opinion before such resolutions are passed.	No. But Storting is notified of the decision.	None
Sweden	Riksbank but must inform the government (minister) in advance	May not seek or take instructions for fulfilling monetary policy duties but shall inform government well in advance; (Chair and Vice-chair of Governing Council may participate in Executive board meeting but not vote; can propose to government for statutory amendment of government decision.	No	No	None

Source: Tuladhar, 2003.

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that it does not materially enter into the decisions of households and firms" (Greenspan, 2001). Other FOMC members have provided their own definitions of price stability: for example, Lacker (2005) argues in favor of a 2 percent CPI target with a 2 percent band; Santomero (2004) proposes a 1 to 3 percent inflation rate target for the 12-month moving average of the core PCE; and Bernanke (2003b) does not explicitly specify a target, but he argues that research suggests it is likely to be around 2 percent.

15. ***A clearer price objective may be especially important at low levels of inflation***. Bernanke (2003b) argues that in a high-inflation environment, the Fed would clearly prefer to reduce inflation, and expectations would be for monetary policy to tighten. However, in a low-inflation environment the public could not be sure that the Fed would not change its view of the level of long-term price stability consistent with full employment. Defining price stability could therefore reduce economic and financial uncertainty, potentially shifting long-term interest rates to a lower level. Indeed, with the advent of deflation fears during 2003, it was argued by a number of analysts that an explicit inflation objective could have helped the Fed reassure the public and financial markets that it stood ready to take measures to maintain a positive rate of inflation.

16. ***An explicit inflation objective would reduce these uncertainties***. The stabilizing impact of a long-term definition of price stability could also be enhanced by prospective uncertainties regarding the monetary policy setting. For example, Goodfriend (2003) and Stone (2003) take the view that an inflation target could help resolve uncertainty regarding the prospective change in chairmanship at the Fed.

17. ***An explicit inflation objective may also reduce the volatility of inflation expectations in the United States—which appears higher than in FFIT countries***. As discussed in Box 3 of the accompanying *Staff Report*, the volatility of inflation forecasts in the United States—measured by the standard deviation of CPI inflation forecasts surveyed by Consensus Forecasts—has dropped over the past 15 years. However, the decline has been smaller than in Canada and the United Kingdom, the two G-7 countries that have adopted FFIT. Similarly, volatility measures for benchmark government bond yields and inflation-indexed bond yields are higher for the United States than the two other countries.[52]

Inflation measures

18. ***Concerns have been raised about tying a central bank to a particular definition of the inflation index*** (Ferguson, 2004). The most relevant inflation index is typically influenced by technological and other advances, as illustrated by the Fed's shift in focus from a fixed weight CPI to a chain-weighted core PCE deflator. The concern would be that—once the inflation objective was defined explicitly—a change in the index would adversely affect

[52] The box calculated the 12-month moving average of the monthly standard deviation of daily 10-year government bond yields.

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credibility. However, the experience in other countries (e.g., Canada) suggests that redefinitions of indices do not present major problems.

Flexibility

19. ***Some FOMC members argue that an explicit inflation objective could hinder the Fed in pursuing its other policy objectives*** (Ferguson 2003, 2004; Kohn 2003a, 2004). Compared with price stability, the Fed's other objectives—maintaining full employment and moderate long-term interest rates—may be harder to quantify or define. For this reason, it is sometimes argued that an explicit inflation objective would cause the Fed to place an undue emphasis on price stability versus its other objectives.

20. ***However, there is no clear evidence that a formal inflation target has reduced flexibility for other countries***. In particular, FFIT central banks also pay close attention to output and employment stabilization. Indeed, industrial FFIT countries miss their inflation range a surprisingly high 35 percent of the time, and no FFIT country has so far dropped its regime, notwithstanding some episodes of large and prolonged misses (Roger and Stone, 2005). Corbo and others (2001), de Simone (2002), and Hu (2003) found that even FFIT does not seem to entail much cost in terms of output volatility. As Bernanke (2003a) argues, "the general approach of inflation targeting is fully consistent with any set of relative societal weights on inflation and unemployment; the approach can be applied equally well by inflation 'hawks,' 'growth hawks,' and anyone in between." Moreover, a credible explicit inflation objective could actually enhance flexibility with respect to other targets because, for example, the impact on inflation expectations and price stability of policy changes aimed at output stability could be weaker (Yellen, 2005).

Accountability

21. ***A clearer policy objective should enhance accountability, making it more difficult for monetary policy to deviate from a target-consistent path***. Santomero (2004) has argued that an explicit inflation objective would make it easier for the public to monitor the Fed's performance, increasing incentives for monetary policy to adhere to the objective. An explicit objective could also improve accountability by focusing congressional testimony of the Chairman on monetary policy and price stability, and less on tangential issues (Gramlich, 2005). Announcement of an explicit inflation objective could increase "democratic accountability" by requiring the Fed to be clearer and more open about its decision-making process (Blinder and others, 2001).

22. ***By contrast, Ferguson (2003) argues that a flexible inflation target policy could lead to a loss in accountability and ultimately credibility***. The central bank could adopt only the language of a more formal inflation target without any of the constraints and, in doing so, would become less transparent and accountable.

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Central bank independence

23. ***Some FOMC members have warned that adopting an explicit inflation objective could compromise the Fed's independence***. Kohn (2003a) argues that Congress could involve itself in either defining policy objectives or determining accountability arrangements in ways that might undermine Fed independence. Similarly, Gramlich (2005) warns that, while the Fed's dual legal mandate is well entrenched, introducing an explicit price objective could possibly trigger a Congressional debate on the formalization of the employment objective.

Communication policy

24. ***The Fed's reliance on the precise wording of policy statements to convey its forward-looking views has the potential for confusing financial markets***. For example, the statement of the May 2003 FOMC meeting cautioned that inflation could fall below 1 percent, surprising markets and leading to a sharp fall in long-term interest rates (Lacker, 2005). Bernanke (2003b) argues that announcing a numerical objective "would help to reduce the reliance of the Fed on complex and easily misinterpreted qualitative language in its communications with the public."

25. ***The experience of FFIT countries indicates that an explicit inflation objective could reduce the potential for miscommunication***. FFIT central banks disclose in detail their policy framework, and publish their forecasts and detailed assessments of the economic outlook and the implications for policy looking ahead. Under this approach, there is less weight on the precise wording of the text of policy statements.

26. ***However, some argue that an explicit inflation objective could reduce transparency*** Friedman (2004) suggests that an explicit inflation objective would obscure the weights accorded by the Fed to output and financial stability. Similarly, Kohn (2003a) argues that FFIT is less transparent than the current Fed policy, because it emphasizes the observable inflation objective, downplaying other "messy stuff that does not fit into the IT framework well." He suggests that other goals—such as economic and financial stability—are not sufficiently covered in FFIT central bank communications although they are in fact factored into policy decisions. Ferguson (2003) says that a flexible version of inflation targeting may lead to greater uncertainty about policy: should a deviation from the target occur, there could be uncertainty about how quickly the central bank would want to take inflation back to the target path.

D. Implementing an Explicit Inflation Objective

27. ***The technical details of the target would need to be specified***. The Fed would need to decide on: (i) what long-term average rate of change in prices to aim for; (ii) whether to specify the target in terms of a point, a range, or a point and a range, and (iii) how wide to set the range. International experience suggests that, for practical purposes, inflation targets anywhere in the range of 1-3 percent are uncontroversial. Although international practices

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vary on the issue of point versus range targets, no clear-cut advantages have emerged for one or the other (Roger and Stone, 2005).

28. ***The Fed would also have to choose a price index on which to base its objective***. All FFIT and implicit price stability anchor countries have opted to define the inflation target in terms of the CPI or the CPI excluding particular items such as fresh food and fuel. This reflects the assessment that the CPI is the most widely known measure of inflation and, therefore, plays a central role in forming expectations. At the same time, all inflation targeters routinely discuss a variety of analytical measures of "core" inflation, as well as wages and costs, tradable and non-tradable prices, etc., in their inflation reports.

29. ***The central bank may well choose to focus on a different inflation measure internally***. Typically, a central bank would closely track a measure of inflation more reliably related to the evolution of the output gap than the CPI, but still linked to the CPI over time. The Fed has already undertaken considerable work on measurement issues in the headline and core CPI and PCE indices and would continue to have considerable scope for taking a range of other price and cost factors into account.

30. ***Policy formulation and decision-making would also be affected by announcing an explicit inflation objective***. The need to communicate policy with reference to the inflation target tends to establish the achievement of the inflation target as the benchmark for internal forecasting and policy judgments. The inflation target therefore provides a systematic starting point for policy discussions.

31. ***Policy communication would need to be adjusted slightly to explain monetary policy actions in terms of the inflation objective***. FOMC policy discussions would likely be conducted in an even more forward-looking way, which should be reflected in press statements and transcripts.

32. ***Inflation reports published by FFIT countries offer some insights into how the Fed's Monetary Policy Report could change*** (Schmidt-Hebbel and Tapia, 2002; Wyplosz and others, 2003; Leeper, 2003).[53] These reports provide detailed backward-looking accounts of recent economic and financial developments and their effects on the behavior of inflation relative to the target. Inflation reports also contain a forward-looking discussion of inflation trends over the policy horizon, as well as a discussion of the attendant risks and uncertainties. All but one industrial country publish an inflation report on a quarterly basis, reflecting the quarterly publication of national accounts data, which serves as the starting point for forecast updates (Laxton and Scott, 2001; Table 4).

[53] Two of the central banks with implicit price stability objectives publish reports that resemble the inflation reports of FFIT countries. The Swiss National Bank discusses inflation, including a forecast, in its *Quarterly Bulletin* but coverage is less complete than in FFIT countries (Wyplosz and others, 2003). The ECB extensively discusses inflation developments in its Monthly Bulletin.

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33. ***The Fed might also report key assumptions underlying its inflation forecast***. All inflation-targeting central banks publish an inflation forecast, either in a more limited form (using a fan chart), or based on unchanged interest rate assumptions or on market interest rate forecasts (Table 4). Very few central banks (Colombia, Czech Republic, and New Zealand) publish forecasts that include endogenous policy settings. Mishkin (2004) argues that this may be going too far on the grounds that markets might not understand the fact that these forecasts are highly conditional on the assumptions made—and therefore subject to frequent revision. On the other hand, endogenous policy forecasts can be extremely effective in explaining the central bank's perception of trade-offs between rapid action and more gradual responses to various kinds of shocks.

Table 4. Inflation Reports

Country	Number of Reports Per Year	Fan Chart
Australia	4	No
Brazil	4	Yes
Canada	4	No
Chile	3	Yes
Colombia	4	Yes
Czech Republic	4	No
Hungary	4	Yes
Iceland	4	No
Israel	2	Yes
Korea	2	Yes
Mexico	4	No
New Zealand	4	No
Norway	3	Yes
Peru	3	Yes
Philippines	4	Yes
Poland	4	Yes
South Africa	2	Yes
Sweden	4	Yes
Thailand	4	Yes
United Kingdom	4	Yes

Source: Roger and Stone, 2005.

E. Conclusion

34. ***On balance, the case for an explicit inflation objective appears to outweigh the possible drawbacks***. An explicit inflation objective would almost certainly attaining price stability, and less volatile interest rates arising from greater transparency and accountability could foster higher employment. In addition to the axiom "if it ain't broke, why fix it?" counterarguments include the potential loss of policy flexibility and independence, but the strong record of other inflation targeting countries and the degree of credibility that the Fed enjoys suggest that the potential downside may be limited.

35. ***Adopting an explicit inflation objective would not necessitate significant changes to monetary operations or the monetary framework*** (Bernanke 2003a,b; Gramlich, 2000). Unlike inflation-targeting central banks, the Fed need not be required to meet its objective within a given time horizon. Operating procedures for policy implementation would also remain largely unchanged, and most of the monitoring and analysis of economic and financial developments would not be altered. On the other hand, choices would have to be made regarding the objective itself and what inflation index to employ, and some changes in internal practices might be required.

36. ***The Fed's communication policy would also need to be adjusted to the new policy environment***. This could affect the frequency of publication of the MPR, and the presentation of the forecast of the FOMC. Moreover, external statements would likely need

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to become more forward-looking and focus on the Fed's policy in the context of attaining the price stability objective.

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Share of U.S. dollar reserve holdings remains steady

Total international reserves, including gold, increased by 15 percent during 2004, reaching SDR 2.7 trillion ($4 trillion) at year-end, according to the newly released IMF *2005 Annual Report* (available on the IMF's website, *www.imf.org*). Foreign exchange reserves—the largest component of official reserve holdings—grew by 18 percent, to SDR 2.4 trillion ($3.6 trillion). IMF-related assets, which make up the rest of nongold reserves, declined by 12 percent to SDR 76 billion ($113 billion), reflecting the recent decline in outstanding credit to member countries. And the market value of gold held by monetary authorities declined by 1 percent to SDR 254 billion ($377 billion) in 2004.

The report notes that the currency composition of foreign exchange reserves has changed gradually over the past decade (see table), with the share of U.S. dollar holdings rising from 60 percent in 1995 to 71 percent in 1999, and remaining broadly stable in 2000 and 2001. In 2002, the share of U.S. dollar holdings sharply declined to 67 percent, driven by the fall in value of the U.S. dollar and a reduced share of U.S. dollar assets in net purchases. The dollar share declined slightly further in 2003 before stabilizing in 2004. While official reserves held in U.S. dollars picked up strongly over these two years—accounting for more than 80 percent of the increase in official reserve holdings—this was offset by the depreciation of the U.S. dollar vis-à-vis other major currencies.

The euro, which replaced 11 European currencies on January 1, 1999, accounted for 24–25 percent of total foreign exchange reserves in 2002–04, higher than in 1999–2001. Over the past decade, the share of the Japanese yen declined from 7 percent to 4 percent; the share of the pound sterling rose slightly from around 2 percent to around 3 percent; and that of the Swiss franc remained below 1 percent.

The data in this year's *Annual Report* reflect an improved compilation methodology and other data improvements. The aggregate currency shares are calculated based on data reported by the authorities, while unallocated reserves are reported under memorandum items (see *Annual Report* for details).

Given a heightened interest in the currency composition of reserves, the IMF plans to disseminate data on a quarterly basis beginning in December 2005. ■

Currency composition of reserves

	1995	1999	2000	2001	2002	2003	2004
				(percent, end of year)[1]			
U.S. dollar	59.9	71.0	70.5	70.7	66.5	65.8	65.9
Japanese yen	6.8	6.4	6.3	5.2	4.5	4.1	3.9
Pound sterling	2.1	2.9	2.8	2.7	2.9	2.6	3.3
Swiss franc	0.3	0.2	0.3	0.3	0.4	0.2	0.2
Euro[2]	–	17.9	18.8	19.8	24.2	25.3	24.9
Deutsche mark	15.8	–	–	–	–	–	–
French franc	2.4	–	–	–	–	–	–
Netherlands guilder	0.3	–	–	–	–	–	–
Other currencies	4.8	1.6	1.4	1.2	1.4	1.9	1.8
Memorandum items							
Unallocated reserves[3]							
All countries	25.6	22.9	23.6	26.0	28.3	29.8	32.6
Industrial countries	1.0	1.1	0.3	0.3	0.3	0.2	0.3
Developing countries	47.6	37.8	39.4	42.1	45.0	47.2	50.2

Note: Components may not sum to total because of rounding. Country coverage changes marginally every year, but the changes were larger than usual in 1996 (broader coverage) and in 2000 (narrower coverage). The data for 2004 are preliminary.
[1]The currency shares are calculated for the reserves of member countries that report the currency composition of their foreign exchange reserves. The data include minimal estimation undertaken mainly for late reporters. Reserves for which currency composition is not reported are shown under "Unallocated reserves."
[2]Not comparable with the combined share of euro legacy currencies in previous years because it excludes the euros received by euro area members when their previous holdings of other euro area members' legacy currencies were converted into euros on January 1, 1999.
[3]Foreign exchange reserves whose currency composition information is not submitted to the IMF, in percent of total official holdings of reserves.

Data: IMF, *International Financial Statistics*.

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IMF Publication

Anti-Money Laundering and Combating the Financing of Terrorism - Observations from the Work Program and Implications Going Forward - Supplementary Information

INTERNATIONAL MONETARY FUND

INTERNATIONAL MONETARY FUND AND WORLD BANK

Anti-Money Laundering and Combating the Financing of Terrorism: Observations from the Work Program and Implications Going Forward

Supplementary Information

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August 31, 2005

Contents Page

Acronyms....3

I. Findings from the AML/CFT Assessments....5
- A. Compliance with the FATF Recommendations....5
- B. Comparison with Assessments Under the Old Standard and Methodology....12
- C. Issues of Application and Interpretation....16
- D. Assessment Logistics and Process....16

II. Experience with Technical Assistance....18
- A. Technical Assistance Provided....18
- B. Lessons Learned....24
- C. Technical Assistance by Region....27

III. Implementing the Revised AML/CFT Standards: DNFBPs....38
- A. Characteristics and Practices....38
- B. Implementing AML/CFT Obligations....39
- C. Experiences with Assessments....43

IV. Implementing the Revised AML/CFT Standard: Remittances....44
- A. Characteristics and Practices....45
- B. Implementing AML/CFT Obligations....45
- C. Ongoing and Completed Work....46

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V. Implementing the Revised AML/CFT Standard: Non-Profit Organizations.....52
A. Characteristics and Practices.....53
B. Implementing CFT Obligations 55
C. Experiences with Assessments.....56

VI. List of Bank/Fund AML/CFT Publications.....56

Tables

1. Profile of Overall Compliance with FATF Recommendations 9
2. FATF Recommendations Rated Partially Compliant and Non-Compliant 10
3. Average Size of ROSC-Assessment Mission Teams, 2004–2005.....17
4. Bank/Fund TA Projects: January 2004 to June 2005 Projects by Region, Topic, and Modality.....**Error! Bookmark not defined.**

Figures

1. Compliance with AML/CFT: All Countries Assessed 11
2. Comparison of Compliance Levels between Old & New Methodology of Low-, Middle-, and High-Income Countries 15
3. TA Project by Category and Region.....21

Boxes

1. Examples of Innovative Modalities for TA Delivery 19
2. Highlights of TA in Africa.....28
3. Highlights of TA in Asia Pacific 30
4. Highlights of TA in Eastern and Central Europe.....32
5. Highlights of TA in the Middle East, Central Asia, and Caucasus.....33
6. Highlights of TA in Latin America and the Caribbean.....35
7. List of FSRBs and Other Regional Bodies by Region.....37
8. Bank's Activities on Remittance 48
9. Study of Remittance Service Providers in the United States.....50

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ACRONYMS

AML	Anti-Money Laundering
APEC	Asia Pacific Economic Corporation
APG	Asia-Pacific Group on Money Laundering
ARS	Alternative Remittance Systems
BPP	Best Practices Paper
BRCA	Bilateral Remittance Corridor Analysis
CAS	Country Assistance Strategy
CDD	Customer due diligence
CFATF	Caribbean Financial Action Task Force
CFT	Combating the Financing of Terrorism
CIS	Commonwealth of Independent States
CPSS	Committee for Payment and Settlement Systems
DNFBP	Designated non-financial businesses and professions
EAG	Eurasian Anti-Money Laundering Group
ESAAMLG	Eastern and Southern Africa Anti-Money Laundering Group
FATF	Financial Action Task Force
FIRST	Financial Sector Reform and Strengthening Initiative
FIU	Financial intelligence unit
FSA	Financial Sector Assessment
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
FSRB	FATF–Style Regional Bodies
FT	Financing of terrorism
GAFISUD	South American Financial Action Task Force
GEP	Global Economic Prospects
GIABA	Groupe Inter-gouvernemental d'Action contre le Blanchiment d'Argent en Afrique Ouest
IAE	Independent AML Expert
IFI	International Financial Institutions
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
IN	Interpretative Note
MENAFATF	Middle East and North Africa FATF
ML	Money laundering
MLA	Mutual Legal Assistance
MONEYVAL	Council of Europe Group on Money Laundering
NBFI	Non-bank financial institution
NCCT	Non-Cooperative Countries and Territories
NPO	Non-profit organization

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OFC	Offshore Financial Center
ROSC	Report on the Observance of Standards and Codes
RSP	Remittance Services Provider
SR	Special Recommendations
SRO	Self-Regulatory Organization
STR	Suspicious Transaction Report
TA	Technical Assistance
TCSP	Trust and Company Services Provider
UN	United Nations
UNCTC	United Nations Counter Terrorism Committee
UNODC	United Nations Office on Drugs and Crime

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I. FINDINGS FROM THE AML/CFT ASSESSMENTS

1. **This Section is divided into four parts.** The first part presents the findings concerning overall compliance with the revised standard and methodology and the second part compares these findings to those of assessments under the old methodology. The third part discusses interpretative and application issues and the fourth describes logistical issues based on the experience of the assessments carried out to date.

A. Compliance with the FATF Recommendations

2. **Table 1 provides an overview of compliance with the revised standard** according to each individual FATF Recommendation.[1] Figure 1 provides a bar chart for the compliance of all jurisdictions assessed and Table 2 ranks individual FATF Recommendations by how frequently they were rated in the two lowest grades—non-compliant or partially-compliant.

3. **Based on the assessments the following general conclusions on the performance of the assessed countries can be drawn:**

Overall level of compliance

- **The overall level of compliance is low for all assessed countries**. 21 percent of all recommendations were rated fully compliant, 24 percent were rated largely compliant, 29 percent were rated partially compliant, and 26 percent non-compliant.

- **Overall compliance is better for the 40 AML Recommendations (47 percent rated fully or largely compliant) versus only 33 percent fully or largely compliant for the CFT Special Recommendations.**

Legal systems

- **Of twelve assessed high- and middle-income countries, all have criminalized money laundering.** However, in five cases (42 percent), the list of money laundering offences does not fully comply with the standard because it does not cover all the relevant circumstances reflected in the standard. Of six assessed low-income countries, 3 have recently passed AML laws, at least three, countries were still in the process of passing drafted legislation.

- **44 percent of assessed countries were rated non-compliant** on criminalizing the financing of terrorism (SR II).

- **International cooperation (including mutual legal assistance) was generally rated favorably** in assessments, though no countries were considered fully compliant, in part because of incomplete implementation. Dual criminality measures impeded the

[1] According to the revised methodology, a four-grade rating system was used: compliant (C), largely compliant (LC), partially compliant (PC), and non-compliant (NC).

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effectiveness of international cooperation in three countries and relevant international conventions were not ratified in one country. Low-income countries generally had only limited legal frameworks for international cooperation. In practice, this has meant that the authorities' power to cooperate is rarely impeded by legal procedural requirements; however, the absence of clear legal rules renders the process of cooperation more ad hoc and less systematic.

- **No country was rated non-compliant with the requirement to sign, ratify and fully implement the Vienna, Palermo, and 1999 Terrorist Financing conventions** (Recommendation 35), only 6 percent of assessed countries were rated fully compliant, 33 percent were largely compliant, and 61 percent were partially compliant.

- **Most countries' bank secrecy laws were positively assessed** as not inhibiting the implementation of the FATF Recommendations.

Preventative Measures—Financial Institutions

- **All assessed high- and middle-income countries have adopted a range of preventive measures** applicable to the prudentially-regulated financial sectors (the banking, securities, and insurance sectors), but implementation is uneven. No countries were fully compliant, and a large percentage of the countries were non-compliant with the Recommendation requiring enhanced due diligence for politically exposed persons.[2] Many of the assessed low-income countries had only begun the process of creating regulatory frameworks. Where such frameworks were present, they only covered the banking sector.

- **61 percent of assessed countries were non-compliant with the FATF Recommendation (SR IV)** that compels reporting of transactions when there is suspicion that there are funds linked to terrorism;

- **Compliance regarding basic AML/CFT preventative measures is low**

    - For customer due diligence (CDD) (Recommendation 5), no countries were rated compliant, 33 percent were considered largely compliant, 67 percent were partially compliant or non-compliant.

    - For suspicious transaction reporting (STR) (Recommendation 13), only 6 percent were considered compliant, 22 percent largely compliant, 33 percent partially compliant, and 39 percent non-compliant.

[2] Politically Exposed Persons (PEPs) are individuals who are or have been entrusted with prominent public functions in a foreign country, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials. Business relationships with family members or close associates of PEPs involve reputational risks similar to those with PEPs themselves.

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- **Generally, the effectiveness of the supervisory systems remains a concern.** Even among assessed high- and middle-income countries, the supervisory framework did not yet cover all aspects of the relevant Recommendations. In addition, sanctioning powers needed to be either strengthened or streamlined. Assessors expressed a general concern that the supervisors did not have sufficient means to perform their supervisory duty effectively and such capacity issues were particularly acute in the assessed low-income countries.

Preventative Measures—Designated Non-Financial Businesses and Professions (DNFBP)

- **No countries were fully compliant** and a large percentage of assessed countries were non-compliant with the recommendations concerning DNFBPs. Even where AML/CFT requirements had been fully extended to DNFBPs, implementation was weak.

- **The observed weaknesses in DNFBP preventative measures were not uniform** (see Section III for a more detailed discussion). Of the sectors covered, the casino sector is the most heavily supervised and extension of the AML/CFT obligations has been the least problematic. Similarly, as customer identification and record-keeping are essential elements of the notary's role in many jurisdictions, few issues have been encountered regarding their new AML/CFT compliance. At the other end of the spectrum, implementing the Recommendation requiring that lawyers report suspicious transactions under certain circumstances is problematic in almost all jurisdictions. Real estate agents and dealers in precious metals and stones have posed a different kind of problem, as they tend to be unfamiliar with AML/CFT issues and these professions typically have had no pre-existing supervisory structure.

- **Breaking down the findings by income groups, the assessed low-income countries were universally non-compliant on Recommendations 12 and 16** (CDD and STR respectively) and 83 percent non-compliant on Recommendation 24 (supervision). The assessed middle-income countries were 80 percent partially compliant and 20 percent non-compliant on R 12 and 16, and 20 percent largely, 20 percent partially, and 60 percent non-compliant on R 24. The assessed high-income countries received ratings on R 12 similar to those of the middle-income countries (71 percent partially and 29 percent non-compliant), did somewhat better on R 16 (14 percent largely, 57 percent partially, and 29 percent non-compliant), and on R 24 (14 percent largely, 43 percent partially and 43 percent non-compliant).

Law Enforcement

- **With respect to FIUs (Recommendation 26), 6 percent were rated compliant,** 39 percent largely compliant, 6 percent partially compliant, and 50 percent non-compliant. This indicates some major shortcomings in an area that is critical to AML/CFT efforts. The observed weaknesses in the high- and middle-income countries concerned lack of resources, failure to provide adequate feedback to the reporting institutions, and insufficient analysis of the suspicious transaction reports.

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No assessed low-income country had an operational FIU, although some jurisdictions had set up units performing some FIU-related functions.

- **Compliance regarding SR III on freezing and confiscation of terrorist assets is weak.** No countries were fully compliant, 11 percent largely compliant, 50 percent partially compliant, and 39 percent non-compliant. Despite identified flaws in the legal framework, the assessed countries have adopted transitional measures to implement UN Security Council Resolution 1267 and successor resolutions on terrorist financing.

- **Many assessors noted that even where legal provisions and law enforcement powers were in place, ML/FT investigations and prosecutions were limited.**

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Table 1. Profile of Overall Compliance with FATF Recommendations

FATF Recommendations	Compliant (in percent)	Largely Compliant (in percent)	Partially Compliant (in percent)	Non- compliant (in percent)	Assessed Jursidictions (number)
The Forty Recommendations					
1 - ML offence	17	39	28	17	18
2 - ML offence–mental element and corporate liability	33	33	17	17	18
3 - Confiscation and provisional measures	11	44	39	6	18
4 - Secrecy laws consistent with the Recommendations	61	28	11	0	18
5 - Customer due diligence	0	33	56	11	18
6 - Politically exposed persons	6	17	17	61	18
7 - Correspondent banking	17	22	22	39	18
8 - New technologies & non face-to-face business	28	11	28	33	18
9 - Third parties and introducers	29	14	43	14	14
10 - Record keeping	39	33	11	17	18
11 - Unusual transactions	22	33	22	22	18
12 - DNFBP–R.5, 6, 8-11	0	0	56	44	18
13 - Suspicious transaction reporting	6	22	33	39	18
14 - Protection & no tipping-off	39	22	28	11	18
15 - Internal controls, compliance & audit	17	28	39	17	18
16 - DNFBP–R.13-15 & 21	0	6	44	50	18
17 - Sanctions	6	33	39	22	18
18 - Shell banks	33	39	17	11	18
19 - Other forms of reporting	44	17	6	33	18
20 - Other NFBP & secure transaction techniques	24	12	12	53	17
21 - Special attention for higher risk countries	22	17	33	28	18
22 - Foreign branches & subsidiaries	13	27	40	20	15
23 - Regulation, supervision and monitoring	0	28	56	17	18
24 - DNFBP - regulation, supervision and monitoring	0	11	28	61	18
25 - Guidelines & Feedback	0	33	28	39	18
26 - The FIU	6	39	6	50	18
27 - Law enforcement authorities	28	28	28	17	18
28 - Powers of competent authorities	67	11	22	0	18
29 - Supervisors	28	28	33	11	18
30 - Resources, integrity and training	6	28	44	22	18
31 - National co-operation	17	33	39	11	18
32 - Statistics	0	33	28	39	18
33 - Legal persons–beneficial owners	28	33	28	11	18
34 - Legal arrangements – beneficial owners	70	10	10	10	10
35 - Conventions	6	33	61	0	18
36 - Mutual legal assistance (MLA)	28	33	33	6	18
37 - Dual criminality	39	28	22	11	18
38 - MLA on confiscation and freezing	22	17	44	17	18
39 - Extradition	39	22	17	22	18
40 - Other forms of co-operation	44	17	22	17	18
Nine Special Recommendations					
SR.I - Implement UN instruments	11	22	50	17	18
SR.II - Criminalize terrorist financing	11	28	17	44	18
SR.III - Freeze and confiscate terrorist assets	0	11	50	39	18
SR.IV - Suspicious transaction reporting	6	22	11	61	18
SR.V - International cooperation	17	28	22	33	18
SR.VI - AML requirements for money/value transfer services	35	24	29	12	17
SR.VII - Wire transfer rules	17	17	17	50	18
SR.VIII - Nonprofit organizations	17	17	28	39	18
SR.IX - Cash Couriers	15	0	31	54	13

Source: Assessment Reports

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Table 2. FATF Recommendations Rated Partially Compliant and Non-Compliant

Proportion of jurisdictions [1/]	Nine Special Recommendations	Proportion of jurisdictions [1/]	Nine Special Recommendations
16/18	SR.III - Freeze and confiscate terrorist assets	12/18	SR.VIII - Nonprofit organizations
11/13	SR.IX - Cash Couriers	11/18	SR.II - Criminalize terrorist financing
13/18	SR.IV - Suspicious transaction reporting	10/18	SR.V - International cooperation
12/18	SR.I - Implement UN instruments	7/17	SR.VI - AML requirements for money/value transfer services
12/18	SR.VII - Wire transfer rules		
	FATF Recommendations		**FATF Recommendations**
18/18	12 - DNFBP–R.5, 6, 8-11	10/18	26 - The FIU
17/18	16 - DNFBP–R.13-15 & 21	9/18	31 - National co-operation
16/18	24 - DNFBP - regulation, supervision and monitoring	8/18	1 - ML offence
14/18	6 - Politically exposed persons	8/18	3 - Confiscation and provisional measures
13/18	13 - Suspicious transaction reporting	8/18	11 - Unusual transactions
13/18	23 - Regulation, supervision and monitoring	8/18	27 - Law enforcement authorities
12/18	5 - Customer due diligence	8/18	29 - Supervisors
12/18	25 - Guidelines & Feedback	7/18	33 - Legal persons–beneficial owners
12/18	30 - Resources, integrity and training	7/18	14 - Protection & no tipping-off
12/18	32 - Statistics	7/18	19 - Other forms of reporting
11/17	20 - Other NFBP & secure transaction techniques	7/18	36 - Mutual legal assistance (MLA)
11/18	7 - Correspondent banking	7/18	39 - Extradition
11/18	8 - New technologies & non face-to-face business	7/18	40 - Other forms of co-operation
11/18	17 - Sanctions	6/18	2 - ML offence–mental element and corporate liability
11/18	21 - Special attention for higher risk countries	6/18	37 - Dual criminality
11/18	35 - Conventions	5/18	18 - Shell banks
11/18	38 - MLA on confiscation and freezing	5/18	10 - Record keeping
9/15	22 - Foreign branches & subsidiaries	4/18	28 - Powers of competent authorities
8/14	9 - Third parties and introducers	2/10	34 - Legal arrangements – beneficial owners
10/18	15 - Internal controls, compliance & audit	2/18	4 - Secrecy laws consistent with the Recommendations

Source: Assessment Reports

1/ Ratings were not recorded for all recommendations in some assessments. Proportion represents the number of jurisdictions adversely rated out of total jurisdictions assessed for each recommendation.

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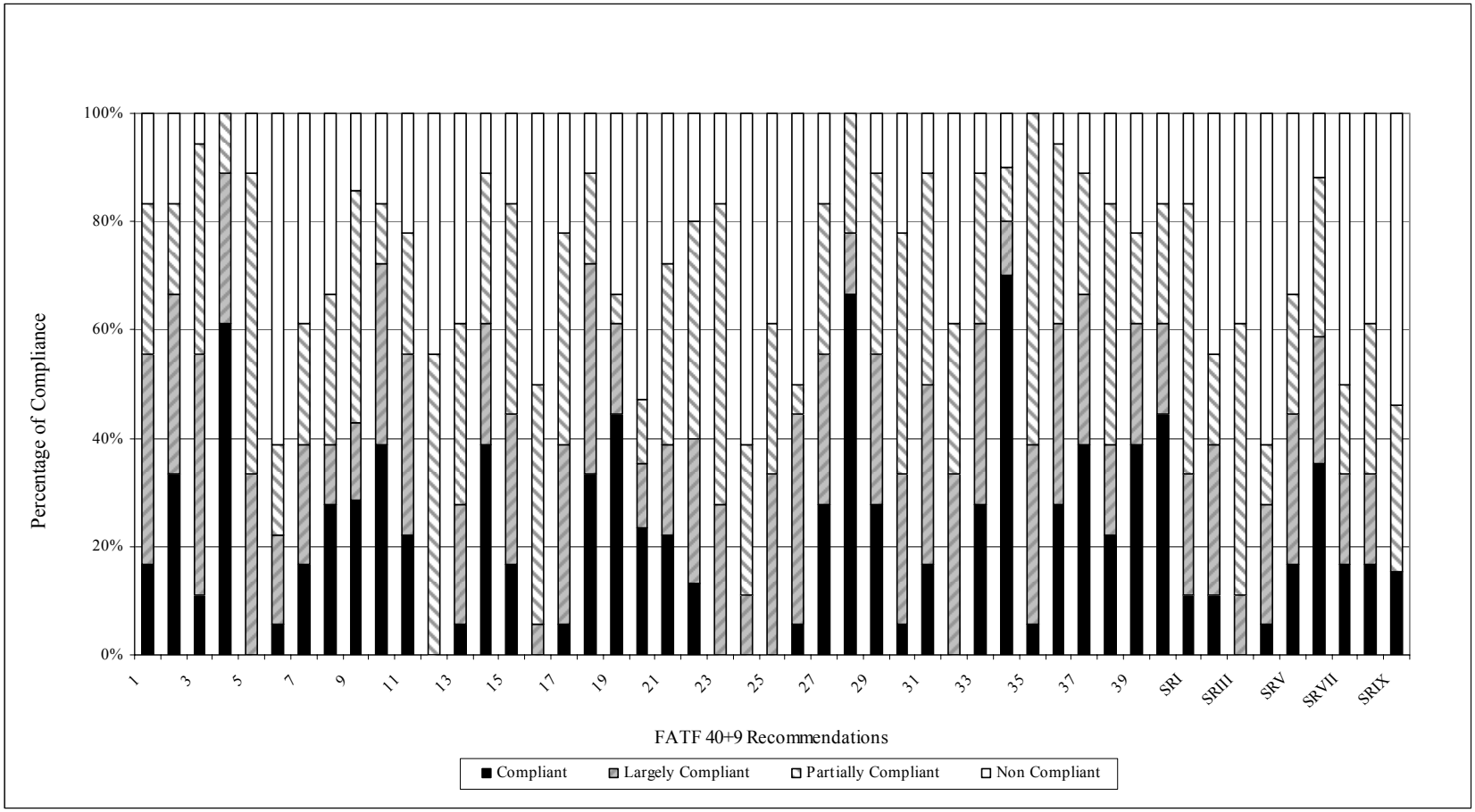
Figure 1. Compliance with AML/CFT: All Countries Assessed



Source: Assessment Reports

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B. Comparison with Assessments Under the Old Standard and Methodology

4. **The revision of the FATF 40 AML Recommendations in 2003 and the adoption of the Special Recommendations on Terrorist Financing in 2001 required a fundamental revision of the Assessment Methodology,** which was adopted by the FATF in February, 2004 and endorsed by the Bank/Fund Boards in March 2004.

5. The new standard and methodology differed from the old in several critical ways, including:[3]

- **The 2004 Methodology contains over 200 essential criteria, 20 sub-criteria and 35 additional criteria, as compared to 120 criteria under the 2002 Methodology**.

- **There are significant differences between the two methodologies with respect to the Special Recommendations on Terrorist Financing,** owing to the fact that the FATF developed and endorsed a number of interpretative notes, guidance and best practices after its endorsement of the 2002 Methodology. The most significant changes concern criteria relating to SR III (Freezing and Confiscating Terrorist Assets), SR VI (Alternative Remittance) and SR VII (Wire Transfers), for which the FATF issued interpretative notes in 2003.

- **Strengthened and expanded preventive measures for financial institutions.** For example, following the enhancement of the FATF Recommendation 5, there are more detailed criteria concerning the conduct of customer due diligence (CDD) with respect to the circumstances under which CDD is to be conducted, the timing of verification, measures to be taken with respect to existing customers and conditions under which simplified customer due diligence may be allowed.

- **Preventive measures are to apply to a designated set of non-financial businesses and professions where they prepare for, or carry out, certain types of transactions.** The designated non-financial businesses and professions are: casinos; real estate agents; dealers in precious metals and stones; lawyers, notaries and other independent legal professionals; accountants; and trust and company service providers.

- **There are more explicit and detailed requirements for setting up an FIU.** While the old methodology has included some requirements for setting up an FIU, the new

[3] See *Twelve-Month Pilot Program of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) Assessments: Joint Report on the Review of the Pilot Program; Supplement 1* (Washington: IMF/WB: March 16, 2004) for more detail. The old methodology also used a four-level rating system—compliant, largely compliant, materially non-compliant, and non-compliant.

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methodology provides specific essential criteria for FIUs' functions, independence, and access to information arrangements.

- **With respect to international cooperation, there are more developed and refined requirements concerning mutual legal assistance (MLA)** and a much greater recognition and specification of the measures needed for non-MLA cooperation, amongst FIUs but also for law enforcement, regulators, and other competent authorities. The requirements also articulate more precisely the need to eliminate measures that hinder and prevent international co-operation.

- **Enhanced attention to the effectiveness of implementation of AML/CFT measures**. Compliance under the 2004 Methodology requires effective implementation, in addition to the adoption of laws, regulations and other measures. To receive a compliance rating countries must not only adopt appropriate laws, regulations and other measures, but also implement and utilize them.

6. **Comparison of the assessments performed under the old and new methodologies indicates that overall compliance ratings have gone down.** Comparing samples of assessed countries indicates that the level of compliance of the sample assessed under the old methodology was 62 percent compared to 45 percent for the sample assessed under the new methodology. Differences are large both for the 40 Recommendations (compliance falls from 67 to 44 percent) and the CFT Recommendations (58 percent to 33 percent). The comparison is based on the 18 countries assessed under the new methodology (comprising 7 high-income, 5 middle-income, and 6 low-income countries) and a sample of 18 countries of similar size and composition taken from the 41 countries assessed under the old methodology (as reported under the pilot program). Of the 18 countries assessed under the new methodology, only 11 of the assessment findings have been finalized (to date).

7. **The results from the sample of countries assessed under the old methodology and the 18 countries assessed under the new methodology reveals two major differences.** For the 40 AML Recommendations the level of non-compliance[4] is lower in the sample of countries assessed under the old methodology (17 percent) than is non-compliance in the sample of countries assessed under the new methodology (26 percent). With regard to the CFT Special Recommendations the increase in non-compliant ratings under the new methodology was far more pronounced—39 percent in countries assessed under the new methodology compared with 20 percent in the sample of countries assessed under the old methodology.

8. **Changes in ratings are also evident with respect to some key AML and CFT Recommendations.** For example, 40 percent of the countries assessed under the new methodology were rated non-compliant on the criminalization of the financing of terrorism

[4] Partially compliant, materially non-compliant, and non-compliant ratings.

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and 64 percent on FT STR Reporting (SR IV), as opposed to 33 percent and 28 percent respectively for the sample of countries assessed under the old methodology.

9. **Also, no countries were rated fully compliant with the Recommendation for CDD requirements under the new methodology**, as opposed to 22 percent of the sample of countries assessed under the old methodology. Similarly, only 7 percent of countries received a rating of fully compliant with the STR requirements under the recommendations, down from 39 percent under the old methodology.

10. Differences are observable for assessed countries in all income groups (see Figure 2), although the trend is not uniform.

- **Assessed low-income countries have had difficulty achieving high compliance ratings under either methodology**, reflecting in part the very rudimentary nature of their AML/CFT regimes. However, the ratings under the new methodology are somewhat worse. Among the assessed low-income countries 23 percent of the recommendations were found to be compliant or largely compliant under the old standard, compared to 13 percent under the revised standard. These countries' ratings for CFT compliance were particularly affected, going from 14 percent compliant or largely compliant under the old methodology to 2 percent under the new.

- **Assessed high-income countries had significantly lower compliance levels under the new methodology than the old.** Under the old methodology, 90 percent of their recommendations were rated compliant or largely compliant, compared to 57 percent under the new methodology, which could mean that the expansion of the standard and the greater precision of the methodology has had a greater effect on countries whose AML/CFT regimes were already established

- **Assessed middle-income countries were the only sub group which showed higher ratings under the new methodology,** with 73 percent of recommendations rated compliant or largely compliant compared to 59 percent before.

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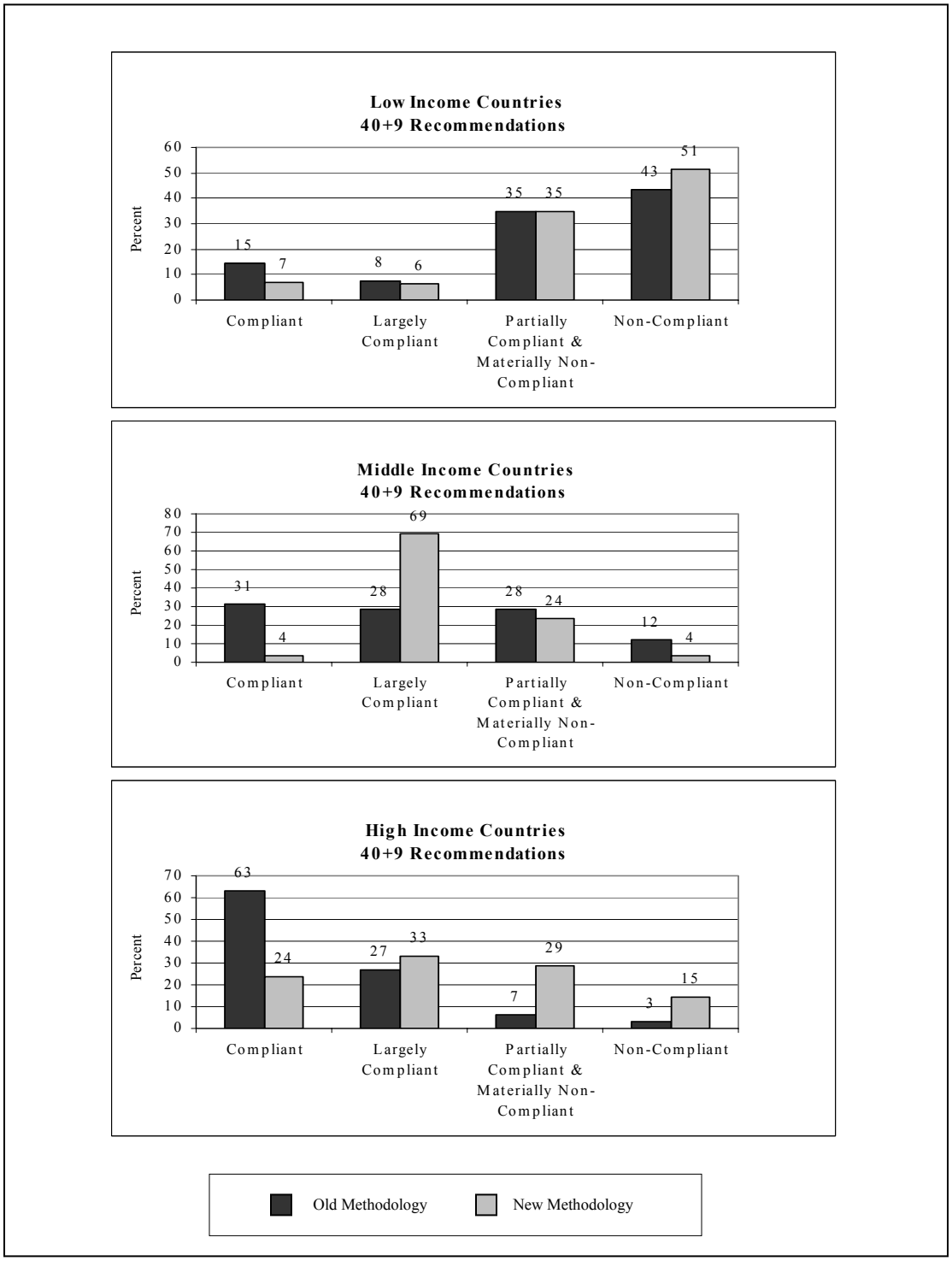
Figure 2. Comparison of Compliance Levels between Old & New Methodology of Low-, Middle-, and High-Income Countries



Source: Bank/Fund staff
- Under the old methodology, 27 of the 40 and 7 of the 8 Special Recommendations were rated in the assessments, and under the new methodology all 40 and all special Recommendations were rated in the assessments.
- The sample countries assessed under the old methodology included 18 high-income, 18 middle-income, and 5 low-income countries; the sample countries assessed under the revised methodology included 7 high-income, 5 middle-income and 6 low-income countries.

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C. Issues of Application and Interpretation

11. **Analysis of the assessments has identified issues in the application and interpretation of the revised standard** relating to: (i) the consistency in applying the methodology; and (ii) interpretation of the FATF standard, including:

- **Assessors often base their judgment of effectiveness on statistical information, which is open to divergent interpretations.** In a number of cases, divergence in the use of statistical information has led to different assessments of comparable situations in assessed countries.

- **Some Recommendations (such as those relating to customer due diligence or supervision) require a single aggregate rating for compliance** in wide variety of financial sectors. Given the differences in compliance that may exist between sectors, aggregate rating in such cases may be misleading and certainly lacks transparency.

- **Strengths or weaknesses observed under one Recommendation can have an effect on the rating of other recommendations.** For example, failure to criminalize terrorist financing might affect compliance with STR and FIU requirements among others. Absent clear guidance, different assessors have rated these related Recommendations differently.

- **Some features of the AML/CFT regime are rated under more than one Recommendation**, i.e., "Regulation and supervision" and "Ongoing supervision and monitoring" (R. 23 & R. 29), which leads to analytical inconsistencies.

- **The great variety in the operational rules and guidelines adopted by countries in the implementation of AML/CFT measures for DNFBPs requires assessors to undertake case by case review of arrangements in each sector** and make more independent judgments about their reasonableness and effectiveness, adding a greater degree of subjectivity to their findings. Moreover, the absence of any concrete preventative measures specified for NPOs under SR VIII makes assessment even less precise, as assessors may have to examine a wide range of oversight practices to see if the overall environment achieves the objectives set in the standard.

- **Finally, some criteria also appeared to be difficult to assess in largely cash-based economies.**

D. Assessment Logistics and Process

12. **There are three stages to the AML/CFT assessment:** (i) preparation (based primarily, but not exclusively on the assessed country's response to a self-assessment questionnaire); (ii) on-site visit; and (iii) finalization of reports (Detailed Assessment Report and Report on the Observance of Standards and Codes). The preparation generally required three weeks of work prior to the start of the assessment with the onsite visits usually lasting for 12–17 days each for a team of three to five experts. The experience is that following the on-site visit, an additional three weeks of processing time, in total, were required to finalize

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the draft report. However, finalization of the report usually required a four to six-months period following the on-site mission to allow for feedback from stakeholders.

13. **The logistics for assessments under the revised standard have been a challenge for all countries and assessors.** This is especially problematic for low-income countries, where capacity constraints have often led to difficulties in completing the assessment questionnaire and other elements of the preparatory process. Some high- and middle-income countries also experienced difficulties in completing the questionnaire. Incomplete pre-mission information places a significant burden on assessors during the onsite visit. The self-assessment questionnaire needs further development and should be focused more on the essential criteria listed in the methodology. Furthermore, for low-income countries, some consideration should be given to providing assistance for completing the self-assessment questionnaire.

14. **For the assessors, the addition of ten or so new sectors (DNFBP and NPO) to each AML/CFT assessment has added considerable resource demands.** Typically two, and sometimes three, entities have roles in the organization and regulation of each of the new areas (e.g., for lawyers, the Justice Ministry may have responsibility for the legal framework, the bar/law society for ongoing oversight, and the courts may play a role in disciplining and sanctioning). Assessors need to meet with (i) each authority to evaluate the framework of oversight; (ii) professional associations; and (iii) practitioners to gauge the effectiveness of implementation. As each additional sector assessed requires three to four meetings, proper coverage of all relevant DNFBPs adds an additional 10 to 20 meetings. As a result of the increased resource demands, the average size of an AML/CFT mission team has increased. Table 3 illustrates the average size of an AML/CFT mission team in comparison to teams used for other ROSCs.

15. **With the inclusion of DNFBPs, assessment reports have grown in length.** The draft detailed assessment reports compiled for the first nine reports prepared using the revised methodology run from 100 to 195 pages in length.

Table 3. Average Size of ROSC-Assessment Mission Teams, 2004–2005
(Number of persons)

Type of ROSC		Number of Persons
STA-	Data	5.2
FAD-	Fiscal	3.1
MFD-	IAIS principles	1.0
	IOSCO principles	1.0
	Financial Transparency Code	1.0
	Basel core principles	2.0
	AML/CFT standard	4.0

Source: The Standards and Codes Initiative – Is it Effective? And How Can it be Improved? Background Paper - Supplement 1, Table 25 and staff estimates

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II. Experience with Technical Assistance

16. **During the period January 2004–June 2005, countries have increased their demands for anti-money laundering and combating the financing of terrorism (AML/CFT) technical assistance (TA).** Factors influencing the growth in demand include countries' efforts to implement the more rigorous and extensive AML/CFT standard, a greater awareness of the AML/CFT requirements, lack of experience and capacity to implement these measures, and referrals from agencies such as the United Nations Counter Terrorism Committee (UNCTC) and the FSRBs to the Bank/Fund. The Bank/Fund have continued to collaborate with donor countries and organizations in this respect.

17. **One objective of the strategy for the delivery of TA is to have it gradually evolve from primarily short-term initiatives (with some exceptions), to more substantive, tailor-made programs that are sustainable over the longer-term**. Some of the more recent TA projects have been designed to provide multi-disciplined, sequenced and prioritized assistance spanning several months or even several years. These projects require a significant commitment of financial and human resources. In the 18 months between January 2004 and June 2005, the Bank/Fund delivered 210 TA projects (169 field and 41 HQ-based projects). In so doing, the Bank/Fund have become major providers of AML/CFT TA.

This section provides an overview of the type of TA which was delivered as well as a regional breakdown on the Bank/Fund experience.

A. Technical Assistance Provided

18. **The primary objective of TA provided by the Bank/Fund is to assist countries in the implementation of the full AML/CFT standard.** In order to meet this objective, TA included (i) designing institutional frameworks; (ii) legislative drafting and the provision of legal advice; (iii) enhancing financial supervisory regimes; and (iv) building capacity of financial intelligence units and other agencies.

The Fund/Bank have utilized different modalities in delivering TA:

- Traditional workshops and seminars;
- Video conferencing (Global Policy Dialogues) (See Box 1);
- Multi-year (Capacity Enhancement Program) (See Box 1);
- Appointment of mentors and peripatetic advisors;
- In addition the Fund/Bank have produced several publications on a wide range of AML/CFT topics (see Section VI).

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Box 1: Examples of Innovative Modalities for TA Delivery

Global Policy Dialogue Series

The Global Policy Dialogue Series is a live video conference with AML/CFT policy makers from five or more countries, experts in the region and Bank/Fund experts. The Dialogue Series which started in January 2002 is now in its 3rd series. The first Global Policy Dialogue Series "Combating Financial Abuse" reached more than 700 policy makers and senior government officials from 42 countries from all over the world, while the second Global Policy Dialogue "Strengthening Collaborative Process to Build an Effective AML/CFT Regime" reached approximately 600 public and private sector representatives from 24 countries around the world. The third series "New International Standards on AML/CFT," has reached, as of June 2005, 425 participants from 33 countries in East Asia, Latin America and Caribbean, and Africa regions. More are planned for Middle East and North Africa, Eastern Europe, and South Asia. In addition, a fourth Dialogue Series is now being considered to address common challenges faced by many developing countries, "How to Build an Effective AML/CFT Regime in a Cash-based Economy."

Capacity Enhancement Program

The Bank in conjunction with the Fund has developed a new multi-year AML/CFT capacity enhancement program. The program offers countries the tools, skills and knowledge to build or strengthen their institutional, legal and regulatory frameworks to successfully implement their national action plan on AML/CFT through comprehensive training and policy discussions. It is currently being piloted in 7 countries. A set of comprehensive training modules which cover multidisciplinary areas is now offered to countries and to 8 other TA providers that participated in the "train-the-trainers" workshop in May 2005. The countries are beginning to take ownership of the training product by customizing contents and training fellow officials and employees of financial institutions according to their individual country action plan on training.

19. **The Fund/Bank have delivered a significant amount of TA on a bilateral and regional basis.** Of the 169 field missions, 130 were classified as bilateral missions providing country-specific TA, 12 were workshops held for the primary benefit of one country, and 27 were workshops held for the benefit of an entire region. Fifty-two of the field-based projects were conducted in the Asia Pacific region, 40 in the Latin America and Caribbean region, 28 in Africa, 24 in Eastern Europe, and 25 in the Middle East and Central Asia region (see Figure 3).

The combined 210 field missions and HQ-based projects can be further broken down into functional categories. Legal drafting work accounted for 64 projects (including 28 HQ-based), general institution building for 75, while specific work with FIUs was the subject of 27 projects and work with financial sector supervisors of 34. There were 10 global dialogue video conferences.

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Table 4. Bank/Fund TA Projects: January 2004 to June 2005
Projects by Region, Topic, and Modality

Category	Bilateral Mission	Bilateral HQ	Regional HQ	Bilateral Workshop	Regional Workshop	**Total**
Africa						
Institution Building	14	–	–	–	2	**16**
Legal framework	6	7	–	–	2	**15**
Supervision	2	–	–	–	–	**2**
FIUs	2	–	–	–	–	**2**
Global Dialogue	–	–	2	–	–	**2**
Total	**24**	7	**2**	**–**	**4**	**37**
Asia Pacific Region						
Institution Building	19	2	–	2	4	**27**
Legal framework	10	6	–	1	1	**18**
Supervision	6	–	–	1	1	**8**
FIUs	6	–	–	–	1	**7**
Global Dialogue	–	–	1	–	–	**1**
Total	**41**	**8**	**1**	**4**	**7**	**61**
Eastern and Central Europe						
Institution Building	7	–	–	–	1	**8**
Legal framework	1	–	2	2	2	**7**
Supervision	3	–	–	–	2	**5**
FIUs	6	–	–	–	–	**6**
Global Dialogue	–	–	–	–	–	**–**
Total	**17**	**–**	**2**	**2**	**5**	**26**
Middle East, Central Asia, and Caucasus						
Institution Building	13	1	–	–	1	**15**
Legal framework	6	5			1	**12**
Supervision	–	–	–	1	1	**2**
FIUs	–	–	–	2	–	**2**
Global Dialogue	–	–	3	–	–	**3**
Total	**19**	**6**	**3**	**3**	**3**	**34**
Latin America and Caribbean						
Institution Building	6	–	–	2	1	**9**
Legal framework	2	8	–	–	2	**12**
Supervision	11	–	–	1	5	**17**
FIUs	10	–	–	–	–	**10**
Global Dialogue	–	–	4	–	–	**4**
Total	**29**	**8**	**4**	**3**	**8**	**52**
Grand Total	**130**	**29**	**12**	**12**	**27**	**210**

Source: Bank and Fund

Category Definitions
Institution Building: Comprehensive capacity building on multiple areas of the AML/CFT system including the design of institutional, legal, and regulatory frameworks, the training of government officials on several AML/CFT specialties and the assessment of countries' needs.
Legal Frameworks: Adapting legal systems to international AML/CFT standards.
Supervision & Regulation: Strengthening the AML/CFT aspects of supervisory practices in financial and non-financial institutions.
Financial Intelligence Units: Creation and strengthening of FIUs.
Global Dialogue: Regional video-conference for TA coordination and lessons learned.

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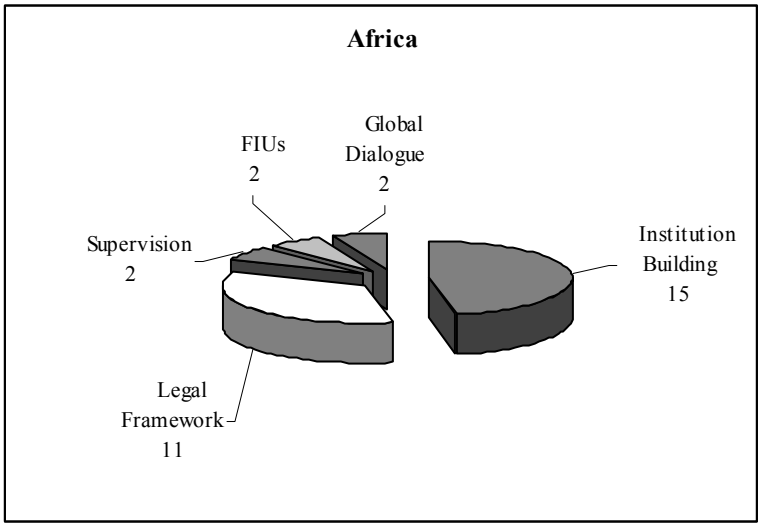
Figure 3. TA Project by Category and Region



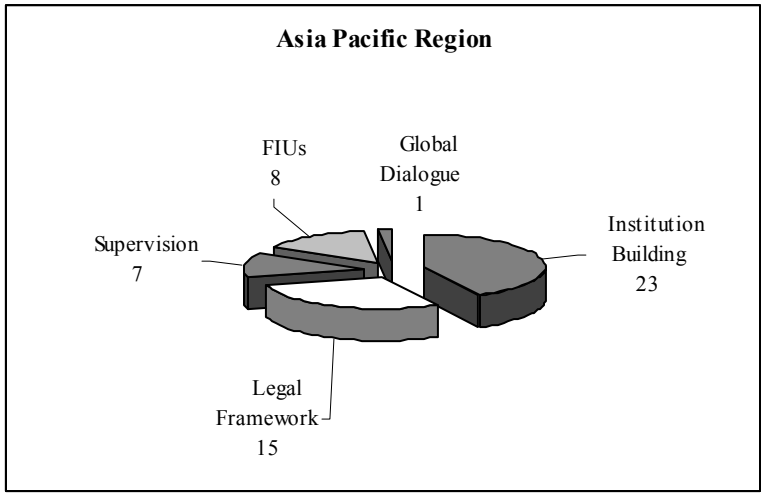


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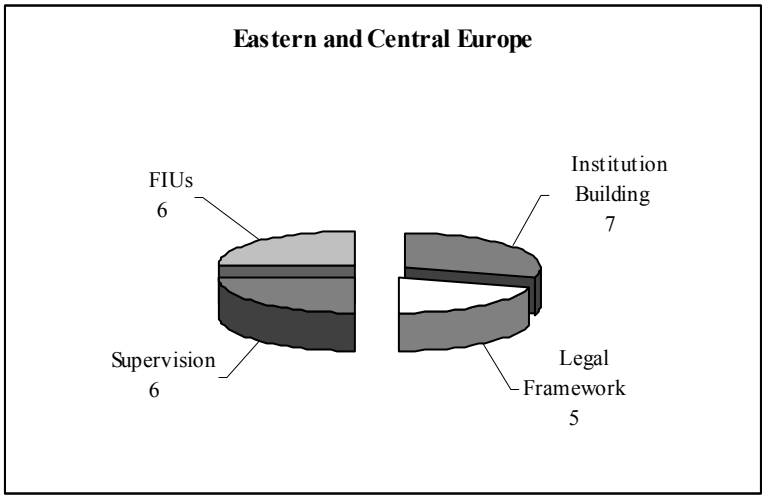
Figure 3. TA Project by Category and Region (cont.)



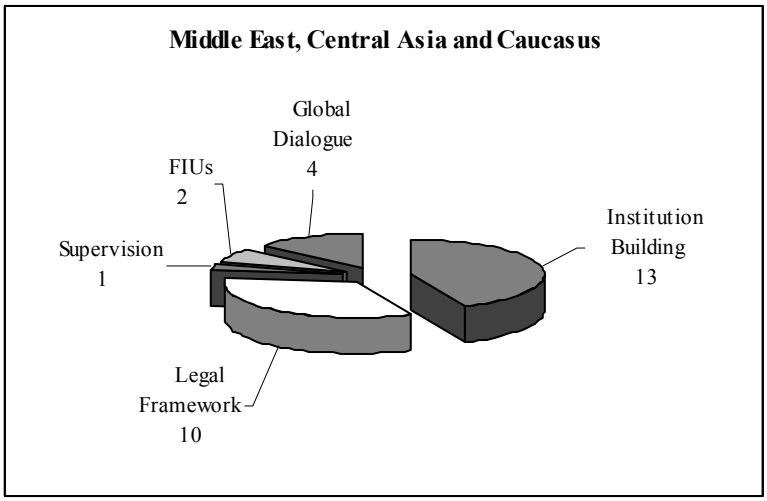


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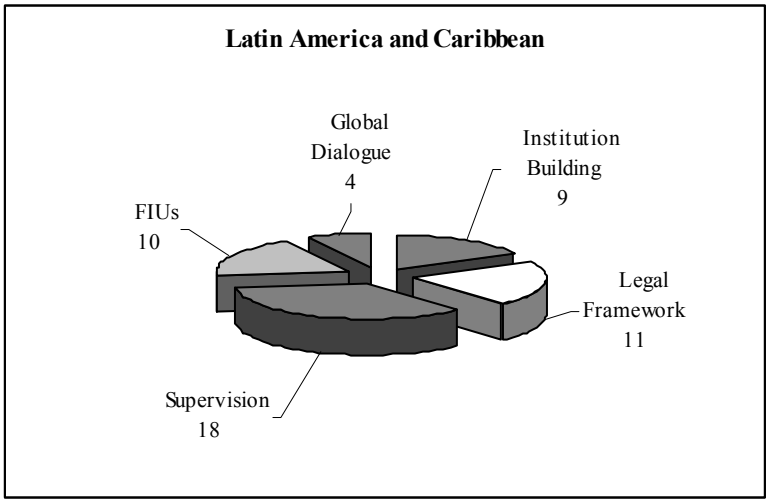
Figure 3. TA Project by Category and Region (concluded)



TA provided to countries has yielded the following results:

- **Countries are at various stages of adopting AML/CFT legislation on the basis of the TA provided**. Of the 64 legal drafting projects, at least seven countries have adopted legislation incorporating recommendations made by the missions. Authorities from ten countries have accepted the recommendations of staff regarding AML/CFT laws being considered for enactment and have incorporated the recommended provisions in their draft AML/CFT laws. The authorities in these countries are in various stages of submitting the draft AML/CFT laws to their legislature for consideration and ultimate enactment.

- **Considerable work has also been undertaken in developing supervisory guidance, inspection manuals and more recently, guidance notes.** In six instances, initial assistance was followed-up by subsequent visits to regulatory authorities to monitor their progress in implementing the new supervisory techniques. In four instances, Fund staff provided support to regulators as they undertook their first on-site examinations using the examination manuals developed with Fund assistance.

- **TA provided has contributed to the establishment or strengthening of FIUs.** FIU-related projects contributed to the establishment of one FIU and in the strengthening of six FIUs. The other FIU-related missions provided countries with advice on how to establish an FIU and make it operational and build capacity of FIU officials.

- **Regional workshops on AML/CFT have been successful in providing training to approximately 1000 officials from 111 countries.** The workshops targeted mainly countries with significant FT and ML issues in the various regions. The workshops have concentrated on drafting of legislation, primarily CFT legislation, building the capacity of FIU and criminal justice officials and training financial sector regulators.

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Workshops were also held for regulators of company and trust service providers and non-profit organizations.

- **The legislative drafting workshops supported the efforts of officials from various countries in crafting new laws, particularly on CFT, or amending existing laws.** Since the time of these workshops and other similar workshops conducted the previous year, eight countries have passed CFT laws and 12 countries are considering passing AML/CFT legislation. The capacity building workshops concentrated on building the technical expertise of FIU, prosecutorial and other criminal justice officials on the receipt and analysis of financial information and the subsequent dissemination of intelligence, the investigation and prosecution of money laundering cases and the process of forfeiting the proceeds of crime. These workshops have increasingly provided more practical hands-on training in response to requests from member countries.

- **As a result of bilateral and regional workshops for financial sector supervisors, a number of countries are at various stages of developing risk-based supervisory frameworks including overall strategies and supervisory tools.** Fifteen countries developed either supervisory guidelines and/or inspection manuals. Two workshops catered specifically to insurance supervisors, while another focused on the supervision of trust and company service providers.

20. **TA coordination with external partners continues to be a key objective of Fund/Bank efforts.** The Fund/Bank meet regularly to discuss ongoing and new TA projects and to coordinate activities in conjunction with the plenary meetings of the FATF and FSRBs (see Box 7 for listing of countries covered by FSRBs). In addition, TA coordination meetings are held with other donor organizations including through informal contact with strategic partners (e.g., the Egmont Group of Financial Intelligence Units, FATF, UN-CTC, and UN-ODC), and key bilateral donors. There is significant emphasis on regional training sessions through the Fund and Bank training institutes.

21. **The Bank has begun work on developing TA Strategies to provide TA and work in partnership with the regions at multilateral and bilateral levels**. The TA Strategy includes identifying champion countries in the region that will encourage other countries to develop effective AML/CFT programs.

22. **The Fund's Pacific Financial Supervision Technical Assistance Centre serves 15 countries** (not all are Fund member countries). The mandate of the centre's financial sector expert now includes AML/CFT for all financial sector activity.

B. Lessons Learned

What Has Worked Well

23. **Staff has, within limitations, moved effectively to develop appropriate responses to the increasing demand for TA**. The Bank/Fund have adjusted the modalities of delivery

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of TA, changed the mix of the staff expertise, and increased coordination with other TA providers. Specifically, this included:

- **Developing strategic and targeted TA programs**. This involved assisting countries to identify gaps in their AML/CFT frameworks and thereafter to design corrective action plans. Where political will and ownership are present, staff is successfully delivering multi-phased TA programs.

- **Building core teams of experts with the necessary operational knowledge**. This was achieved by recruiting experts with substantial operational experience in all the related disciplines and by intensifying the Fund and Bank research activities.

- **Adapting tools to increase cost efficiency while maintaining effectiveness**. This has included regional training programs, train-the-trainers efforts, mentoring programs, distance learning, leveraging existing technical assistance centers (e.g., regional technical assistance centers, Bank and Fund training institutes) and training initiatives.

- **Intensifying partnerships with other TA providers.** This entails collaboration and coordination on all aspects of TA, including design, delivery, sharing of experts, and funding. Staff has worked closely with UN, other international financial institutions, specialized organizations (e.g., Egmont Group), and key bilateral providers.

- **Using assessments as a basis for targeted TA.** In countries with rudimentary AML/CFT systems, the development of a TA program based on the findings of an assessment has the following advantages: (1) The assessment work and accompanying recommendations to facilitate the development of a more accurate and focused TA plan; (2) The political dynamics following acceptance of the assessment findings can be leveraged; and (3) Already available expert resources can be more effectively utilized.

Challenges and Areas for Improvement

24. **While the Fund/Bank have been providing TA, countries confront the following challenges** in implementing the recommended reforms:

- **Corruption and Weak Governance.** Corruption in some countries undermines the effectiveness of AML/CFT measures. In environments where corruption is prevalent, legislators are less likely to enact strong and effective AML/CFT laws and key institutions (courts, law enforcement and supervisory agencies) may be hindered from carrying out their official duties in an effective manner. Development of an AML/CFT regime in such an environment also requires the establishment of an effective anti-corruption framework.

- **Achieving sufficient political commitment.** The absence of strong political commitment at the level of policy makers and legislators is a significant hindrance to

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the development and implementation of a robust AML/CFT framework. In some countries, the dedication of officials at the technical level of supervisory and law enforcement authorities is hampered by lack of political commitment of government and parliament to pass legislation and assign the necessary resources.

- **High start-up and ongoing costs to implement the AML/CFT standard.** Regardless of country income level, the establishment of effective AML/CFT regimes requires significant expenditure to develop appropriate institutions, recruit personnel, train staff, and acquire resources (e.g., technology).

- **Low-income countries face resource constraints in implementing AML/CFT regimes.** As a result of competing demand for limited resources, AML/CFT will not necessarily emerge as a national priority in many countries.

25. **As indicated in the section on the experience of assessments, many countries are finding that their current regimes fall short of the newly revised, rigorous AML/CFT standard.** Where appropriate, countries could adopt a phased approach towards achieving full implementation of the standard. Proper sequencing of TA is crucial and countries need guidance in addressing their shortcomings in the most efficient manner. Priority could be placed on the following: (i) criminalization of ML/TF activities; (ii) safeguarding the international payments system by implementing effective preventive measures in the banking system, including the global network of correspondent accounts, and wire transfers; (iii) asset freezing and forfeiture regimes; (iv) cooperation and information sharing arrangements; and (v) financial intelligence units. Countries should decide on the amount of attention to place on DNFBPs in light of the size and vulnerability of the sector to ML/TF. It will also be important to create in-country TA coordination mechanisms, to enhance local "ownership" of various TA initiatives by the authorities and to promote the effective implementation of AML/CFT measures by the relevant authorities.

Resource Considerations

26. **Mobilization of resources to support an intensive AML/CFT TA program has been a challenge.** The staff's ability to assist countries with implementing the revised standard is determined by available resources. The IMF's administered accounts to support AML/CFT have been substantially committed as has the funding from the FIRST Initiative for middle income countries. Earlier proposals by the Fund's staff for creation of funding vehicles through contributions by interested donors, including a trust fund, have not met with success. Given the clear and urgent need to support countries in the implementation of the more comprehensive revised standard, the staff would again request the donor community to commit additional resources.

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C. Technical Assistance by Region

Africa

TA Delivered

27. **While only a few countries in Africa have implemented AML/CFT regimes, most have only rudimentary AML/CFT measures in place or none at all**. Countries in this region face a number of challenges in instituting adequate AML/CFT regimes. These include, in many instances, the absence of basic legal and institutional frameworks, as well as inadequate financial, human, and technological resources to ensure effective compliance with AML requirements.

28. **Much of the TA provided focused on legislative drafting to help countries address vulnerabilities to money laundering and terrorist financing** (see Box 2). Other TA initiatives involved training criminal justice officials and helping national authorities develop AML/CFT strategies. TA has been delivered to countries bilaterally and regionally. Some regional assistance has been delivered to member countries of the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG) and to western African countries comprising the *Groupe Inter-gouvernemental d'Action contre le Blanchiment d'argent en Afrique Ouest* (GIABA).

In addition to the categories listed above, staff also assisted in the training of evaluators on the AML/CFT methodology for GIABA, and FIU and criminal justice officials on the implementation aspects of their AML/CFT frameworks. Training was also provided to financial sector supervisors in developing supervisory guidance and inspection manuals.

Due to difficulties in ESAAMLG's mutual evaluation process, some of its member countries delayed receiving TA pending the completion of their mutual evaluation reports. In an effort to support the region's mutual evaluation process, FATF has agreed to a proposal for a TA needs assessment of each ESAAMLG member country to be followed by the provision of assistance to meet the identified needs. FATF indicated that the proposal should not be seen as a substitute for a mutual evaluation program.

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Box 2. Highlights of TA in Africa

Designing Supervisory Tools for African Countries

Four countries in Southern and East Africa received focused training and support in developing their bank supervisory frameworks to specifically address AML/CFT risks. TA activities delivered within this framework focused on two main aspects: i) providing one-on-one guidance to and working together with supervisors in drafting risk-based AML/CFT inspection procedures for core activities, products, services, and operations identified as high risk; and ii) testing the adequacy of the newly-developed inspections procedures during limited-scope on-site reviews of selected financial institutions, within each country. In the latter, Fund staff and experts provided advice on the effective implementation of procedures. In total, inspection procedures for at least 10 financial activities were drafted/developed by country supervisors and six financial institutions were selected and received limited-scope on-site AML/CFT reviews by the supervisors who were subject to the training.

Workshop for Criminal Justice Officials

The Fund's Legal Department delivered a follow-up AML training workshop to criminal justice officials of Eastern and Southern African countries in Maputo, Mozambique, May 16–20, 2005. The workshop was attended by participants from Botswana, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Uganda, and Zambia. The workshop aimed at training prosecutors and other criminal justice officials in the practical aspects involved in investigating and prosecuting money laundering cases. The workshop also covered forfeiting the proceeds of crime and gathering evidence for these cases. Participants were asked to apply the theory learned in the early part of the week to a case study. The case study was from the region and involved the prosecution of money laundering and the forfeiture of the proceeds of crime. Participants were required to make various applications and presentations in a "mock hearing" before two judges, who were participants as well. The participants found the whole exercise extremely useful, especially the practical applicability for the cases they were handling.

TA Program for Portuguese-Speaking Countries

The Bank is currently leading a TA program, in cooperation with the Portuguese Ministry of Justice and FIRST Initiative, designed to disseminate and strengthen AML/CFT frameworks in six Portuguese-speaking countries. This project is in four phases (see below) and revolves around the organization of a workshop which was held in Lisbon in May 2005. Raising awareness of the link between stable and sound development and AML as well as the importance of inter-agency and international cooperation are key components of this program. This TA program represented a unique opportunity for the targeted countries to receive advice from AML/CFT experts from Brazil, Portugal, and international organizations on how to develop and enhance their AML/CFT regime, taking into account the new international standard. Each country will adopt action plans to address weaknesses in the AML/CFT framework.

Going forward

The Fund and Bank have various AML/CFT projects underway in Africa.

29. **Due to the rudimentary nature of the AML/CFT legal framework of a number of African countries, legislative drafting will continue to be an important aspect of TA delivery**. Efforts will also continue to train criminal justice officials, financial sector

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regulators, and to develop FIUs. Africa will continue to be an important region in the ongoing work on remittances.

30. **To deepen political commitment, outreach and awareness-raising will continue to be important components of the TA program.** Bilateral and regional workshops, the Global Dialogue Series, and the Capacity Enhancement Program will be important vehicles to accomplish this goal.

The Fund/Bank support the strategy, endorsed by FATF, of conducting TA needs assessments and are willing to participate in the process and thereafter to assist in providing targeted TA to ESAAMLG countries. The Fund/Bank will continue efforts to strengthen the operational capacity of ESAAMLG in Eastern and Southern Africa and assist GIABA in West Africa where possible.

In addition to the above new approaches, to aggressively address the specific needs of each country, efforts would be directed at (i) coordination of AML/CFT activities with the regional African technical assistance centers (East and West AFRITAC); (ii) recruiting peripatetic advisor(s) to provide intermittent assistance to a group of countries in the region; and iii) delivering additional awareness raising seminars to Parliamentarians and senior government officials to sensitize them about the importance of establishing sound and effective AML/CFT regimes in their countries.

Asia Pacific Region

TA Delivered

31. **TA has varied significantly in this region.** TA provided to the region has been divided between countries that are taking initial steps to establish AML/CFT regimes and others trying to deepen their AML/CFT frameworks. Some countries in the region received TA to develop the legal framework for AML/CFT and to establish effective FIUs. Other countries with more developed AML/CFT infrastructure received TA that was designed to strengthen capacity in their FIUs, criminal justice systems and financial sector regulatory regimes. At a regional level, capacity-building TA was also provided to train FIUs, criminal justice officials, and bank supervisors (see Box 3). Needs assessments missions focusing on the identification of gaps and developing priorities for these countries have been an important tool for devising TA for the region. Financial sector supervisors were trained in developing supervisory strategies and guidelines. In one instance assistance was provided in developing an MOU with a foreign supervisor. In addition, staff participated in two training workshops for assessors.

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Box 3. Highlights of TA in Asia Pacific

Legal Drafting in the Pacific

As part of the Pacific Project, LEG has been reviewing and strengthening countries' AML/CFT legal framework. Since end-2001, in one Pacific country, stemming from the commitment and efforts of the authorities and the work of two LEG missions in November 2002 and May 2003, and the LEG expert for the Pacific region between April and August 2004, the Financial Transactions Reporting Act 2004 was enacted in December 2004. Amendments proposed by LEG to the existing Proceeds of Crime Act 1997 and the Mutual Assistance in Criminal Matters Act 1997 have also been adopted in early 2005. These three Acts provide a substantial legal framework for the country.

Training of Financial Sector Supervisors

This program which was jointly hosted with the Asian Development Bank (ADB), focused on the development of supervisory guidelines and oversight for AML/CFT compliance (off-site monitoring and on-site inspection), and supervisory action against non-compliance. The seminar also invited experts from the private sector, including compliance officers for AML/CFT at banks as well as experts on internal and external audit functions for AML/CFT internal controls. Following the lectures by the experts, the participants, who were divided into six groups, worked on reviewing a mock internal control procedures of a bank (prepared by the Fund-ADB staff) and presented identified weaknesses. At the end of the seminar, the participants also worked on developing and presenting a strategy for each jurisdiction to enhance the AML/CFT supervisory regime.

Remittance Project in conjunction with the Asia-Pacific Economic Cooperation (APEC) Body

Since 2002, the Bank has been providing TA to countries in the region pursuant to the Asia-Pacific Economic Cooperation (APEC) Initiative on Remittance Systems.[1/] In May 2005, the Bank organized a Policy Dialogue on remittances in Bangkok, Thailand as a follow-up of the 2004 symposium.[2/] A CD-ROM including all the presentations at the policy dialogue will be published. The Bank is also preparing a final report to APEC Finance Ministers and Deputies in September 2005 in Jeju, Korea.[3/]

[1/] The initiative is co-chaired by Japan, Mexico, Singapore, Thailand, and the United States.
[2/] APEC Symposium on Alternative Remittance Systems (ARS): Shaping the Remittances Market by Shifting to Formal Systems, June 3–4, 2005, Tokyo, Japan.
[3/] The Bank prepared and presented two reports to the APEC Finance Ministers' Meeting (FMM) in 2003 and 2004. The report presented to the FMM in September is a final report of the APEC Initiative on Remittance Systems.

Going Forward

32. **TA efforts will continue to focus on individual country needs including legislative drafting assistance for those countries with no or weak AML/CFT laws, and capacity building of FIUs, criminal justice officials and financial sector supervisors.** To the extent that microfinance institutions become vulnerable to money laundering and terrorist financing, TA programs will be developed to help countries integrate this sector into the AML/CFT regime without unintended consequences on the access to finance by any segment of society. The Bank will continue implementing its Capacity Enhancement Program.

33. **The Bank and UNODC identified a mentor to be placed for the Indochina region to provide long-term TA to support countries' efforts to adopt and implement**

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AML/CFT. The mentor is expected to start his work in October 2005 for two years. He will assist in developing FIUs, training law enforcement and other agencies, and facilitating inter-agency and international cooperation. The mentor will work with national authorities in countries that are beginning to undertake AML/CFT initiatives.

More efforts are now being made to enhance collaboration and coordination among TA providers, including the TA donor and providers meetings held during the APG annual meetings.

Eastern and Central Europe

TA Delivered

34. **Regional projects included participation in MONEYVAL training and awareness-raising seminars and assisting MONEYVAL in the training of its evaluators in the use of the latest assessment methodology**. Delivery of a series of regional training workshops is ongoing at the Joint Vienna Institute and other venues, including training on drafting of legislation to counter terrorist financing and capacity building training of criminal justice officials in relation to implementation aspects of their AML/CFT legislation, as well as targeted AML/CFT training for financial sector supervisors and FIUs.

35. **At the individual country level, delivery of TA has included intensive needs assessments and assistance in the creation and strategic development of the basic framework for AML/CFT in a number of countries in the Balkan region and some CIS countries.** For countries with more developed systems, TA has been provided to address specific gaps, with the objective of improving the effectiveness of current arrangements. Increasingly, emphasis in the TA is being placed on strengthening FIUs, the role of nonbank financial institutions and designated nonfinancial businesses and professions and the training of criminal justice officials.

36. **In addition to drafting and reviewing AML/CFT laws and regulations, TA outputs have included strategy documents, action plans, and needs assessments.** Assistance has been provided to FIUs in planning and enhancing their organization, operations and structure, and in formalizing arrangements for information flow and inter-agency cooperation, both domestic and cross border. Assistance has been provided to financial regulators in the drafting of regulations and guidance notes for the financial sector, and in developing on-site inspection procedures for AML/CFT. A range of country-specific training and awareness-raising seminars have also been delivered (see Box 4).

Going Forward

37. **Continued strong demand for TA is anticipated across the region.** As some countries move closer to EU membership, their requests for TA may be increasingly addressed to EU agencies instead of the Bank/Fund. In the interim, however, there is considerable scope to assist countries in Central and Eastern Europe, particularly in the Balkan region. There are many providers of AML/CFT and related technical assistance

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currently active in Central and Eastern Europe. Coordination of our respective efforts will continue to be essential for efficient TA delivery.

Box 4. Highlights of TA in Eastern and Central Europe

Training on the implementation of the standard

In May 2005, LEG organized a workshop on implementation of AML/CFT standards for FIU and criminal justice officials of Bulgaria, Croatia, The Former Yugoslav Republic of Macedonia, Moldova and Romania. The topics discussed were practical issues related to implementation of AML/CFT provisions and in particular, the issues relating to financial investigations, collecting evidence by the police and prosecutors and bringing cases to court in ML/FT related prosecutions. Several concrete cases of ML and TF, from the experience of the represented countries, were presented.

Developing the AML/CFT framework in the Balkans

In one Balkan country, the Fund during 2004/05 gave assistance to: (1) redraft the current AML law (planned for consideration in parliament by end-2005); (2) plan the ongoing development of the financial intelligence unit; (3) redraft and develop AML/CFT regulations and guidance notes to help supervised financial institutions to comply with the AML law; (4) develop on-site inspection procedures for the central bank; and (5) deliver a package of seminars and other training to relevant institutions. As a result, and with appropriate political support, the country concerned should be in a position to achieve compliance with the main components of the international standard for AML/CFT during 2006, although achieving full implementation of effective measures will take longer and require ongoing international support.

Mentor for the region

The World Bank and UNODC are jointly sponsoring an AML/CFT mentor for two years to assist countries of Eastern Europe and Central Asia to develop robust AML/CFT regimes. The mentor is providing training to countries on AML/CFT, including assistance in legislative drafting and FIU development. The mentor is collaborating with the IMF on projects for the region.

Middle East, Central Asia, and Caucasus

TA Delivered

38. **A significant program of TA is being developed for the Caucasus region,** ranging from targeted TA to improve the effectiveness of measures in place in certain countries to assisting in the development of basic legal, institutional, and supervisory structures for AML/CFT in some CIS countries. Other Fund/Bank TA initiatives have included a workshop for bank supervisors, another on the regulation/oversight of non-profit organizations and alternative remittance systems, an awareness raising seminar for senior officials of the Middle East and North Africa FATF (MENAFATF), one of the new FSRBs in the region, and advice in designing a curriculum for a certification program for compliance officers (see Box 5). Staff has also participated in a small number of seminars/workshops hosted by regional organizations. Country-specific TA has involved three legislative drafting missions and one mission that addressed implementation issues related to the AML/CFT program as

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well as a number of workshops on drafting of AML/CFT laws and training of FIU and criminal justice officials.

39. **The World Bank and UNODC are jointly sponsoring an AML/CFT mentor in the Countries of Central Asia**. This mentor is coordinating closely with the Fund in all TA projects in Central Asia which have included a series of FIU workshops in all Central Asian countries. The Fund/Bank supported the U.A.E.'s Hawala conference series and also published a book of the proceedings of one recent conference: "Regulatory Frameworks for Hawala and Other Remittance Systems."

Box 5. Highlights of TA in the Middle East, Central Asia, and Caucasus

Legislative drafting in the MENAFATF region

A legal drafting mission worked with the authorities in one country in reviewing and strengthening a draft AML/CFT law. The country subsequently enacted the AML/CFT law several months after the mission, having amended the earlier draft law to incorporate some of the Fund's recommendations.

Needs Assessment for MENAFATF Member Countries

A major initiative was the development of a technical assistance needs assessment questionnaire for MENAFATF. The questionnaire was distributed by the secretariat and has already been completed by four of the fourteen member countries. The questionnaires will be utilized at a TA donor forum will coincide with a plenary meeting scheduled for the third quarter of 2005.

Comprehensive Program of Assistance

Following an AML/CFT assessment, in October 2003, a TA action plan was proposed to the assessed country by the Bank, comprised of two main components: building the FIU and a training program for the banking industry. Two phases were planned, one for the general framework, one for the implementation. Each concerning two modules. The first module was to help the existing board of the FIU to operate the unit, first by organizing the structure, the decision process, the profiles of the agents and the methods of analysis. The second one was devoted to raising awareness for managers and officers of the banks, with a "training the trainers" session for all. The program was built with the collaboration of France, which financed it on a priority governmental plan, and started in March 2005. The main results are the current legislative drafting and the progress made by the FIU.

Going Forward

40. **Given the limited AML/CFT infrastructure of the majority of the Middle East and Central Asia countries, TA needs are considerable.** The World Bank/UNODC mentor is dedicating substantial efforts to donor coordination in Central Asia as well as with EAG. In the near-term, legal drafting and capacity building including development of skills of financial sector regulators are anticipated to be priorities. Some AML/CFT work in Central Asia has been subject to postponements due to recent political unrest.

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The most important platform for the overall development of TA initiatives in the region will be continued support for the development of the two new FSRBs. However, since they are both at an early stage of formation, it will be some time before they are able to act as effective regional coordination mechanisms. A central component of the strategy for the region will be the assessor training which will assist these organizations in their preparations to undertake mutual evaluations. It will also be critical to continue the TA needs assessment initiatives to better understand country-specific TA needs. The EAG will be sharing its own TA needs assessments with donors in a conference in December 2005. An expansion of TA to the Middle East is expected in light of the important needs of the region. We expect that the regulation of the informal funds transfer and non-profit sectors will continue to be areas of specific focus in MCD regional TA initiatives.

Latin America and the Caribbean

TA Delivered

41. **After an initial high level of demand for assistance with respect to the banking sector in 2004, the demand for TA has shifted to new areas especially the insurance sector and FIUs.** The insurance sector has historically been slower in the implementation of AML/CFT standards and financial intelligence units, which have been recently created in many countries of the region, are in need of training and capacity enhancement (see Box 6). During the last year, there were two regional training seminars for insurance regulators on AML/CFT supervision (one for Latin America and one for the English speaking Caribbean). In addition, two country-specific TA missions were undertaken for insurance regulators (one in South America and one in the Caribbean) while another regional training workshop is being planned for the Caribbean later in 2005. With the cooperation of CFATF, a first of its kind training program for Trust and Company Service Provider (TCSP) regulators on the supervision for AML/CFT compliance was conducted. Legislative drafting and FIU related TA has been provided to several WHD countries, including a legislative drafting workshop on CFT for nine South American countries, and a seminar on AML/CFT for FIU and Criminal Justice Officials for 12 Central and South American countries.

Training of mutual evaluators in coordination with each of the two FSRBs of the region (CFATF and GAFISUD) continued; staff participated in four training sessions.

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Box 6. Highlights of TA in Latin America and the Caribbean

Workshop on CFT Legislative Drafting

In collaboration with the United Nations Office on Drugs and Crime (UNODC) and the Ministry of Foreign Affairs of Peru, the Legal Department, delivered a five-day regional legislative drafting workshop on CFT in Lima, Peru from March 1–5, 2004. The workshop was attended by 33 participants from 9 South American countries: Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Uruguay and Venezuela. Participants included prosecutors, investigators, banking supervisors and legal drafters. The workshop included presentations, discussions, and a significant amount of legislative drafting on the criminalization of the financing of terrorism; freezing, seizing, and confiscating terrorist assets; reporting suspicious transactions related to terrorist financing; international cooperation; informal remittance services; information required in wire transfers and treatment of non-profit organizations. The seminar's objective was to acquaint participants with the international legal requirements relating to the various components of a comprehensive CFT framework.

Training of Insurance Supervisors

In response to a request from a group of Caribbean countries a regional training program was conducted for insurance supervisors. This sector has historically been considered weak in the implementation of AML/CFT standards. The program focused on the development of risk-based AML/CFT supervision and controls under the new FATF standards. Topics covered at the workshop included cross-border supervision and cooperation, internal controls and fraud prevention, money laundering/terrorism techniques, and cases in the insurance sector, corporate governance and its supervision, risk management systems and controls, consolidated supervision, off-site and on-site inspections and financial analysis and reinsurance risk.

The workshop was supplemented by case studies, including an AML/CFT working group project that brought together the AML/CFT and prudential elements. It also included presentations from a leading regional insurance company. From participant feedback received so far, the workshop was considered a success and very practical for the work of the insurance supervisors.

Training for the Private Sector on Developing a Risk-Based Approach to AML/CFT

The World Bank launched in 2005 a TA program that is designed to deliver long-term TA that is tailored to the specific challenges of one country. This country's FIU, with the support of the World Bank, hosted a two-day conference for the local financial community to help it assess the risks of ML/TF sector by sector. AML/CFT experts from the country, the World Bank, and the United Kingdom spoke about the major crimes in the country that generate proceeds, the flow of funds in the country related to ML, the vulnerabilities of the remittance and banking and insurance sectors to ML/TF, and private sector approaches to building risk models to support AML/CFT. On the second day, involving more than 100 representatives from 12 financial sectors, representatives for each sector identified, categorized, and measured the risks of ML/TF that their sector encounters by focusing on the client base and business products/services. The long-term goals of the conference were to encourage financial institutions across the board to develop their own risk analysis, including risk models, related to AML/CFT and prompt the financial sector trade associations to develop best practices of their members over the medium term.

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Going Forward

42. **Many countries in the region still face significant weaknesses in the core sectors, (especially insurance and securities) due to capacity and institutional constraints both in terms of financial and human resources.** In others, the existence of significant offshore financial sectors, for instance, calls for enhanced attention, resources and TA for regulators of these sectors if weaknesses in the regime are to be addressed in a timely manner. The TA provided to the supervisors of the TCSPs is expected to generate further TA requests and, more importantly, result in the development of harmonized regional approaches to identification, control and supervision of ML/FT risk in the sector.

43. **Close cooperation with GAFISUD and CFATF is expected to continue, especially with regards to identification of priorities at a multi-country level.** A diagnostic exercise is currently underway by the GAFISUD Secretariat. Going forward, other areas that have been identified for TA in the near term are the casino and internet gaming industries and capacity building of criminal justice officials to effectively implement their laws. In coordination with CFATF, plans are already underway to organize a joint regional Caribbean and Central American training workshop for regulators of casinos as well as joint training for FIUs in the region. The expansion of the donor community to include countries in the region that are leaders on AML/CFT will be an important element of future TA initiatives.

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Box 7. List of FSRBs and Other Regional Bodies by Region

FSRBs

Africa
ESAAMLG: Botswana, Kenya, Lesotho, Malawi, Mozambique, Mauritius, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe.

Asia Pacific Region
APG: Australia, Bangladesh, Brunei Darussalam, Cambodia, Chinese Taipei, Cook Islands, Fiji Islands, Hong Kong, China; India, Indonesia, Japan, Republic of Korea (South Korea), Macau, China; Malaysia, The Marshall Islands, Mongolia, Nepal, New Zealand, Niue, Pakistan, Palau. The Philippines, Samoa, Singapore, Sri Lanka, Thailand, Tonga, United States of America, Vanuatu.

Middle East
MENAFATF: Algeria, Bahrain, Egypt, Jordan, Kuwait, Lebanon, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, the United Arab Emirates, and Yemen.

EAG (includes countries in Europe and Asia/Pacific): Kyrgyzstan, Kazakhstan, and Tajikistan are the MCD countries in the EAG. Non-MCD members are Russia, China, and Belarus.

Europe
MONEYVAL(includes countries in Caucasus: Albania, Andorra, Armenia, Azerbaijan, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Georgia, Hungary, Latvia, Liechtenstein, Lithuania, Moldova, Malta, Monaco, Poland, Romania, Russia, San Marino, Serbia and Montenegro, Slovakia, Slovenia, The former Yugoslav Republic of Macedonia, and Ukraine.

Latin America and Caribbean
CFATF: Anguilla, Antigua and Barbuda, Aruba, Bahamas, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Costa Rica, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Montserrat, Netherlands Antilles, Nicaragua, Panama, St Kitts and Nevis, St. Lucia, St Vincent and the Grenadines, Suriname, Trinidad and Tobago, Turks and Caicos Islands, and Venezuela.

GAFISUD: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, and Uruguay.

Other Regional Bodies
GIABA: Benin, Burkina Faso, Cape Verde, Cote d'Ivoire, Gambia, Ghana, Guinea Bissau, Guinea, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, and Togo.

GABAC: Cameroon, Congo Rep. of , Gabon, Equatorial Guinea, Central African Republic, and Chad.

OGBS: Aruba, Bahamas, Barbados, Bermuda, Cayman islands, Cyprus, Gibraltar, Guernsey, Hong Kong, China; Isle of Man, Jersey, Labuan, Macao SAR, China; Mauritius, Netherlands Antilles, Panama, Singapore, and Vanuatu.

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III. Implementing the Revised AML/CFT Standards: DNFBPs

44. **This section discusses the conceptual and implementation challenges posed by the extension of AML/CFT obligations to designated non-financial businesses and professions (DNFBPs)**[5] under the revised FATF 40 Recommendations and the adoption of the Special Recommendations on Terrorist Finance.

45. **The extension of AML/CFT obligations to DNFBPs was one of the key changes in the revised FATF 40.** This change had been under discussion for some time and was based on a significant body of case-studies and analytical work.[6] The European Union (EU) anticipated this change by placing DNFBPs under the Second Money Laundering Directive of 2001.

46. **There are significant implementation challenges facing the DNFBPs.** First, the scope and organization of DNFBPs differ greatly from those of the supervised financial institutions on which AML/CFT work has been focused to date. Secondly, few of these professions have much experience with AML/CFT obligations and some—lawyers in particular—have concerns about the compatibility of these requirements with their professional obligations. Finally, general supervisory regimes in these sectors, where they exist at all, differ greatly from those for financial institutions.

A. Characteristics and Practices

47. **The challenges in applying the FATF requirements to DNFBPs are most clearly evidenced by the wide range of activities permitted for DNFBPs across different countries.** For example, because of legal restrictions or conventional practice, in a number of countries it is unusual for lawyers to carry out financial transactions for or on behalf of clients. In other countries, lawyers are actively involved in a very broad range of financial activity. Similarly, in several countries notaries are a highly specialized and strictly governed private profession; in other countries they are public servants; in still other countries there is no such distinct profession. Likewise, the scope and responsibilities of auditors and accountants, and the extent of their regulation, varies considerably from country to country. In many countries, there is no distinct profession of trust and company service providers, but the constituent activities may be carried out by lawyers, auditors, accountants, notaries or other practitioners. Casino operations differ substantially across countries: some are authorized to provide a range of financial services (foreign exchange, credit, and payments transfers); some are not permitted to provide any financial services; and some countries do

[5] Lawyers, notaries, and other independent legal professionals; accountants; real estate agents, trust and company service providers, dealers in precious metals and stones, and casinos. The FATF Recommendations that apply to them are R 12, R 16, R 24, and R 25, many of which are incorporated by reference to the parallel customer identification, suspicious transaction reporting, record-keeping, training, and supervision requirements already applied to financial institutions in R 5, R 6, R 8, R 9, R 10, R 11, R 13, R 15, and R 21.

[6] FATF conducts such analytical and case-studies work under its "Typologies" process.

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not permit casinos at all. Real estate agents may be informally organized, very lightly regulated, and offer a range of related financial services, or they may be licensed only for a narrow brokerage function with collateral financial services provided by other professions or financial institutions.

48. **The variety of business practices for DNFBPs is mirrored in a wide range of existing regulatory regimes.** In some countries, the covered professions are subject to demanding qualifications and strict licensing. In others, entry into the professions is more flexible and subject to light regulation. Lawyers are typically governed by some form of self-regulation; auditors and accountants may or may not be subject to any regulation. In general, there is little organized regulation or oversight of real estate agents and even less of dealers in precious metals and stones. Where casinos are legal, they are always closely regulated and some are starting to apply AML/CFT requirements.

B. Implementing AML/CFT Obligations

49. Since the AML/CFT obligations were only relatively recently extended to DNFBPs, many countries are just beginning to introduce the necessary legal and regulatory framework. Staff found in the benchmarking work that even within the European Union, several countries have had difficulty in designing and implementing provisions that fit their circumstances and the requirements of the second EU directive.

50. **Countries assessed to date performed poorly on preventive measures for DNFBPs.** The analysis of DNFBPs is based on the preliminary findings of the first series of AML/CFT assessments that have been conducted using the 2004 Methodology with a view to identifying: (a) issues that have arisen in implementing the new regime for DNFBPs and, (b) issues encountered in carrying out assessments using the methodology. Specifically, the ratings for the DNFBPs as reflected in Recommendations 12, 16, and 24 point to clear weaknesses. For Recommendation 12, on extending customer due diligence procedures to DNFPBs, no country was rated either fully or largely compliant; 56 percent achieved a partially compliant rating, and 44 percent were non-compliant (see Section I). The situation was similar for Recommendation 16, suspicious activity reporting, where no countries were compliant, 11 percent were largely compliant, 44 percent partially compliant and 50 percent non-compliant. In the same fashion, the ratings regarding Recommendation 24, on general AML/CFT supervision of DNFBPs, show no compliant countries, 11 percent largely compliant, 28 percent partially, and 61 percent non-compliant.

51. **The strikingly diverse profiles of the different businesses and professions leads to a variety of specific issues in each sector.** Staff made more detailed observations on the basis of an in-depth examination of the preliminary drafts of a sub-set of nine country assessments, of which six were carried out by the IMF (Bahrain, Belarus, Greece, Hungary, Italy, and Panama); two were carried out by FATF (Belgium and Norway) and one by MONEYVAL (Slovenia). It should be noted that this sample is small and not very representative of a cross section of countries; most are high- to middle-income countries, except for Belarus. It is generally well established that such countries are better aware of the AML/CFT requirements and have taken more measures compared to low-income countries. In addition, as a prelude to formal assessments, during the summer of 2004, Fund Staff

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visited five major countries (United States, United Kingdom, Germany, Netherlands, and Switzerland) to benchmark progress in implementing the new FATF requirements. The results of that benchmarking exercise were very much in line with findings reported here.

Lawyers

52. **Extending AML/CFT obligations to lawyers has been controversial in many countries.** The requirement to report suspicious transactions, in particular, is viewed as encroaching on the tradition of lawyer-client privilege. In a few countries, law associations have been able to stall introduction of new regulations or have challenged them in court. It must be noted that FATF does recognize that exemptions to suspicious transaction reporting are applicable to lawyers, notaries, other independent legal professionals, and accountants when they are acting as independent legal professions, and "if the information was obtained in circumstances where they are subject to professional secrecy or legal professional privilege." Thus, under FATF, the obligation to report is confined to circumstances in which the professionals are acting "on behalf of or for a client, and engaging in a financial transaction in relation to" defined financial activities. Such activities may include buying and selling of real estate; managing of client money, securities or other assets; management of bank, savings or securities accounts; organization of contributions for the creation, operation or management of companies; creation, operation or management of legal persons; and arrangements, and buying and selling of business entities. The findings show that from country to country there is considerable variation in the recognition of the scope of legal professional privilege as well as wide differences in the understanding of "engaging in financial transaction on behalf or for a client." Generally, legal professional privilege covers information received from or obtained through a client: (a) in the course of ascertaining the legal position of their client; or (b) in the course of representing a client in judicial, administrative, arbitration or mediation proceedings.

53. **Of the nine countries reviewed, four have not yet extended AML/CFT preventive measures to lawyers.** Of the five that have introduced such requirements, three have followed the FATF approach of limiting the requirement to those circumstances in which the lawyers provide some form of financial services. The two other countries have included a much wider range of legal services within the scope of the obligation of lawyers, subject always to exemption for legal privilege.

54. **Most countries have not yet fully implemented effect compliance monitoring programs for lawyers.** Self regulation of lawyers by their professional associations is the norm in almost all countries. Binding codes of conduct are typical but these frequently do not cover AML/CFT, and relatively few law associations have a tradition of pro-active examination of members for compliance. In two jurisdictions, the FIU has been given authority to supervise lawyers for AML/CFT compliance but, to date, these powers have not been exercised. It is frequently unclear whether the law association or another agency has enforcement authority for non-compliance with preventive requirements. Only one country has provided guidance tailored to the specific circumstances of lawyers, while another considers that the lawyers' code of conduct is the relevant compliance guide. Countries have few to no reporting of suspicious transactions by lawyers. While the regime applicable to lawyers is relatively new, assessors generally reported that limited STR reporting is probably

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the result of uncertain obligations, insufficient training and awareness, and weak compliance monitoring and enforcement.

Notaries

55. **Among countries reviewed, four have extended AML/CFT obligations to notaries**, three have not, and two do not consider notaries to be a distinct profession. In European countries where notaries are a distinct profession, they are typically considered to perform a public or quasi-public function and are subject to strict professional qualification requirements. In these countries, notaries typically do not engage in financial transactions for or on behalf of clients. Also, arrangements for oversight and enforcement of professional standards are usually spelled out in law, regulation or professional codes, and are actively supervised either by an SRO or by the courts. While notaries are not always covered by AML/CFT obligations, many of the CDD, record keeping, and compliance requirements established in AML/CFT legislation are central to the day-to-day responsibilities of notaries. In the assessments to date, few issues have been encountered regarding AML/CFT compliance by notaries. Even so, relatively few STR reports have been filed by notaries.

Auditors and Accountants

56. **Of the nine countries reviewed, five have imposed AML/CFT obligation on auditors and accountants** and four have not. In two of the countries that do not cover auditors and accountants, the authorities assert that accountants and auditors do not normally engage in financial transactions for or on behalf of clients. In the other countries, about half have some restrictions on commercial/financial activities of auditors and accountants, the other half does not. In general, independent auditors who have the authority to certify financial statements are subject to more demanding professional qualifications and are subject to stricter regulation than are accountants. However, the necessary qualifications, the scope of responsibilities, and the form of regulation of accountants, in particular, vary considerably among countries. Auditors and accountants generally belong to separate SROs or professional organizations. Oversight of AML/CFT obligations of auditors and accountants is poorly developed in the five countries that have imposed preventive requirements. In three countries, oversight responsibility has been assigned to either the FIU or a government ministry, but no compliance monitoring has been initiated. In the two other countries, compliance monitoring has been assigned to SROs which have not yet organized themselves to take up this responsibility. Across all the countries assessed only a few STRs have been reported by auditors and accountants.

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Trust and Company Service Providers

57. **Of the countries reviewed only one has a distinct profession of trust and company service (TCS) provider.** No countries assessed have extended AML/CFT obligations to TCS providers. Some countries state that such services are provided by lawyers, accountants (which are covered by AML/CFT obligations where they have been introduced) or by other business service providers (who fall outside the DNFBP regime). Several countries do not recognize trust arrangements and consequently it appears that relatively little attention has been paid to the difficult CDD issues posed by such arrangements. The assessments undertaken to date have not delved deeply into issues related to TCS providers.

Real Estate Agents

58. **Of the countries reviewed, six have extended AML/CFT obligations to real estate agents.** While real estate agents are frequently registered or licensed, they generally do not have a tradition of professional regulation. Consequently there are no pre-existing bodies that could assume responsibility for oversight of compliance with AML/CFT obligations. Three countries have assigned formal oversight responsibility to either a ministry or to the FIU, but none have yet initiated active oversight for real estate agents. Assessments generally found that awareness of, and compliance with, AML/CFT obligations are relatively low among real estate agents and, across all countries, relatively few suspicious transactions have been filed by real estate agents.

Dealers in Precious Metals and Stones

59. **Of the countries reviewed, three have imposed AML/CFT obligations on dealers in high value goods**, four have imposed such obligations on a limited class of dealers in precious metals and stones (e.g., bullion, auction dealers, jewelers), and two have not yet addressed the topic. In several countries, AML/CFT obligations only apply for cash (or all) transactions above a minimum value, as allowed under the FATF recommendations. In some countries, authorities believe they satisfy FATF Recommendations by prohibiting cash payments in excess of certain amounts or have cash transaction reporting requirements above certain thresholds. Monitoring compliance with the AML/CFT requirements for high value goods dealers has proven to be a problem for all countries. In general, there are no pre-existing regulatory organizations with a capacity to take on AML/CFT oversight of these businesses. Some governments have assigned compliance monitoring to their FIU. While there is some spot checking, no countries have developed a systematic regime for overseeing compliance by dealers in high value goods.

Casinos

60. **Casino operations are authorized in seven of the nine countries reviewed**. AML/CFT requirements have been imposed in five of those countries. The scope of casino activity varies from country to country. Some countries have capped the number of authorized casinos; and/or limit activities to a few games; and/or restrict casino's scope for offering financial services (foreign exchange, credit, balance transfers), while others allow a

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wide range of games and financial services. Casinos are generally subject to oversight by a gaming commission and are subject to close regulation for tax or public policy purposes. Oversight generally addresses customer identification, record keeping and internal control requirements, even when these are not specifically required for AML/CFT purposes. AML/CFT compliance by casinos is actively supervised. However, suspicious transactions reporting by casinos is frequently based on reporting of winnings above a certain threshold and it is unclear whether casino controls adequately detect transactions that are truly suspicious.

C. Experiences with Assessments

61. **There has been a significant expansion of the number of distinct sectors requiring detailed assessment;** at least ten non-financial professions, business or activities in addition to the three prudentially regulated financial sectors (banking, securities, and insurance). In every country, each of the new areas has a distinct legal framework, regulatory environment and business practices. While the categories of preventive measures that are required (customer due diligence, record keeping, compliance programs, and suspicious transactions reporting) are the same as those for the prudentially regulated financial sectors, evaluating their effective implementation requires case by case review of arrangements in each sector. To illustrate, appropriate customer due diligence practices for lawyers, accountants, casinos, or dealers in high value goods can be considerably different based on the type of business conducted and whether the relationship with the client is ongoing or one-off. Similarly, the internal controls necessary for compliance with AML/CFT measures differ from sector to sector.

62. **A consensus on best practice for preventive AML/CFT measures has not yet emerged among the DNFBPs themselves or their respective supervisors**. Over the last decade, core principles of supervision have been carefully developed for each of the major prudentially regulated sectors. These principles provide clear benchmarks for evaluating whether institutions and supervisors are carrying out their responsibilities with respect to regulated activities, including for implementing AML/CFT requirements. There is no similar reference point for evaluating AML/CFT implementation by DNFBPs. Consequently, assessors must make independent judgments about the reasonableness and effectiveness of arrangements in each area reviewed, adding a greater degree of subjectivity to their findings.

63. **There is inconsistency among assessors when rating compliance because of the wide variety of regulatory frameworks and oversight mechanisms found in each of the different DNFBP areas.** Typically, each area is subject to its own unique regulatory regime; or it may be only superficially regulated. In most countries, regulation does not include the detailed operational rules and guidelines that are common in the prudentially regulated financial sectors and which are a feature of most AML/CFT regulations. Functional supervisors in these areas also do not have a tradition of close oversight and examination practices, in addition to having differing oversight and enforcement capacity from area to area within individual countries and across countries.

64. **In some reviewed countries, responsibilities for regulating, compliance monitoring, and sanctioning are dispersed.** It is not unusual for AML/CFT compliance

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monitoring to be exercised by an agency other than the functional regulator and for sanctioning authority to be assigned to a third body. Even where the compliance monitoring responsibility is clearly spelled out, in many countries the assigned supervisors do not have sufficient resources and/or adequate enforcement authority to ensure effective compliance with AML/CFT requirements.

65. **Assessors also need to have additional expertise and familiarity with the business practices and regulatory environment of DNFBPs.** The assessment experience indicates that some assessors are unfamiliar with the operational practices of casinos, the regulatory requirements of the relevant tax authorities, the self regulatory practices of lawyers, auditors, accountants and notaries, as well as their business practices. Thus, in several instances some areas have been lightly covered.

IV. Implementing the Revised AML/CFT Standard: Remittances

66. **This section discusses particular challenges of implementing AML/CFT obligations that apply to Remittance Service Providers (RSPs) and describes Fund/Bank work on remittances systems.** This work has focused on improving data and knowledge on remittance flows; reducing remittance costs; improving developmental impact; and regulating and supervising remittance systems.

67. **RSPs are not a separate category under the FATF revised Recommendations.** In many countries, the transfer of money or value is one of the functions performed by financial institutions and, therefore, the full range of AML/CFT obligations already apply to them. In some countries, RSPs also include any person or entity conducting this function as a business or a part of a business, and may be subject to specific regulations. However, for AML/CFT purposes FATF requires that such businesses be subject to Special Recommendation VI (SR VI). SR VI specifies that RSPs must be either registered or licensed and be subject to effective systems for monitoring and ensuring compliance. This calls for RSPs to be subject to customer identification, record keeping, suspicious transactions reporting, and ML/FT prevention policies.

68. **One of the main difficulties a country may face when introducing specific AML/CFT requirements for RSPs, is how to encourage informal funds transfer agents to be part of the regulatory framework.** RSPs that are not part of the regulatory framework may pose a particular risk of misuse for ML/FT; this risk differs from country-to-country. A majority of the clients of RSPs are migrant workers remitting funds back to their country of origin. Accordingly, effective regulation involves finding the appropriate balance for preventive measures that do not impede the flows of remittances nor drive remittance systems underground. These measures should also not limit competition among RSPs nor represent obstacles to deepening financial services for both senders and beneficiaries of such flows.

69. **Bank/Fund staff work has noted that come countries have a tendency to over-regulate.** Some country's regulations may also unintentionally favor certain RSPs. It is generally recommended that countries consult with RSPs before introducing regulations and conduct specific risk-based analysis on the potential for ML/FT abuse.

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A. Characteristics and Practices

70. **Remittance flows are an important source of funds for many developing countries.** Officially recorded remittance flows to developing countries are estimated to have reached $126 billion in 2004, registering an increase of 49 percent since 2001.[7] Much of this increase occurred in low-income countries, where remittances rose by 82 percent during the period from 2001 to 2004. Most of the $41 billion increase in remittances to developing countries from 2001 to 2004 was concentrated in South Asia ($17 billion), Latin America and the Caribbean ($13 billion), and, to a lesser extent, East Asia and the Pacific ($7 billion).[8]

71. **The increase in remittance flows have been particularly strong in China, India, Mexico, Pakistan, and the Philippines.** Even though most top recipient countries are large, remittances in many small developing countries (e.g., Lebanon, Lesotho, Tajikistan, and Tonga) are significant as a share of GDP or in per capita terms. In some cases, the increase in recorded flows may be explained, in part, by the implementation of more accurate recording mechanisms after the events of September 2001.[9]

72. **Workers' remittances have been recognized as a significant source of external funding for developing countries.** They are deemed to have counter cyclical effects in stabilizing household incomes during periods of economic distress.[10] Therefore, since remittances have tended to be more stable than private capital flows, by strengthening financial-sector infrastructure and facilitating international migration, countries could increase the development impact of remittance flows.[11] Studies in this area address questions like the effects of remittances on poverty, on financial development and, at a macro level, the impact of remittances on recipient countries.

B. Implementing AML/CFT Obligations

73. **Overall compliance with SR IV concerning remittance systems from assessments were mixed.** 35 percent of countries were assessed as compliant with another 24 percent

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[7] This estimate is based on the official recording of remittance flows for balance-of- payments statistics. Flows through unofficial channels, such as informal funds transfer systems, are likely to be under recorded.

[8] World Bank, Global Development Finance Report 2005.

[9] Central banks in Mexico and Guatemala have improved the recording of remittance flows in recent years coinciding with implementation of new AML/CFT legislation.

[10] IMF Staff Papers. Vol. 52, No.1, 2005. The authors confirmed the countercyclical effect of remittance flows based on aggregate data on remittances, but imply that remittances do not act like a source of capital for economic development.

[11] Dilip Ratha. 2003. "Workers' Remittances: An Important and Stable Source of External Development Finance." *Global Development Finance, Chapter 7.*

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found largely compliant, while 29 percent were partially compliant, and 12 percent were non-compliant. Among the Special Recommendations for CFT, the compliance with SR VI turned out the best. As in Section III a more detailed analysis of the same nine countries (see paragraph 51) was made which allowed the additional specific observations below.

74. **Of the nine countries reviewed, all have extended their AML/CFT regime to cover RSPs**. Where RSPs are affiliated with banks, AML compliance tends to track that of the parent organization. In three countries where independent RSPs are allowed to operate, compliance with AML requirements is not closely supervised. Post offices, which commonly provide remittance services, are generally subject to the AML/CFT requirements, but their compliance has not been closely evaluated in most assessments. This is in part attributed to the fact that the postal agency may be government owned and subject to supervision by a designated official body.

75. **As far as informal providers are concerned, all nine countries have a strict licensing regime in place that prohibits any money transfer activity outside the regulated framework**. Most of these countries believed that the presence of informal, unlicensed remittance businesses was not significant. However, only a few countries have made systematic efforts to verify that this is in fact the case.[12]

76. **Remittance sending and recipient countries have different approaches when introducing AML/CFT regulations for RSPs**. Sending countries are particularly concerned with risks associated with the financing of terrorism. Recipient countries, in many instances, are more concerned with maximizing the developmental impact of these flows, and thus the rationale behind regulating remittances (including AML/CFT preventive measures) for them is closely related to this factor.

C. Ongoing and Completed Work

77. **Protecting the integrity of remittance flows and maximizing their development impact has been identified as the main priorities of Bank/Fund work.** Staff have contributed to increasing the understanding of factors behind these flows, the main channels used in key remittance corridors, the role of the private sector in promoting remittance systems, the potential for abuse of the systems, and the AML/CFT framework needed to protect and monitor remittance systems. The work to date, in cooperation with other organizations and institutions, has focused on the reduction of the price of transfers, improvements in the efficiency of payment systems infrastructure; the study and development of regulations to protect the integrity of these flows; the analysis of their development impact; and the improvement of data collection.

[12] During the course of the DNFBP benchmarking exercise, Staff was also able to gather information on remittance issues, identify good practices for a supervisory framework and look into the effects of the regulations on the accessibility of migrants and other unbanked segments of society. The various countries visited have implemented either a registration or a licensing regime, consistent with FATF recommendations. The choice of regime usually reflects the characteristics of national financial systems as well as national approaches to financial regulation.

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Improving Data and Knowledge

78. **Bank staff have developed and tested methodologies to better understand and monitor the size and nature of bilateral flows**, the factors that influence flows, and the mechanisms through which flows move. The information gathered serves to better inform and guide policies to lower remittance transaction costs, enhance the developmental impact in the recipient countries, and minimize opportunities for abuse. Bilateral Remittance Corridor Analyses (BRCA) have already been conducted in seven remittance corridors. In some cases, the BRCA was done in partnership with donors and national government agencies. There are plans to provide TA to countries on how to conduct their own BRCA.[13]

79. **Bank/Fund work on statistical issues is part of broader initiatives to improve, over the longer term, the world-wide recording of remittances within the balance-of-payments framework**. Following calls from users for improvements in remittances statistics, including from the G8 Heads of State, G7 Finance Ministers requested the formation of an international working group to recommend measures to improve remittances statistics. The work on reviewing international concepts was assigned to a United Nations-led group of technical experts, which includes Fund and Bank staff. In consultation with an even wider cross-section of statistical compilers, this group developed recommendations on improved concepts and definitions.[14] These recommendations will be reflected in revised versions of the IMF Balance of Payments Manual, fifth edition and the 1993 System of National Accounts.

80. **Bank's Global Economic Prospects 2006 (GEP 2006) will focus on International Remittances and Migration.** The GEP 2006 will review key questions surrounding the size of remittances for developing countries. In addition to the size, channels, and major corridors of remittance flows, it will discuss their macroeconomic effects and government policy responses in the recipient countries.

[13] The Netherlands has expressed interest in conducting research on its remittances corridor with Surinam using the Bank's methodology.

[14] Papers of this group are available at its website http://unstats.un.org/unsd/tradeserv/reldocs.asp.

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Box 8. Bank's Activities on Remittances

The large remittance flows (estimated more than $150 billion in 2005) and its significant development impact present challenges to policy makers. Increasing remittances flows and demands for access to financial services among senders and receivers have created new transfer mechanisms and financial products for large volume of smaller transactions. Studies at the Bank aim to improve knowledge on these flows with a view to offer policy guidance to client countries.

Bank/CPSS Task Force for General Principles on International Remittance Systems

The Bank co-chaired with the Bank for International Settlements' Committee for Payment and Settlement Systems (CPSS) a Task Force to address the needs of international policy coordination for remittance payment systems. Main topics of their work include market environment, consumer protection and transparency, Market infrastructure, and public policy. The output from this Task Force will form a basis for the development and oversight of payment systems for remittances.

Remittances Corridors Analysis

The nature of the remittance senders and their incentives to use Formal Fund Transfer (FFT) systems shape remittance corridors between sender and recipient countries. Analysis of these corridors in different regions confirms that reliability, access to formal remittance mechanisms and cultural familiarity are key to promoting the use of FFT systems, while linking remittance transfers to financial products, which range from saving accounts to mortgages.* Also studies in Mexico, the Philippines, Guatemala, Pakistan, Ghana, Albania, have confirmed the positive effect that remittances have on poverty reduction. The Bank is also collaborating with the ADB Bank on a study of hindrances to the use of ATMs to lower costs of remitting in Central Asia, the Caucasus and Moldova.

International Working Group to improve remittance statistics

The Bank is chairing a multilateral effort, which includes the Fund and the UN statistics division, aimed at improving the reporting of remittance statistics, particularly in the framework of the Balance of Payments.

Surveys

Surveys covering all remittance stakeholders have been conducted. Central banks have been asked about the challenges they face to collect data on remittances. Characteristics of remittance senders and recipients among different migrant communities have been identified by household surveys. And finally, the private sector has responded to surveys on their business models, geographical coverage, size of flows, and costs.

CGAP work on remittances

In addressing AML/CFT compliance by service providers catering to low-income customer, CGAP undertook joint research with the Bank. CGAP has also conducted studies to estimate remittance flows, domestically and between South Africa and neighboring countries, and to characterize the nature of demand for money transfer services among poor migrants and recipients. Other studies include household and focus group surveys of domestic migrants from rural to urban areas, and financial service providers in both labor-importing and -exporting provinces in China and India. These studies identified the need for gradual implementation of new measures, adoption of risk-based approach to regulate and the use of exemptions for low-risk categories of transactions.

2006 Global Economic Prospects

Remittances size, determinants, development impact, and steps to reduce transactions costs will be drawn from Bank's work listed above and captured in the *Global Economic Prospects (GEP).* The GEP will outline measures to reduce remittance fees and strengthen the financial infrastructure by encouraging competition among RSPs, avoiding over-regulation, introducing new technologies, harmonizing payment systems and extending financial services for both remittance senders and recipients.

* Countries involved in this analysis are Canada, Germany, Guatemala, Indonesia, Italy, Mexico, Morocco, Nepal, Netherlands, Nigeria, Qatar, Saudi Arabia, Serbia, Surinam, United Kingdom, United States, and Vietnam.

Source: World Bank

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81. **The Bank's work on Global Economic Prospects 2006 (GEP 2006) will focus on International Remittances and Migration.** The GEP 2006 will review key questions surrounding the size of remittances for developing countries. In addition to the size, channels, and major corridors of remittance flows, it will discuss their macroeconomic effects and government policy responses in the recipient countries.

Improving Developmental Impact

82. **Preliminary lessons from staff work indicate differing levels of impact on development depending upon whether flows come through formal or informal channels.** Two main categories have been identified: 1) "Mature" corridors where the use of formal mechanisms are already in place, and 2) "Nascent" corridors where initial market conditions need to be fostered and cultivated for formal remittance mechanisms to thrive.

83. **Those corridors with a higher degree of maturity have experienced reduction in transfer cost**, improvement in the recording of remittance flows and better awareness of the potential to link remittance senders and recipients to other financial products. Greater use of formal channels is believed to reduce the risk of abuse of remittance systems for ML/FT. In both remittance-sending and remittance-receiving countries, improving access to financial services has been associated with a shift from informal to regulated systems, especially among lower income groups. Encouraging senders to channel a growing proportion of remittances through regulated RSPs has greater potential for increasing the access of both senders and recipients to other financial services, providing both additional income-earning opportunities and enhanced capacity to manage financial risks. However, this requires an increasing awareness on the part of senders and recipients to available formal options and the benefits of using them in order to maximize the developmental impact of remittances.

Reducing Remittance Cost

84. **A key factor in reducing remittance costs in bilateral corridors is generating market competition among RSPs.** There is evidence that the entry of diverse RSPs, such as banks, credit unions, money transfer operators and others into the remittance market often stimulates the discovery of more cost-effective ways of doing business and this ultimately drives down prices for the consumer. In the U.S.-Mexico corridor, for example, the steady decline in prices and reduction of business costs followed the increase in the variety of market competitors. The implementation of technology and efficient payment systems are also important factors in reducing cost.

85. **Providing basic financial infrastructure and allowing access to RSPs are important pre-requisites** for regulated providers to attract remitters away from informal systems. Access by non-bank RSPs to the payments systems infrastructure including sharing the benefits of real-time settlements could facilitate better liquidity management while contributing to lowering cost of remittances through formal channels.

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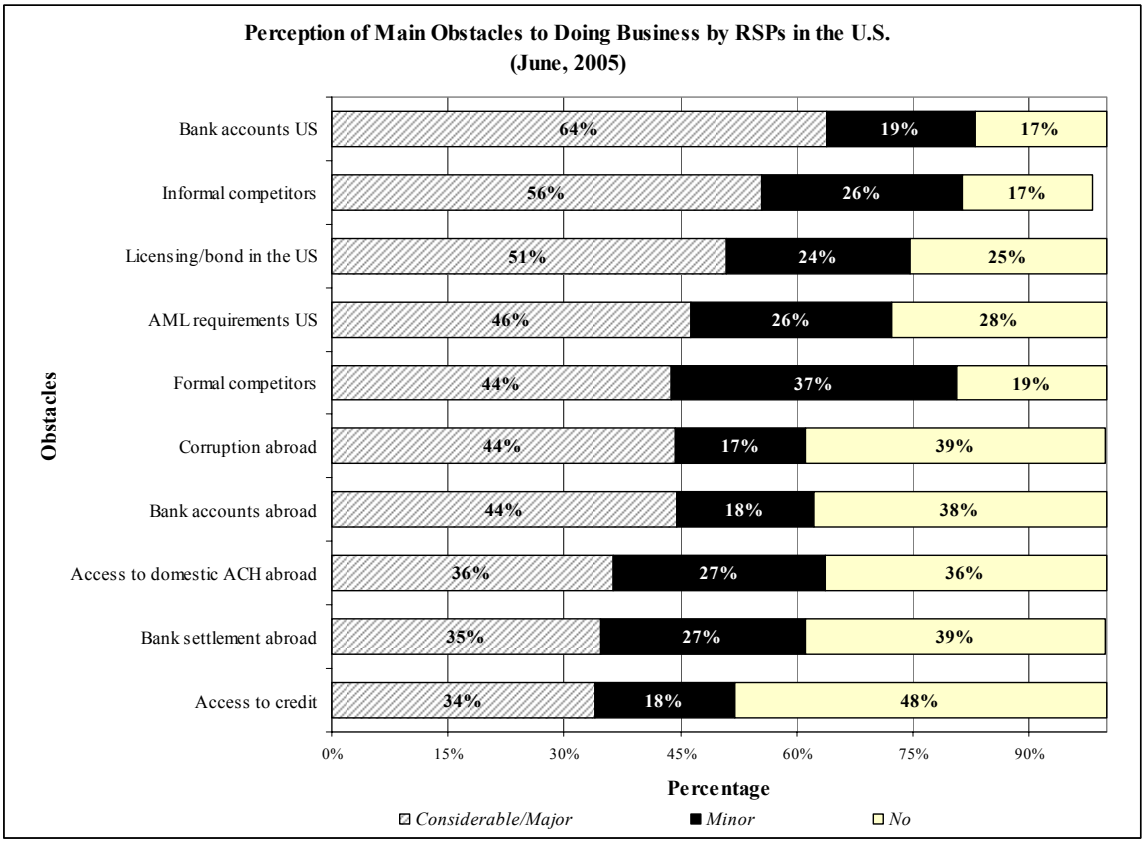
Box 9. Study of Remittance Service Providers in the United States

The Bank conducted a survey on remittance service providers (RSPs) in selected parts of the U.S. Findings from the survey describe how business environment is perceived by these RSPs. The following figure represents some of the obstacles to doing business listed by the surveyed RSPs. The four largest obstacles are related to their regulatory regime, either directly or indirectly.



Source: *World Bank. Andreassen, Ole. (forthcoming). "Remittance service providers in the United States."*

86. **Cooperation on payment systems is common in order to ensure the safety, efficiency, and transparency of the way payments are processed** and of the circuits which support remittance transactions. The leading international forum for policy development in this area is the Bank for International Settlements' Committee for Payment and Settlement Systems (CPSS). At the end of 2004, the World Bank and the CPSS convened a Task Force, with IMF involvement, to address the needs of international policy coordination for remittance systems, which is expected to issue *General Principles for International Remittance Systems* during the first half of 2006.[15] The output from this Task Force will form a basis for the development and oversight of remittance payment systems in the future and

[15] The Task Force includes central banks from sending and receiving countries, international financial institutions, and development banks.

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will address market environment, consumer protection and transparency, market infrastructure, and public policy for remittance systems.

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Regulating Remittance Systems

88. **In March 2005, Fund staff issued a paper presenting some lessons for implementing a regulatory framework for both the formal and informal remittance sectors** based on the experience of a sample of countries that have issued specific regulations to implement the FATF recommendations. The main points highlighted in the paper are that:

- Countries should consult the private sector before imposing a regulatory regime;
- Application procedures should be clear and simple, whether a country chooses registration or licensing;
- Owners and managers of a remittance provider should be identified and subject to the minimum requirement of a background check by the authorities;
- Remittance providers must have programs to guard against money laundering and terrorist financing;
- There should be onsite and offsite monitoring to ensure compliance; and
- Authorities should be able to impose sanctions.

In addition to these supervisory requirements, providers should also be required to comply with specific AML/CFT requirements, consisting of minimum customer identification, tailored record keeping and reporting of suspicious activity.

89. **Ensuring the integrity of flows is important both to enhance the income effect on growth and the safety of financial sectors.** It is possible that the introduction of new or intensified AML/CFT regulations could have the unintentional and undesirable consequence of reducing the access of the low-income group to formal financial services. Bank staff studies with CGAP recommends that this outcome could be minimized or avoided through

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gradual implementation of new measures; the adoption of a risk-based approach to regulation; and the use of exemptions for low-risk categories of transactions.

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91. **The Bank/Fund continue to provide support to increase awareness of remittances.** The Fund co-organized the Hawala Conference with the Central Bank of the U.A.E., and published the book "Regulatory Frameworks for Hawala and Other Remittance Systems." The Bank continued its support of the APEC Remittance Systems Initiative and organized a Second Policy Dialogue in Bangkok, Thailand in May 2005.

92. **Staff have been cooperating with the FATF, IFIs, and national agencies** through participation in working groups, outreach and technical assistance to address issues for strengthening the regulatory and supervisory aspects of remittance systems including AML/CFT issues. This work aims to raise the overall awareness of remittance systems and to protect the integrity of remittances flows for countries and providers from the risk of money laundering and terrorist financing and for consumers with respect to transparency of transfer costs. The technical assistance of the Fund concentrates on reviewing information on the size and major operational details of remittance providers and the vulnerabilities for misuse by criminals for money laundering and terrorist financing purposes.

V. Implementing the Revised AML/CFT Standard: Non-Profit Organizations

93. **This section discusses the conceptual and implementation challenges faced by the extension of AML/CFT obligations to non-profit organizations (NPOs)** under the revised FATF 40 Recommendations and the Special Recommendations on Terrorist Finance. Unlike the AML/CFT issues surrounding DNFBPs and remittance systems, the challenges for NPOs are of a different order of magnitude. Special Recommendation VIII (SR VIII), adopted in October 2001, requires countries to address the risk of terrorist financing through NPOs. Specifically, it calls for a review of the adequacy of existing legislation and for countries to ensure that NPOs cannot be abused. There is no explicit link to money-laundering in either the Recommendation or the assessment criteria, nor does the Recommendation specify what measures should be taken.[16]

[16] While there is no explicit AML component, it would appear in practice that many specific mechanisms for implementing CFT protections would also protect against ML.

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94. **FATF had little prior experience with the NPO sector,** and there have not been many case-studies nor analytical work predating the introduction of SR VIII.[17] FATF has not yet issued an Interpretative Note providing official guidance for assessors and authorities, but published a Best Practices Paper in October 2002.[18] The discussion of the NPO sector in this section is based on a review of assessments undertaken thus far and as in Section III (see paragraph 51), a more detailed analysis of the same nine countries was made contributing to additional specific observations in this section. Further, staff is undertaking broader studies of the NPO sector which includes a general survey and analysis of issues in the sector. The results of this staff study on NPOs will be the subject of a separate paper to be submitted to the Board at a later date which will examine the economic significance of NPOs worldwide and summarize global practice in NPO supervision.

A. Characteristics and Practices

95. **By any definition, the NPO sector worldwide is vast**, encompassing millions of entities with annual expenditures of over $1.3 trillion.[19] The structures that countries have put in place to oversee NPOs also vary widely. Depending on the country, NPOs may come under the scrutiny of specialized supervisors, tax authorities, public prosecutors, courts of registry, social welfare ministries, religious authorities or any combination of these or other bodies.

96. **Drawing on the analysis of other supervisory regimes, various institutional structures can be differentiated** on the basis of the kinds of registration that NPOs are subject to and the kind of licenses (broadly defined) that are granted.[20] This analysis can also provide the basis for understanding what elements need to be added to different kinds of existing regimes to strengthen their CFT components.

97. **The practice of registering NPOs is far from universal and the scope of registration varies.** In some countries, NPOs are considered to be a specialized form of legal person, subject to a variation on the registration requirements for a business entity. In others, registration is entirely voluntary. Even in the former cases, it is usually possible to form

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[17] The first typologies conference that addressed NPOs was in October, 2003; although, a few case studies were presented in the 2002 Best Practices Paper.

[18] In FATF practice, an Interpretative Note (IN) is an integral part of the standard and can be used to develop essential assessment criteria for rating a country. A Best Practices Paper (BPP) cannot be used as a basis for essential, only additional (voluntary) criteria. The BPP for non-profits, however, does provide some fairly detailed suggestions about how jurisdictions could approach the problem.

[19] Salamon, Lester; Solkolowski, S. Wojciech; *et al, Global Civil Society: Dimensions of the Nonprofit Sector*, (Kumarian Press: Bloomfield, CT, 2004), vol. 2, pp. 15–16. This study, sponsored by Johns Hopkins University, only covers 36 countries, so the real size of the global sector is larger.

[20] Registration involves authorities collecting and maintaining informational records about an entity. Licensing is granting an entity permission to perform an activity or receive a benefit and usually implies some level of government approbation.

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small associations without legal personality. Countries with established religions may register houses of worship, but others do not. In most registration regimes, some classes of NPOs are exempted a priori. The information that is included in registration files can also vary a great deal from country to country. Some require NPOs to present founding documents or charters which set out the purpose of the organization. Others require some form of financial statement. Still others only require basic name and address information. Of the countries reviewed, several have voluntary registration, a few countries require mandatory registration involving extensive financial and documentary information, and others report some form of universal registration with more limited information being provided.[21]

98. **The terminology of licensing is not customarily applied to government oversight of NPOs**, but the concept can be usefully applied to provide an analytical framework. There are generally two classes of rights that the state can grant to NPOs, both having to do with their financial operations. The first is the right to receive money directly or indirectly from the state. The second is the right to raise money from the citizens of the state. In return for one or another of these "licenses," the government can require more information from the entity, impose a fit-and-proper tests for its leadership, exercise some influence over program choices, and/or apply sanctions for abuses. However, such licenses tend to be voluntary and therefore license-based regimes can be evaded. An NPO that does not care for tax-exempt status does not have to seek it and many private foundations do not have to solicit funds from the public. However, they may still pose a risk for FT purposes.

99. **The most common form of public financing "license" is the granting of tax privileges.** Countries can, and the majority do, offer various forms of tax exemption to certain classes of NPOs and/or to their donors. In exchange for forgoing expected revenue, the tax authorities usually require information on the financial activity of the organization and can be granted a quasi-supervisory role vis-à-vis the NPO. Several assessed countries reported some form of tax privilege for some of their NPOs (although other countries did not convey any information about this aspect of NPO oversight). Another form of "license" is the right to receive grants or contracts from the state, which will often carry a higher level of scrutiny, especially in highly developed government procurement systems. Finally, some jurisdictions have set up quasi-governmental charities which perform social services and can use government channels for receiving donations.[22]

100. **A distinct form of "license" is the right to solicit donations from the public.** In return for this privilege, the authorities can impose anti-fraud (donor-protection) regimes. The most extensive of these require proof that donations are going for the purposes of specified activities. The authorities can also examine the NPO's books and replace

[21] Due to lack of consistency in the assessment process on this Recommendation, not all the reports convey clear information about country NPO regimes. These breakdowns are therefore tentative.

[22] The most prevalent type of such organizations is the government "Zakat" organization in certain jurisdictions where Islam is the established religion. However, variations on this model can be found elsewhere as well.

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management where they are performing unsatisfactorily. The regime can involve all the traditional tools of supervision such as on-site and off-site inspections. Such licenses can be granted, and the attendant supervision imposed at either the national or the sub-national level. However, very few countries assessed reported controls over the solicitation of funds, some countries even stated explicitly that controls were absent, while the rest were silent on this issue.

101. **In a number of countries, the NPO sector has some form of self-regulatory organizations (SRO)** which evaluate individual NPOs and bestow ratings (in some cases membership in an umbrella organization or a "seal of approval" is required). While SROs are not government agencies, the ratings or seals given serve to address the same anti-fraud, donor protection issues—often demanding a much higher level of transparency than does the applicable government regulatory body.

B. Implementing CFT Obligations

102. **Countering terrorism or the financing of terrorism was not a central part of any of the NPO oversight regimes prior to the adoption of SR VIII by FATF**. NPOs, like other natural and legal persons, are explicitly prohibited from supporting terrorism. In those countries which had anti-"extremism" legislation, NPOs could not be formed to support causes that were otherwise prohibited. However, these are not issues that attract the attention of most officials involved in NPO supervision and oversight. Rather, traditionally the focus has been on preventing the misuse of tax privileges or the defrauding of donors.

103. **Legal and regulatory frameworks do not appear to have changed significantly since 2001**. While awareness of terrorist-related risks among NPOs has been raised (particularly by high-profile asset-freezing actions in certain countries), few authorities have adopted new measures to address these issues.[23] Nonetheless, compliance with SR VIII was rated more favorably than for many other CFT special recommendations. 17 percent of countries were rated compliant, 17 percent largely compliant, 28 percent partially compliant and 39 percent non-compliant. With respect to the nine countries on which staff focused, only two had conducted the FATF-required review of the CFT vulnerabilities of their NPO regimes, and none had introduced any new or special measures to modify their existing regimes. However, while the Recommendation does not require the introduction of specific measures, many existing protections for NPOs focus on detecting fraud by founders or managers and on ensuring greater transparency of financial records and flows. These would

[23] In one country, the authorities have published a set of "voluntary best practices" and the tax authorities are preparing guidance for overseas grant-makers. These efforts have come under a great deal of criticism from the country's NPO sector. In addition, the country's bilateral donor agency has tightened the due diligence procedures it demands from its grantees and contractors to minimize the possibility of their funds ending up in the hands of terrorists. In another country, the NPO regulatory authority has, without having to issue new regulations, focused its considerable powers over domestically-based charities on the fight against FT. One new possibility that has been raised by FATF is whether NPO-specific indicators of suspicion could be developed and disseminated to guide financial institutions in their dealings with NPOs.

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provide a measure of protection against diversion of funds to support FT, which some assessors may have considered as a factor in their ratings.

C. Experiences with Assessments

104. **The absence of any concrete specific preventative measures for NPOs is the major challenge for assessors.** Conscientious assessors may have to examine a wide range of oversight practices to see if the overall environment achieves the objectives set in the standard. The extension of AML/CFT preventive measures to NPOs remains tentative, the regulatory framework weak or uncertain, and there have been few incidences or no filing of suspicious transactions reports.

VI. List of Bank/Fund AML/CFT Publications

Joint Publications

Paul Allan Schott, World Bank and International Monetary Fund, Second Edition 2004, *Reference Guide to Anti-Money Laundering and Combating the Financing of Terrorism* (Washington, DC: World Bank).

International Monetary Fund and The World Bank Group, 2004, *Financial Intelligence Unit: An Overview* (Washington, DC: International Monetary Fund).
World Bank and International Monetary Fund, 2004, *Combating Financial Abuse, Regional Videoconference: Middle East and North Africa Region—Egypt, Iran, Jordan, Lebanon, and Yemen,* Global Dialogue Series (Washington, DC: World Bank and International Monetary Fund).

IMF

International Monetary Fund, 2005, *Regulatory Frameworks for Hawala and Other Remittance Systems* (Washington, DC: International Monetary Fund).

International Monetary Fund, 2005, "Approaches to a Regulatory Framework for Formal and Informal Remittance Systems: Experiences and Lessons," (International Monetary Fund) www.imf.org/external/np/pp/eng/2005/021705.htm.

International Monetary Fund (forthcoming 2006), "Working Together – Regulatory Cooperation and Information Exchange" (Washington DC: International Monetary Fund)

Johnston, Barry and John Abbott, 2005 "Deterring the Abuse of the Financial System—Elements of an Emerging International Standard" (Policy Discussion Paper No—PDP 05/03 http://www.imf.org/external/pubs/ft/pdp/2005/pdp03.pdf).

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Thony, Jean-François, 2005, *Money Laundering and Terrorism Financing: An Overview* - Current Developments in Monetary and Financial Law, Vol. 3, pp. 241–264 (Washington, DC: International Monetary Fund).

Kyriakos-Saad, Nadim, 2005, *The Methodology for Assessing Compliance with Anti-Money Laundering and Combating the Financing of Terrorism Standards,* - Current Developments in Monetary and Financial Law, Vol. 3, pp. 265–278 (Washington, DC: International Monetary Fund).

Forget, Louis, 2005, *Combating Money Laundering and Terrorism Financing,* - Current Developments in Monetary and Financial Law, Vol. 3, pp. 279–300, (Washington, DC: International Monetary Fund).

World Bank

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Hernandez-Coss, Raul, World Bank, 2005, *The U.S.-Mexico Remittance Corridor: Lessons on Shifting from Informal to Formal Transfer Systems*, World Bank Working Paper No. 47 (Washington, DC: World Bank).

Hernandez-Coss, Raul, World Bank, 2005, *The Canada-Vietnam Remittance Corridor: Lessons on Shifting from Informal to Formal Transfer Systems*, World Bank Working Paper No. 48 (Washington, DC: World Bank).

World Bank and International Monetary Fund, 2005, *Capacity Enhancement Program on Anti-Money Laundering and Combating the Financing of Terrorism,* Seven Module Series (Washington, DC: World Bank).

World Bank, 2005, *The Second APEC Policy Dialogue: The Role of the Private Sector in Shifting from Informal to Formal Remittance Systems,* (World Bank) www.remittance-initiative.org.

World Bank, 2005, *APEC Symposium on Alternative Remittance Systems: Shaping the Remittances Market by Shifting to Formal Systems,* CD-ROM (Washington, DC: World Bank).

World Bank, 2005, *AML/CFT Regulation: Implications for Financial Service Providers that Serve Low-Income People* (Washington, DC: World Bank) http://www.cgap.org/docs/FocusNote_29.pdf .

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IMF Publication

Progress Report on Crisis Resolution

INTERNATIONAL MONETARY FUND

INTERNATIONAL MONETARY FUND

Progress Report on Crisis Resolution

September 21, 2005

Table of Contents Page

I. Introduction 2

II. Collective Action Clauses 2

III. Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets.....4

IV. Update of Recent Debt Restructuring Cases 5

V. Progress Under the Evian Approach and Other Paris Club Issues 11

VI. Assessing the Determinants and Prospects for the Pace of Market Access by Countries Emerging from Crisis.....13

Figures
1. Yields on Selected Recent Issues of US Dollar Bonds with CACs.....16
2. Emerging Market Outstanding Sovereign Issuance by Governing Law 17

Boxes
1. Dominican Republic: Financial Terms and Legal Features of the Debt Exchange.....8
2. The Paris Club's Framework for Early Debt Repayment.....12

Appendix Tables
1. Emerging Markets Sovereign Bond Issuance by Jurisdiction 15
2. Emerging Market Sovereign Bonds Outstanding Issuance by Governing Law 15
3. Emerging Markets Sovereign Bonds—Outstanding Issuances by Region and Governing Law, 2002 and 2005.....18
4. Collective Action Clauses: G-10 Recommendations and Bonds Issued under New York Law Since March 2005 19
5. Selected Countries: Debt Indicators, 1999-2004 20
6. Argentina: New Bonds Issued, by Currency and Governing Law.....21

I. INTRODUCTION

1. **In its recent Communiqué, the International Monetary and Financial Committee (IMFC) considered progress on crisis resolution initiatives**.[1] It welcomed the increased inclusion of collective action clauses (CACs) in international sovereign bonds, and called on the Fund to continue to promote progress in this area. It also noted the "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets" (henceforth, the "Principles") developed by a number of sovereign issuers and the investor community, and encouraged further efforts to improve the Principles aimed at achieving a broad consensus. The IMFC looked forward to further work on the orderly resolution of financial crises, including the implementation of the Fund's lending into arrears (LIA) policy.

2. **A number of countries have continued the process of restructuring their sovereign debt and several have secured agreements with their private creditors**. This has occurred, in some cases, as part of a comprehensive debt restructuring strategy following earlier agreements with the Paris Club to reschedule official debt. In a separate development, a number of countries have prepaid portions of their Paris Club debt under the Club's new framework for early repayments.

3. **The Executive Board considered a staff paper on issues related to the orderly resolution of financial crises**. The paper assessed the determinants and prospects for the pace of market access by countries emerging from crisis.[2]

4. **This report focuses on these crisis resolution issues**. Section II describes progress in the inclusion of CACs in international sovereign bonds. Section III provides an update of efforts to broaden the consensus on the Principles. Section IV reports on developments in recent sovereign debt restructuring cases. Section V discusses progress in the Evian Approach and other Paris Club issues. Section VI provides a summary of the aforementioned paper on the determinants and prospects for regaining market access.

II. COLLECTIVE ACTION CLAUSES

5. **Since the last progress report in March 2005, with one exception, all newly issued international sovereign bonds have included CACs that are broadly in line with the G-10 recommendations**.[3] As to New York law-governed issues, this reflects the newly

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[1] *Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund*, Washington, 4/16/05, http://www.imf.org/external/np/cm/2005/041605.htm.

[2] See *Assessing the Determinants and Prospects for the Pace of Market Access by Countries Emerging from Crisis—Further Considerations,* http://www.imf.org/external/np/pp/eng/2005/030105a.htm.

[3] See *Review of G-10 Working Group on Contractual Clauses,* 9/26/02, www.bis.org/publ/gten08.htm; and *Collective Action Clauses—Recent Developments and Issues*, 3/25/03, http://www.imf.org/external/np/psi/2003/032503.htm, and the associated Public Information Notice, http://www.imf.org/external/np/sec/pn/2003/pn0353.htm.

established market practice of including CACs in bonds in that jurisdiction.[4] The only country that did not include CACs in its New York law-governed bond was Jamaica. International sovereign bonds governed by English and Japanese laws have continued the existing practice of including such provisions (Appendix, Table 1).[5] There were no issues under German law.[6] To date, the inclusion of CACs has not had any observable impact on bond pricing (Appendix, Figure 1).

6. **As a result, the outstanding stock of emerging market sovereign bonds that include CACs has increased** from approximately 31 percent at end-2002, in value terms, to approximately 53 percent as of end-June 2005(Appendix, Table 2 and Figure 2). Importantly, recent sovereign debt exchanges have replaced a large volume of bonds that did not include CACs with bonds that included these clauses. Correspondingly, this increase reflected a rather even pattern of growth of bonds with CACs across regions (Appendix, Table 3).

7. **Staff has continued to take a proactive role in promoting the inclusion of CACs in international sovereign bonds**. In particular, staff continues to maintain an active dialogue with private market participants and debt managers from a number of emerging market countries, including through the Forum for Public Debt Managers, and to encourage the use of CACs both in the context of the use of Fund resources and the Fund's surveillance activities.

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[4] Fourteen countries issued bonds under New York law including CACs: Argentina, Brazil, Colombia, the Dominican Republic, El Salvador, Indonesia, Italy, Lebanon, Mexico, Peru, the Philippines, Turkey, Uruguay, and Venezuela. The Lebanon bonds include only majority restructuring provisions. See Appendix Table 4 for a detailed description of CACs contained in New York law-governed bonds issued since March 2005, and a comparison of these provisions with the G-10 recommendations.

[5] Seven countries issued bonds under English law: Austria, the Czech Republic, Hungary, Poland, Spain, Sweden, and Tunisia; and three countries issued under Japanese law: Hungary, Poland, and Thailand. Hungary continued to include an engagement clause in its English law governed bonds which allows bondholders with at least 50 percent of outstanding principal to appoint "any persons as a committee to represent the interests" of bondholders in the event of a default or acceleration or following any public announcement by the issuer of a restructuring.

[6] Bonds governed by German law have not included CACs. Legal questions have been raised as to whether the inclusion of CACs in international sovereign bonds governed by German law could be voided by individual bondholders based on consumer protection law. Notably, on June 28, 2005, the German Supreme Court substantially resolved this question in holding that commercial bonds are not subject to certain consumer protection provisions in the German Civil Code. Following the general elections scheduled for September 2005, legislation is expected to be adopted, which will, inter alia, codify the legality of the inclusion of CACs in bonds and set out the limitations for their application (e.g. in terms of required minimum majorities).

III. Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets[7]

8. **Efforts have been made by the Institute of International Finance (IIF) to broaden the consensus on the Principles among emerging market issuers and private sector creditors**. Staff from the IIF has conducted briefings in major financial centers aimed at advancing awareness and developing a better understanding of the Principles. The IIF reports that about 30 countries have expressed support for the Principles. In addition, senior private sector leaders are exchanging views on how best to effectively integrate the Principles within firms' day-to-day practices.

9. **Discussions among emerging market issuers and private sector creditors on a process for implementing the Principles are unfolding**. The IIF has proposed a three-tier process for monitoring implementation of the Principles, which remains the subject of discussion among stakeholders, including emerging market issuers and private sector participants. Fund staff has not been involved in these discussions.

- The implementation process envisaged by the IIF would have four main functions: (i) to identify circumstances where early course correction in specific cases could prevent crises from unfolding; (ii) to offer guidance for the restructuring process in cases where debt restructuring is needed; (iii) to evaluate the overall effectiveness of the Principles, including whether the right balance has been achieved between providing sufficient guidance and allowing flexibility; and (iv) to ensure the continued relevance of the Principles in light of changing characteristics of international capital and credit markets.

- The three tiers suggested by the IIF include:

  - *Technical Work (Tier One)*. An analysis of the Principles' implementation by key emerging market issuers and creditors would be undertaken, based on the IIF's ongoing work on emerging market countries. This is envisaged to involve close consultation with the marketplace and, in selected circumstances, country authorities. Trends in international capital markets as they pertain to the Principles will also be examined.

  - *Principles Consultative Group (PCG) (Tier Two)*. Based on the technical work undertaken in Tier 1, the PCG—comprised of emerging market officials and market participants—would consider specific country circumstances with a view to providing suggestions to authorities and creditors on how better to align their policies and/or actions with the expectations set out in the Principles. The PCG would also review general market trends to help advise the Trustees (see below) whether the Principles remain relevant or require amendment. All parties involved in the discussions would adhere to a code of conduct to ensure confidentiality.

[7] The section is based on information provided by the Institute for International Finance. The Principles can be found at http://www.iif.com/data/public/principles-final_0305.pdf.

- *Group of Trustees (Tier Three)*. The Group of Trustees—comprising senior officials and senior representatives of the financial industry—would provide overall guidance on the implementation of the Principles, with the aim of ensuring the legitimacy and objectivity of the review process. The Trustee Group's role would include reviewing development of the Principles, including their implementation, and modifying the Principles, if needed. It is anticipated that the Trustees would not be involved in specific cases except in exceptional circumstances. Individual countries or market participants could consider seeking the guidance of the Trustees individually or as a group on a confidential basis.

10. **Staff will continue to monitor developments in broadening the consensus on the Principles and in their implementation, and will report on these issues as more concrete details emerge**.

IV. Update of Recent Debt Restructuring Cases

11. **Since March 2005, progress has continued in a number of sovereign debt restructuring cases.** More generally, countries seeking debt restructurings have also put in place supporting macroeconomic and structural reform policies. This section provides an update of these cases (see Appendix, Table 5 for selected debt indicators for these countries).

Argentina

12. **Argentina concluded its global debt exchange on June 10, 2005, after some delays related to court proceedings in New York.** Settlement of the debt exchange, initially scheduled for April 1, was delayed due to attempts by some nonparticipating creditors to attach bonds tendered in the exchange. However, following the appeals court's affirmation of the lower court's decision to vacate the initial attachment orders, settlement of the debt exchange was finally initiated on June 2, and completed on June 10.[8]

13. **In settling the debt exchange, the authorities issued US$35.2 billion in new bonds,** comprising US$15 billion of par bonds, US$11.9 billion of discount bonds and US$8.3 billion of quasi par bonds. Upon settlement, eleven new bonds were issued—the par and discount bonds are denominated in pesos, U.S. dollars (under both Argentine and New York laws), euros, and yen, and the quasi par bonds are denominated only in pesos (Appendix, Table 6). Each new bond has GDP-linked securities attached to it that will be eligible to trade independently after November 29, 2005.[9] The new bonds, other than those governed by Argentine law, were issued under a trust structure and include CACs with an

[8] The US Court of Appeals for the Second Circuit held on May 13, 2005 that the lower court "acted within its discretionary authority to vacate the remedies in order to avoid a substantial risk to the successful conclusion of the debt restructuring. That restructuring is obviously of critical importance to the economic health of a nation. We conclude that it is unnecessary to rule definitively on any of the legal issues disputed by the parties."

[9] A "when-and-if market" for the GDP-linked securities has emerged where forward trades can be made and delivered after November 29. Trading prices in this market indicate a value for the GDP-linked securities ranging from 2.5 cents to 4 cents (per dollar of nominal value).

aggregate voting feature. Two of the three major credit rating agencies raised Argentina's long-term foreign currency issuer rating to the lowest "B" category in June, and applied this rating to the newly issued bonds. On June 30, JP Morgan rebalanced its family of EMBI indices to include the new U.S. dollar par and discount bonds (governed by New York law) while dropping all of the defaulted bonds from the indices. As a result of the rebalancing, spreads on Argentina's external debt fell immediately from over 6000 basis points to 462 basis points.

14. **Argentina's debt exchange constitutes an important step toward normalizing relations with creditors, and has facilitated domestic market reaccess.** With 76 percent participation in the exchange, Argentina's debt structure and debt-service profile have improved significantly.[10] In early May, the authorities regained domestic market access for the first time since mid-2001 with the issuance of a AR$1 billion (about US$347 million) peso-denominated inflation-indexed bond maturing in 2014. This was followed by two other domestic market placements of AR$1 billion each of the same bond in early July, and two domestic issuances of a dollar-denominated bond maturing in 2012 in late July (US$442 million) and early August (US$350 million).[11] Demand for the domestic issues was supported by abundant liquidity in local and international markets, and regulatory changes allowing both local banks and pension funds to increase their exposure to government securities.

15. **Notwithstanding the debt restructuring, there are still unresolved principal claims amounting to almost US$20 billion**. The April 2005 IMFC Communiqué called on Argentina to formulate a forward-looking strategy to resolve the remaining arrears to private creditors consistent with the Fund's LIA policy.

The Dominican Republic

16. **The Dominican Republic embarked on an economic adjustment program supported by a Stand-By Arrangement in early 2005.** The financing strategy of the program aimed at eliminating the residual financing needs during 2005–06 through a debt exchange offer encompassing non-Brady foreign-currency denominated bonds, a rescheduling of external private banks loans and suppliers' credits, credit from Venezuela to finance oil imports, and support from the IDB and the World Bank. The successful completion of the private debt restructurings was also a means to fulfill the Dominican Republic's commitment to seek comparable treatment from private creditors as called for in its April 2004 agreement with the Paris Club. The Dominican Republic launched its debt

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[10] The federal debt stock has declined from about 147 percent of GDP in 2002 to an estimated 84 percent of GDP in 2005 (including unrestructured debt). About 37 percent of the federal government debt stock is denominated in pesos, a sizable increase from 3 percent before the restructuring. At the same time, payment on the restructured debt for the first ten years entails about 3 percent of GDP in savings compared to before the restructuring.

[11] The domestic bonds were issued at a discount so that total net financing raised amounted to US$1.5 billion, about US$283 million less than indicated by the aggregate face value of the bonds. Separately, Argentina has also directly placed some US$500 million of the Boden 2012 with the Venezuelan government.

exchange offer on April 20, 2005, stipulating that two bonds were eligible for the exchange (see Box 1 for a summary of the key terms of the offer).[12]

17. **The Dominican Republic maintained a market-friendly approach to the debt restructuring.** The authorities sought to involve bondholders through an informal consultation process on the terms of the exchange offer. They held road shows in New York and London in late 2004, while conducting meetings with key investors at the same time and immediately prior to the launch. In this context, market participants considered as the main incentive to participate in the offer the potential upside on the new bonds resulting from the improvement in the country's capacity to pay and the reduction in the rollover risk. They also viewed favorably the minimal initial net present value (NPV) losses, amounting to only one percent when discounted at the implicit exit yield of 10 percent, that would result from accepting the offer.

18. **The debt exchange was completed on May 11, 2005, with high participation**. The tendering principal reached US$1.03 billion, representing nearly 94 percent of eligible bonds, and exceeding the minimum participation threshold of 85 percent. The offer was reopened in July with a view to achieving further cash-flow relief. An additional US$36.5 million of principal was tendered, representing 52 percent of the bonds that had not entered the original exchange, and as a result, the overall participation rate increased to 97 percent. The offer provided significant cash-flow relief of US$576 million for the government during 2005–06, and resulted in an increase in the maturity profile of the debt by five years. Spreads on the new bonds have declined by over 130 basis points since mid-May, clearly outperforming the overall market.

19. **In June, the Dominican Republic also reached an agreement with commercial banks to reschedule about US$200 million in principal falling due in 2005–06**. The agreement established (i) a two-year grace period and a three-year repayment period; (ii) a reduction in the average interest rate of the restructured loans of around 2 percentage points; and (iii) the repayment of about US$35 million in arrears accumulated through end-2004.

20. **In August, an agreement was reached for the government to buy back the debt owed by the nationalized electricity distribution companies to Union Fenosa, a foreign electricity and gas company**. The authorities have not yet executed the buyback.

[12] The US$500 million, 9.5 percent Global bond 2006 and the US$600 million, 9.04 percent Global bond 2013 were eligible for the exchange. Two Brady Bonds (US$408 million in remaining principal) and one private placement domestic currency denominated bond (US$200 million in principal at the then current exchange rate) were excluded.

Box 1. Dominican Republic: Financial Terms and Legal Features of the Debt Exchange

Financial terms

- The offer involved a five-year maturity extension, where the Global bond due in 2006 could be exchanged for a new Global bond due in 2011, and the Global bond due in 2013 could be exchanged for a new Global bond due in 2018.
- The new bonds included an amortizing structure with ten equal semi-annual principal installments beginning in 2007 and 2013 for the Global bond 2011 and Global bond 2018, respectively (the existing bonds were bullet-style bonds).
- No principal or interest haircut was involved; but remaining interest payments in 2005, and half of interest payments due in 2006, were capitalized.

Legal features

- To reduce the incentives for non-participation, the offer utilized exit consents to amend the old bonds to limit the ability of holders of these bonds to attach payments on the new bonds and to eliminate the cross-default and cross-acceleration clauses and the negative pledge covenant.
- The new bonds include CACs with an aggregate voting feature and are issued under a trust indenture (the old bonds had a fiscal agency structure) which would make future litigation by bondholders more difficult.
- To encourage participation, the Dominican Republic set a nonbinding minimum participation threshold of 85 percent (which could be waived at the sole discretion of the Dominican Republic).

Antigua and Barbuda

21. **After taking office in March 2004, the newly elected government initiated a dialogue with several key creditors with a view to regularizing creditor relations**—most loans have been in arrears for many years. A major step included an agreement with the Italian government to clear US$196 million debt (one-third of external debt) through a bullet payment of US$18.5 million, thus providing about US$177.5 million of debt stock reduction. Antigua and Barbuda's debt renegotiations continue to take place outside the framework of a Fund-supported program. The authorities are in the process of hiring debt advisors.

Belize

22. **Belize announced on May 26, 2005 that it would put in place measures to attain a sustainable fiscal and external position, and, in this context, seek a restructuring of its debts.** These measures would aim to: (i) maintain the exchange rate peg; (ii) achieve fiscal sustainability; and (iii) stabilize the country's public debt. To this end, the authorities indicated their intention to undertake a debt restructuring to ease pressures on debt-service payments. In the wake of the debt-restructuring announcement, Standard & Poor's lowered Belize's long-term foreign currency rating from CCC to CCC-, while maintaining a negative outlook.

23. **Prompted by the downgrade, Belize clarified its debt management strategy in a subsequent statement issued on June 3**. The statement stressed that the debt restructuring would involve neither unilateral action, nor a request for a reduction of principal or interest. Rather, the authorities would seek an extension of commercial debt maturities. In addition, contacts with creditors would take place only after fiscal adjustment measures had been put in place. The authorities indicated their commitment to seeking a flexible debt restructuring, aimed at balancing the short- and long-term needs of the country with those of its external creditors. Finally, they noted that funds would be set aside to meet obligations falling due during the remainder of 2005. The authorities are now in the process of hiring financial advisors.

Dominica

24. **In April 2004, Dominica launched its debt exchange, aimed at preemptively restructuring its sovereign debt and achieving long-term debt sustainability**. As of end-May 2005, official and private creditors holding over 72 percent of debt to be restructured had participated in the restructuring. The authorities have been in contact with remaining creditors and they also are making payments in line with the terms of the restructuring into escrow accounts for these creditors.

Grenada

25. **Following their announcement in December 2004 to seek a comprehensive debt restructuring, the Grenadian authorities have worked toward towards this objective in the context of a regular dialogue with their creditors**. With the assistance of financial and legal advisors, the authorities have followed a market friendly process. There has been a regular dialogue with creditors, including with a creditor committee composed mainly of regional banks that hold a large proportion of the debt. Grenada has also been in contact with its official bilateral creditors. However, the process is complicated by the fact that Grenada no longer has diplomatic relations with its largest bilateral creditor, Taiwan Province of China. Moreover, some Paris Club creditors have expressed a preference for a restructuring in the context of a Fund-supported program.

26. **On September 9, the Grenadian authorities launched an exchange offer to restructure the country's commercial debt.**[13] Holders of eligible claims, amounting to US$275 million including past due interest, can exchange these for two new bonds, one in U.S. dollars and the other in Eastern Caribbean (E.C.) dollars, with maturities falling due during 2021–2025. The interest rate on the new bonds will be 0.85 percent for the first thee years, and will step up gradually to 8 percent after 10 years. The offer does not involve a principal reduction nor upfront cash payments. The new U.S. dollar bonds will be governed by New York law and use a trust structure, while the new E.C. dollar bonds will be governed by Grenadian law and use a fiscal agency structure. The new bonds contain collective action

[13] The exchange covers 85 percent of Grenada's domestic and external commercial debt and about 30 percent of government-guaranteed debt—in all, 50 percent of the total stock of debt. Treasury bills will not be restructured.

clauses. The closing date for creditors to accept the offer is October 7, 2005 and the authorities have set a minimum participation threshold of 85 percent for the exchange to be concluded. The Fund provided an assessment letter to accompany the offer.

27. **A successful exchange offer will provide substantial cash flow relief over the coming years and reduce external vulnerability.** In the event that full participation is achieved, Grenada's commercial debt service payments would be reduced by over 90 percent over the next three years and by 80 percent over the following five years. The offer represents an NPV "haircut" of 45–50 percent for exit yields in the 9–10 percent range.

Iraq

28. **Following the agreement in November 2004 with Paris Club creditors, Iraq began to take steps to settle claims with private creditors**. To this end, Iraq retained legal and financial advisors for the private debt restructuring, and appointed an accounting firm to assist with the debt reconciliation process.[14] The total amount of commercial claims (principal and imputed late interest) is estimated by the authorities to be around US$20 billion (out of an estimated total debt of US$125 billion).[15] Iraq's commercial debt is held by a broad range of creditors, including suppliers, trading firms, banks, and other financial institutions.

29. **The Iraqi authorities invited those creditors who had submitted claims to meet with them in Dubai on May 4, 2005**. In the meeting, the authorities stated their intention to base any offer to settle private creditor claims on the requirement of comparability of treatment set forth in the November 2004 agreement with the Paris Club, and the principle of equal treatment for all creditors. Following the meeting in Dubai, Iraq's financial advisors met with various creditors to explain Iraq's objectives in settling the claims of the private sector. A group of seven banks that claims the support of 60 financial institutions organized a London Club Coordinating Group to represent the interests of these creditors. This group has urged the authorities to negotiate a settlement with private creditors, and presented its own debt restructuring offer to the authorities in July. Other creditor groups have also been formed to represent the interests of suppliers and trading firms.

30. **On July 26, 2005, Iraq announced an offer to settle private claims, and reopened the claims registration process until August 8, 2005**. Negotiations did not take place with creditors prior to this announcement. The proposed offer is based on Iraq's interpretation of the comparability of treatment clause under the Paris Club agreement, and includes options for both "large" (i.e., those with individual aggregate claims greater than US$35 million) and "small" (i.e., those with individual aggregate claims less than US$35 million) claimants. A first option for large claimants is to enter into a syndicated loan which replicates the cash

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[14] Iraq's Debt Reconciliation Office set up a website (http://www.eyidro.com) which provided information on the reconciliation procedure, and a vehicle for private creditors to submit their claims. The deadline for submission of commercial claims was April 15, 2005.

[15] These estimated claims include both principal and imputed past due interest, calculated using a uniform interest rate. Under this methodology, past due interest represents about 54 percent of the total claims.

flows agreed with the Paris Club, including a cancellation of 80 percent of the total claims in three installments, with the residual 20 percent to be repaid over a 23-year period with six years of principal grace at an interest rate of Libor plus 50 basis points.[16] A second option is for large claimants to exchange claims for a bond with somewhat different cash flows than the loan, but identical value in net present value terms.[17] On the basis of Iraq's valuation, using a commercial discount rate of about 11.5 percent, these debt-for-debt options would confer a "haircut" of 90 percent in net present value terms. Applying a lower discount rate typical of official creditors would imply a lesser net present value "haircut". In addition, the offer entails a cash buyback proposal which would be available only to small claimants. To maintain comparability across the different options, the creditors would receive 10.25 cents for each dollar of their claims.

31. **On August 8, Iraq launched an initial tender for the cash buyback of US$750 million of eligible claims.** The period for submitting tenders closed on September 9, with the exchange to be settled on September 22. Preliminary results show that holders of about 78 percent of the eligible claims accepted the offer, while holders of about 20 percent postponed a decision until all of their claims were reconciled. Holders of about 2 percent of the eligible claims rejected the offer or failed to respond. Further cash buyback tenders will occur during the course of 2005 and 2006 as claims are reconciled. The authorities announced that the debt-for-debt exchange would be launched following Fund approval of a Stand-By Arrangement.

Serbia and Montenegro

32. **Following several years of negotiations, Serbia and Montenegro reached agreement in July 2004 with its London Club creditors to restructure its commercial bank debt.** The terms are comparable to those provided by the Paris Club in 2001. After a write-down of about 62 percent, the remaining debt is to be converted into bonds. The debt conversion process, which began with the listing of bonds at the Luxembourg stock exchange in April 2005, has been completed for 95 percent of the debt. The process is expected to be completed by end-October 2005.

V. Progress Under the Evian Approach and Other Paris Club Issues

33. **Since March 2005, no debt treatments under the Evian approach have been completed.[18]** In April, Paris Club creditors concluded that Gabon's debt position was

[16] The offer indicates that (i) the loan matures in January 2028; (ii) principal amortizations on a semiannual basis begin in July 2011; (iii) interest accruing through end 2007 is capitalized, while interest accruing during 2008–10 is partially capitalized; and (iv) the loan can be denominated in dollars, yen, and euros.

[17] The offer states that (i) the bond matures in 2028; (ii) principal amortizations on a semiannual basis begin in July 2020; (iii) the coupon on the bond is set at 50 basis points over LIBOR or fixed at an equivalent rate; and (iv) the bond is denominated in dollars. The bond would be privately placed.

[18] Additional information on the Evian Approach and other Paris Club issues is available on the Paris Club's website, http://www.clubdeparis.org/en/presentation/presentation.php?BATCH=B06WP14.

sustainable and thus did not warrant the provision of additional debt relief under the "goodwill clause" included in its 2004 Agreed Minute.

34. **In June, Paris Club creditors agreed in principle to provide a comprehensive debt treatment to Nigeria.** Nigeria has expressed interest in using exceptional oil revenues to finance an exit treatment from the Paris Club and in regularizing its relations with international financial institutions. Paris Club creditors expressed their willingness to provide debt reduction up to Naples terms on eligible debt, and to participate in a buyback of the remaining debt at a market-related discount. Consistent with the Evian Approach, the debt treatment would be phased and would aim at providing a definitive solution to Nigeria's debt problems. It would be contingent on the full clearance of Nigeria's arrears to the Paris Club, and the approval of a Policy Support Instrument by the Fund.

35. **The Paris Club has made public its framework for debt buybacks, and three countries have offered to make early repayments** (Box 2). Following Poland's offer in February to buy back of all of its outstanding Paris Club debt, Russia, in May, offered to repay over a third of its Paris Club debt, and Peru, in June, offered to retire about half of its outstanding debt stock.

Box 2. The Paris Club's Framework for Early Debt Repayment

Favorable global liquidity conditions and low international interest rates are providing opportunities for debtors to refinance high, fixed-interest-rate obligations at a lower cost. Against this background, Paris Club creditors defined a common framework for early repayment operations, based on the following principles:

- Early repayment is not a substitute for a debt treatment and should only be considered by debtors with a good payment record and a sustainable financial situation.
- To foster inter-creditor solidarity, the principle and terms of repayment operations must be agreed by the Club as a whole and the offer presented to all creditors under similar terms. Participation remains voluntary, however.
- Early repayment may cover all or only a portion of outstanding Paris Club claims.
- Repayment can be either at par, or at a price reflecting the net present value of the remaining cash flows on the basis of a common market-based discount rate (e.g., spreads on sovereign bonds of similar duration). Thus, in principle, the buyback price may be lower or higher than par.

The framework was made public in a June 2005 meeting of the Paris Club with the private sector. Three early repayment operations have thus far been announced, all of which involved pre-payments at par. In only one case (Poland) did the debtor offer to repay all of its obligations to the Paris Club.

Table. Prepayments of Paris Club Debt
(In billions of US dollars)

	Date of agreement	Total Paris Club debt	Debt eligible for prepayment
Poland	February 2005	14.0	14.0
Russia	May 2005	40.0	15.0
Peru	June 2005	4.2	2.0

VI. Assessing the Determinants and Prospects for the Pace of Market Access by Countries Emerging from Crisis[19]

36. **In a follow-up to the Fund's work on issues of crisis prevention and resolution, in May 2005, the Executive Board discussed the determinants and prospects for the pace of market access by countries emerging from a crisis**. Directors welcomed the opportunity to revisit the issue following the return to international capital markets by some countries that had restructured their debt and the increased attention to market reaccess issues in both the public and private sectors. It was noted that the issue of market reaccess is highly relevant to the Fund—especially in the context of crisis prevention and resolution, including the exceptional access framework. Staff's findings were considered to hold important lessons regarding the steps that countries emerging from a crisis need to take in order to reaccess international capital markets, in particular, the need to build and sustain credibility in the country's policies.

37. **The circumstances underpinning the loss of market access are a key determinant of how and when a country regains market access,** including adverse developments in international capital markets and the deterioration of domestic macroeconomic conditions. Countries that lose access because of adverse market developments normally regain access quickly if there is only a minor decline in investors' risk appetite which does not affect the assessment of the country's creditworthiness, while significant declines in investors' risk appetite imply countries will take considerably longer to regain market access.

38. **The length of time taken to regain markets access varies when the loss of access reflects policy slippages or severe market turbulence that give rise to concerns about the country's ability to service its debt**. In these cases, no country has regained access without committing to policy adjustments. Experience has shown that when conditions in international capital markets are favorable, market reaccess takes anywhere from several months to approximately a year and a half. The timing of reaccess depends heavily on the strength of the corrective policies the country implements which should improve the country's ability to repay its obligations and set the debt dynamics on a credible sustainable course.

39. **Countries that undertook a debt restructuring regained market access only after demonstrating a commitment to strong corrective policies**. The timing of the reaccess again depends on the nature of the external environment and the success of the policy efforts. In recent years, countries that have restructured their bonds have taken anywhere from 18 months to five or more years to restore external market access, or four months to four years after completion of the debt restructuring. In this respect, Fund policy advice and the Fund's financial assistance, including precautionary arrangements to countries during the crisis period before access is regained, can play an active role in helping countries regain market access.

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[19] See *Assessing the Determinants and Prospects for the Pace of Market Access by Countries Emerging from Crisis—Further Considerations,* http://www.imf.org/external/np/pp/eng/2005/030105a.htm.

40. **Countries seeking to reaccess capital markets should put in place a strong communication strategy to explain to investors the nature and the objective of the corrective policies, including the expected results**. Data and other information need to be made available on a timely basis particularly on the early results of the adjustment effort. This would allow investors to manage better the information risk associated with a country emerging from a crisis, and to reassess the risk-return tradeoff of possibly increasing their holdings of a country's debt. Countries would benefit from an open two-way dialogue with investors to get feedback regarding the success of the efforts to strengthen their creditworthiness.

41. **Countries need to give careful attention to the characteristics of the "reaccess bond" and should evaluate the selection of the target investors, as well as size and maturity of the bond**. While fixed-coupon, bullet-payment bonds are most common because they are easy to price which promotes liquidity, smaller countries which are relatively infrequent issuers could consider amortizing structures that could facilitate the management of certain risks, including rollover risk.

42. **Directors supported continued work by staff to develop an analytic framework to evaluate factors affecting market reaccess**. They looked forward to an analysis of the effects of Fund support and its signaling role on market reaccess and the implications for Fund work.

Table 1. Emerging Markets Sovereign Bond Issuance by Jurisdiction 1/

	2003				2004				2005 5/	
	Q1	Q2 3/	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2 4/
With CACs 1/										
Number of issues	9	31	10	5	25	19	19	15	18	39
Of which: NY law	1	22	5	4	14	12	12	13	11	23
	(In billions of U.S. dollars)									
Value of issues	5.6	18.0	6.4	4.3	18.5	15.9	10.7	9.1	22.3	35.1
Of which: NY law	1.0	12.8	3.6	4.0	10.6	9.5	6.5	7.7	11.1	20.2
Without CACs 2/										
Number of issues	14	4	7	7	2	1	1	4	0	1
	(In billions of U.S. dollars)									
Value of issues	8.1	2.5	3.5	4.2	1.5	0.1	0.2	2.7	0.0	0.3

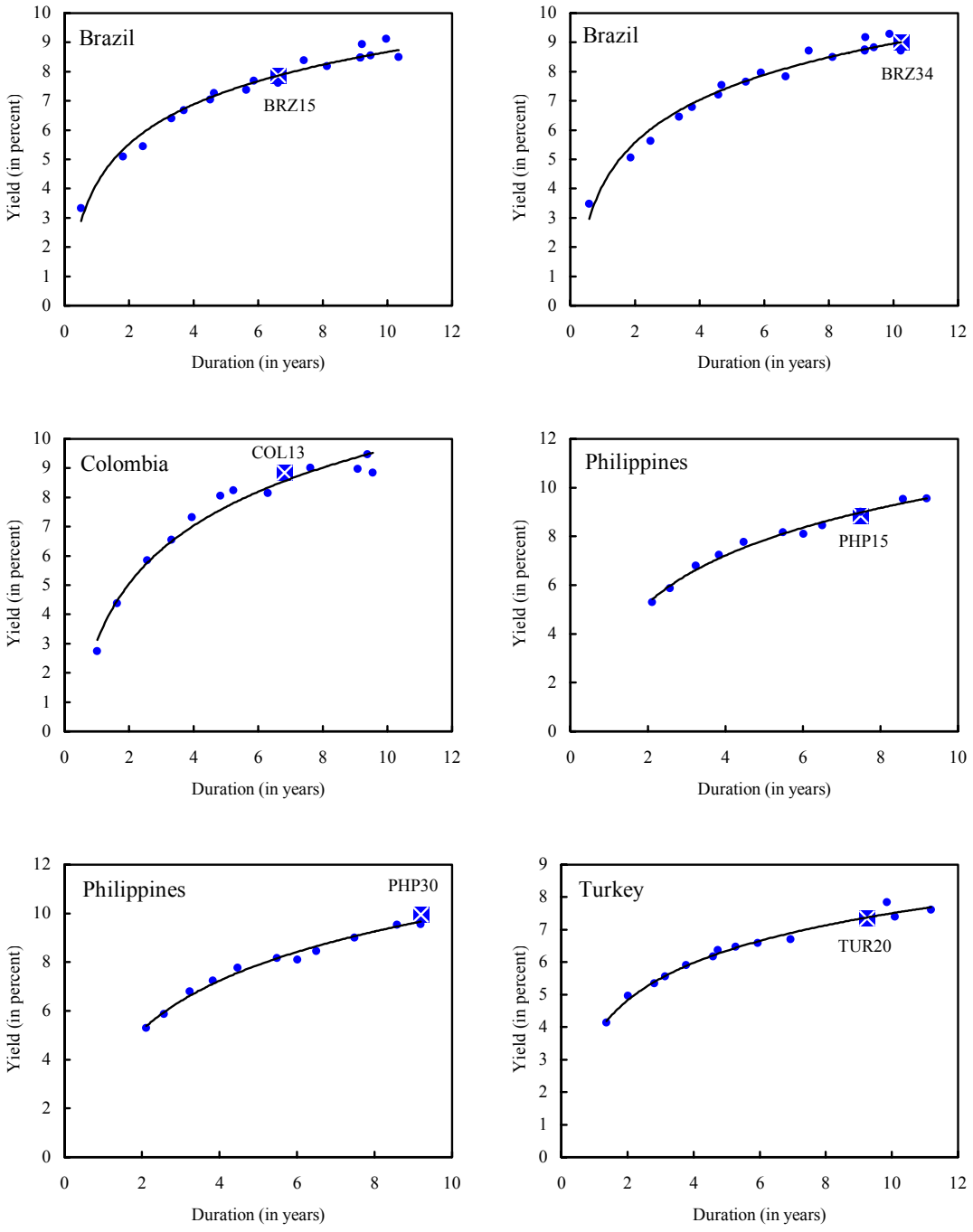
Source: Dealogic.
1/ English and Japanese laws, and New York law where relevant.
2/ German and New York laws (includes reopenings of previously issued bonds without CACs).
3/ Includes bonds issued by Uruguay in the debt exchange.
4/ Includes bonds issued by Argentina and The Dominican Republic in their respective debt exchanges.
5/ Data as of June 30, 2005.

Table 2. Emerging Market Sovereign Bonds Outstanding Issuance by Governing Law

	Number of Issues		Value of Issues	
	(In number)	(In percent)	(In billions of U.S. dollars)	(In percent)
New York	435	62	264	63
English	182	26	120	29
German	45	6	20	5
Japanese	41	6	12	3
Total	703	100	416	100
Of which: with CACs	338	48	220	53

Sources: Dealogic; Bloomberg; and IMF staff calculations (as of June 30, 2005).

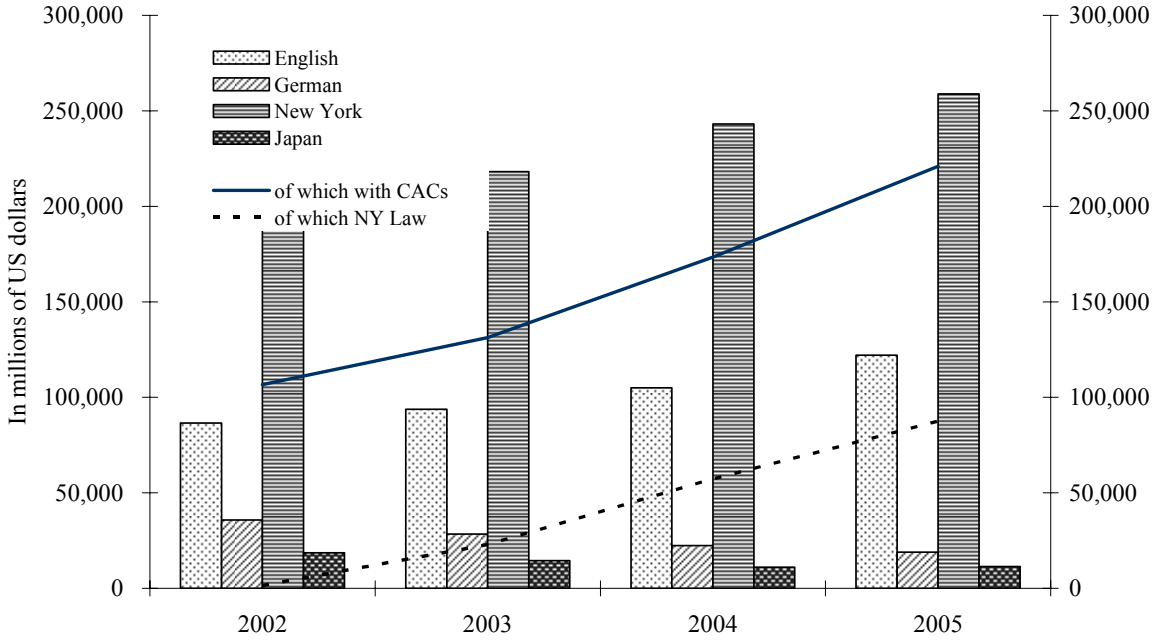
Figure 1. Yields on Selected Recent Issues of U.S. Dollar Bonds with Collective Action Clauses 1/



Sources: Capital Data and Merrill Lynch.

1/ As of date of issuance.

Figure 2. Emerging Market Outstanding Sovereign Issuance by Governing Law



Source: Dealogic; Bloomberg and Fund staff calculations.

Table 3. Emerging Markets Sovereign Bonds—Outstanding Issuances by Region and Governing Law, 2002 and 2005 1/

	2002		2005	
	In billions of US dollars	In percent	In billions of US dollars	In percent
Africa				
Total outstanding issuances	10.0	100.0	12.4	100.0
Total with CACs	4.2	42.5	7.6	61.3
New York	4.3	42.7	6.8	55.0
Of which: with CACs	...	...	2.4	19.5
English	2.0	20.4	3.6	29.1
German	0.3	3.1	...	...
Japanese	2.2	22.1	1.6	12.7
Asia				
Total outstanding issuances	29.8	100.0	43.9	100.0
Total with CACs	8.9	30.0	18.4	41.8
New York	19.0	63.7	30.6	69.8
Of which: with CACs	...	...	8.0	18.1
English	6.4	21.3	8.2	18.6
German	0.7	2.5	0.7	1.7
Japanese	2.6	8.6	2.2	5.1
Eastern Europe				
Total outstanding issuances	74.8	100.0	107.7	100.0
Total with CACs	45.0	60.2	86.0	79.9
New York	14.5	19.3	26.0	24.2
Of which: with CACs	...	...	10.9	10.1
English	39.7	53.1	70.2	65.2
German	14.8	19.8	6.3	5.8
Japanese	5.3	7.1	4.9	4.6
Latin America				
Total outstanding issuances	146.9	100.0	172.0	100.0
Total with CACs	30.6	20.8	68.2	39.7
New York	90.7	61.8	133.4	77.5
Of which: with CACs	...	...	49.5	28.8
English	22.3	15.2	15.7	9.1
German	19.9	13.6	12.2	7.1
Japanese	8.3	5.7	3.0	1.8
Middle East				
Total outstanding issuances	16.2	100.0	20.7	100.0
Total with CACs	8.8	54.6	13.2	63.5
New York	12.5	77.2	16.0	77.0
Of which: with CACs	5.2	31.8	8.6	41.7
English	3.5	21.7	4.3	21.0
German	...	...	...	...
Japanese	0.2	1.1	0.2	0.9

Sources: Dealogic; Bloomberg; and Fund staff calculations.

1/ End of period, data for 2005 are for July.

Table 4. Collective Action Clauses:
G-10 Recommendations and Bonds Issued under New York Law Since March 2005

Provisions	G-10 Recommendations	Argentina, Brazil, Colombia, Dominican Republic, El Salvador, Indonesia, Italy, Lebanon, Mexico, Peru, Philippines, Turkey, Uruguay, and Venezuela
Amendment of Key Terms	75 percent threshold based on either outstanding principal or principal held by those present at a duly convened meeting.	75 percent based on outstanding principal (except the Lebanon bond, where the threshold is based on duly convened meeting).
Aggregate Voting	None.	Argentina, Dominican Republic, and Uruguay: 85 percent of the aggregate outstanding principal of all affected series (taken in aggregate) and 66⅔ percent of outstanding principal of each affected series (taken individually).
Disenfranchise-ment	Bonds owned or controlled directly or indirectly by the issuer or its public sector instrumentalities.	Generally bonds owned directly or indirectly by the issuer or its public sector instrumentalities.
Acceleration	25 percent of outstanding principal.	25 percent of outstanding principal (except the Lebanon bond, where each bondholder has the right to accelerate upon default).
De-acceleration	Between 50 and 66⅔ percent of outstanding principal.	• Argentina, Colombia, Dominican Republic, Indonesia, Mexico, Peru, Philippines and Venezuela: 50 percent of outstanding principal. • Uruguay: 66 percent of the outstanding principal. • Brazil, El Salvador, Italy and Turkey: 66⅔ percent of outstanding principal • Lebanon: none.
Initiation of Proceedings	• Mandate the use of a trust or an equivalent legal structure where the trustee can be instructed by 25 percent to initiate lawsuits. • Pro rata distribution of recovered proceeds under trust structure.	Individual bondholder, except the Argentina, Dominican Republic, Indonesia and Uruguay bonds where the trustee has a limited monopoly over initiation of proceedings whose recovery would be distributed pro rata.
Engagement Provision	• Appoint a bondholder representative for the life of the bond. • 66⅔ percent to appoint at any time any person to represent all holders in negotiation with the issuer or other creditors.	None.
Information Provision	A covenant requiring the issuer to provide certain types of information over the life of the bond and following a default.	None.
Documentation	Trust or an equivalent legal structure.	Fiscal agency agreement, except Argentina, Dominican Republic, Indonesia, and Uruguay which utilized a trust structure.

Table 5. Selected Countries: Debt Indicators, 1999-2004 1/

	1999	2000	2001	2002	2003	2004
Antigua and Barbuda						
Gross public sector debt as a share of GDP	117.2	125.4	123.6	137.6	132.0	99.4
External debt service as a share of total exports	5.6	8.6	8.5	8.4	8.8	40.2
External debt service as a share of GDP	5.0	7.4	6.3	8.6	6.9	26.1
Argentina						
Gross public sector debt as a share of GDP	47.6	50.9	62.2	164.2	144.5	133.9
External debt service as a share of total exports	100.1	105.0	108.3	55.8	61.1	35.8
External debt service as a share of GDP	9.9	11.5	12.5	15.8	16.1	9.3
Belize						
Gross public sector debt as a share of GDP	53.1	75.8	84.1	89.6	103.1	102.3
External debt service as a share of total exports	8.7	13.8	20.6	43.8	28.7	50.9
External debt service as a share of GDP	4.9	7.3	10.5	23.3	14.4	24.9
Dominica						
Gross public sector debt as a share of GDP 2/	71.0	76.8	87.4	95.4	121.9	118.4
External debt service as a share of total exports	5.0	7.4	10.9	11.8	19.5	20.8
External debt service as a share of GDP	2.9	4.0	5.0	5.8	8.9	9.9
Dominican Republic						
Gross public sector debt as a share of GDP	26.8	25.9	23.6	26.8	54.3	52.1
External debt service as a share of total exports	6.5	6.4	9.7	10.8	11.4	8.4
External debt service as a share of GDP	3.0	2.9	3.7	4.1	6.4	4.2
Grenada						
Gross public sector debt as a share of GDP	51.9	56.2	63.7	109.6	110.0	129.4
External debt service as a share of total exports	5.1	5.6	8.2	17.4	18.9	25.0
External debt service as a share of GDP	2.9	3.2	4.1	7.4	7.7	10.1
Serbia and Montenegro						
Gross public sector debt as a share of GDP 3/	...	119.1	123.2	85.4	79.2	60.2
External debt service as a share of total exports	5.9	2.8	5.1	7.1	13.6	24.0
External debt service as a share of GDP	1.0	0.7	0.9	1.2	2.2	4.1
Iraq						
Debt stock as a share of GDP	...	...	...	...	...	306.2
External debt service as a share of total exports 4/	...	...	...	...	...	0.0
External debt service as a share of GDP 4/	...	...	...	...	...	0.0

1/ For Antigua and Barbuda, central government only; for Argentina and Serbia and Montenegro, consolidated government; for Belize and Dominica, nonfinancial public sector; for Dominican Republic nonfinancial public sector and central bank; for Grenada, general government.
2/ Data presented on a fiscal year (July-June) basis; figures shown for a given calendar year relate to the fiscal year beginning on July 1 of the previous year.
3/ Covers gross external debt and net domestic debt.
4/ On cash basis.

Sources: WEO, IMF country staff reports.

Table 6. Argentina: New Bonds Issued, by Currency and Governing Law

(In billions of US dollars, unless otherwise indicated)

Bond	US dollars		Euros	Yen	Pesos	Total
	NY law	Arg law	English law	Japanese law	Arg law	
Par	5.3	1.2	6.4	0.2	1.9	15.0
percent of total	15.1	3.5	18.1	0.6	5.3	42.5
Discount	3.1	0.6	2.9	0.1	5.3	11.9
percent of total	8.8	1.6	8.2	0.2	15.2	33.8
Quasi-par	0.0	0.0	0.0	0.0	8.3	8.3
percent of total	0.0	0.0	0.0	0.0	23.6	23.6
Total	8.4	1.8	9.3	0.2	15.5	35.3

IMF Publication

Managing Director's Statement to the Development Committee

INTERNATIONAL MONETARY FUND

DEVELOPMENT COMMITTEE
(Joint Ministerial Committee
of the
Boards of Governors of the Bank and the Fund
On the
Transfer of Real Resources to Developing Countries)

DC2005-0024
September 21, 2005

STATEMENT FROM THE MANAGING DIRECTOR OF THE IMF

Attached for the September 25, 2005, Development Committee Meeting is a Statement from the Managing Director of the International Monetary Fund to the Development Committee.

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New Text

DEVELOPMENT COMMITTEE: THE MANAGING DIRECTOR'S WRITTEN STATEMENT

I. INTRODUCTION

1. Our meeting takes place at an important juncture in the international community's efforts towards achieving the Millennium Development Goals (MDGs). It is now five years since we took up this enormous challenge, and there is a sense of renewed urgency. The recent UN World Summit on Implementing the Millennium Declaration reaffirmed the commitments made in Monterrey, but stressed the need for more progress, particularly in Sub-Saharan Africa. In addition, at the African Union and G-8 Summits, African leaders and their counterparts in the G-8 committed themselves to intensify their efforts.

2. Sub-Saharan Africa continues to present the most difficult development challenge, and is the region where the task of achieving the MDGs is most daunting. The World Bank has put forward a report for discussion by the Development Committee that sets out a program of action to support an enhanced partnership for Africa's development, including by ensuring the effective use of additional aid.[1] The Fund will play an important role in assisting these efforts as macroeconomic stability is crucial to fostering durable growth and poverty reduction. The many challenges that low-income countries face, including dealing with the macroeconomic impact of higher aid inflows, make rapid progress difficult to achieve, but where governments have established stable macroeconomic frameworks and pushed ahead with structural reforms, we have begun to see encouraging results.

3. The continued recovery in global growth provides a good opportunity to address medium-term vulnerabilities emanating from higher oil prices and large global imbalances. Countries will need to take ambitious actions to correct persistent imbalances among the major economies, remove structural impediments to growth and prepare for changing demographics through forward-looking fiscal consolidation. All countries must be able to take maximum advantage of the benefits from globalization, which will require, among other things, moving decisively to liberalize trade in the Doha Development Round.

4. During the past year, we have held extensive discussions on a medium-term strategy to guide the Fund's future operations, which is reflected in a report circulated recently.[2] This report identifies integration into the global economic and financial systems as a key challenge facing our member countries, and the Fund's assistance in designing and implementing the nehcessary measures and reforms as the organizing principle for our medium-term strategy. The strategy recognizes the changes that have already been made in

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[1] World Bank, *Strengthening the Development Partnership and Financing for Achieving the MDGs: An Africa Action Plan,* background paper for the Fall 2005 Development Committee meeting.

[2] *Report of the Managing Director to the International Monetary and Financial Committee on the Fund's Medium-Term Strategy* (IMFC/Doc/12/05/2, 9/15/05).

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recent years to adapt to this challenge, and provides a framework within which to prioritize the Fund's activities in order to increase its focus, effectiveness, and preparedness to face the future. In this statement, after summarizing the Fund's assessment of the world economic outlook, I shall explain in more detail the Fund's efforts to review, refine and strengthen its activities to help developing member countries accelerate growth and make faster progress toward achieving the MDGs.

II. Global Environment and Policy Response

A. Overall Outlook and Policy Response

5. After very high global growth in 2004, the expansion has moderated to a more sustainable pace, with global growth in 2005 expected to be 4.3 percent, and to remain close to that level in 2006. Although exceeding expectations in the first quarter of 2005, growth appears to have slowed in the second quarter, in part reflecting the earlier rise in oil prices. The expansion continues to depend unduly on continued high growth in the United States and China.

6. Global inflation has picked up slightly in response to higher oil prices, but remains at moderate levels and appears contained in the major industrial countries. However, inflationary pressures have risen somewhat more in emerging markets with forecasts for 2005 revised upwards in most regions. Global financial conditions also remain benign. Long-term interest rates are low, corporate earnings and balance sheets are strong, and a number of emerging markets have benefited from improved economic fundamentals and the increased presence of long-term investors.

7. There are significant downside risks to this short-term outlook. In particular, high and volatile oil prices remain a significant global risk. Continued high oil prices or further increases could entail financial difficulties for both vulnerable emerging market economies and poor oil-importing countries and could have a significantly negative impact on global growth—particularly in light of the disruption in the wake of Hurricane Katrina. A further risk is that, in the context of surging oil prices and widening global imbalances, a sharp rise in long-term interest rates prompted by rising inflation expectations or a shift in investor preferences away from U.S. assets could weaken housing markets, undermine confidence in highly indebted household sectors, and slow growth.

8. Some medium-term vulnerabilities also persist. Global current account imbalances have increased further and little improvement is expected in the near future. This may increase the risk of abrupt movements in exchange rates. Also, although fiscal consolidation is underway in many countries, unsustainable medium-term fiscal positions remain a key risk, posing a significant threat to macroeconomic stability. Moreover, most countries and regions face significant structural challenges that constrain growth in key areas.

9. The global expansion offers a favorable environment in which to address these medium-term vulnerabilities by:

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- reducing global current account imbalances, including through bolder fiscal adjustment in the United States; continued structural reform in the Euro Area and Japan to boost domestic demand and growth; higher public expenditures and accelerated structural reforms in oil-exporting countries; and faster financial sector reform with greater use of exchange rate flexibility in Asia;

- addressing constraints to long-term growth in developing countries by stepping up the pace of structural reform, including through further improvements in the investment climate in many emerging market economies;

- opening markets via a successful and appropriately ambitious trade liberalization under the Doha Round; and

- strengthening medium-term fiscal positions in both industrialized and developing countries to address, among other things, high or rising public debt and changing demographics.

B. Regional Outlooks and Policy Response

10. In the *United States*, growth remained strong in the first half of 2005, and the momentum of the expansion appears to remain solid, although hurricane Katrina has underscored downside risks. Risks include a jump in the very low household savings rate if the housing market were to cool, a slowdown in underlying productivity growth, and further increases in oil prices. With growth still exceeding its potential and interest rates low, a further measured withdrawal of monetary stimulus seems likely to be appropriate. Significant fiscal consolidation will be needed to ensure medium-term sustainability and boost domestic savings for an orderly adjustment in global imbalances. Growth in the *Euro Area* should regain its momentum gradually in the second half of 2005, although there are risks of more extended period of weakness. If inflationary pressures remain restrained, and the recovery appears to be fading, or if the euro appreciates significantly, an interest rate cut may be appropriate. In addition, further action will be required to cope with the fiscal pressures of ageing populations. In *Japan*, growth rebounded in the first half of 2005, and the growth momentum seems likely to continue. There has been considerable progress in addressing weaknesses in the bank and corporate sectors, which has put the economy in a better position to sustain an expansion. The momentum for financial and other structural reforms should be maintained. The accommodative monetary stance should continue until deflation is decisively overcome.

11. In emerging markets, economic performance remains strong.

- In *Emerging Asia*, growth continues to be robust, although there has been a marked increase in intra-regional divergences. Growth in China and India remains high, but the expansion in much of the rest of the region has slowed, reflecting the impact of higher oil prices and of a correction in the information technology sector. However, the expansion should strengthen during the remainder of 2005. The region should

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seek to achieve an appropriate balance between growth in domestic and external demand. In this context, the recent move to more flexible exchange rate arrangements in China and Malaysia is appropriate, and the authorities should make full use of the increased flexibility.

- In *Latin America*, growth has moderated to a more sustainable pace after a sharp rebound in 2004. Looking forward, the expansion is projected to continue at a solid pace, with growth remaining above the 1990s average through 2005-6, underpinned by both external and domestic demand. The current expansion appears to be more resilient than earlier ones, reflecting a combination of improved monetary, fiscal, and external debt management policies, and strong global growth and commodity prices. It is now a good time for undertaking reforms to address long-standing impediments to faster growth while further strengthening the fiscal and debt positions.

- In *Emerging Europe*, growth remains resilient although the pace of expansion has eased since the middle of 2004. Nevertheless, concerns remain about possible overheating in some countries. Where credit is expanding at an unsustainable pace, measures are needed to reduce credit growth and associated risks. Fiscal consolidation and structural reform are also needed to manage demand pressures and improve medium-term sustainability.

12. In the *Middle East*, oil-exporting countries have enjoyed a robust growth performance. With continued prudent financial policies and oil production close to capacity, growth is expected to moderate slightly in 2006. With a significant proportion of the oil revenue increase expected to be permanent, managing the revenue will be a central challenge. The revenue will provide the opportunity to address some of the long-standing economic problems in the region, including the financing of reforms aimed at generating employment opportunities for the rapidly growing working-age population.

13. In most *Commonwealth of Independent States* countries, real GDP growth slowed in early 2005, mainly reflecting sluggish investment and lower oil sector growth, while inflation rose after a long period of sustained disinflation. A combination of tighter monetary policy and exchange rate appreciation will be needed to keep inflation in check.

14. In *Sub-Saharan Africa*, the outlook remains favorable, even though the expansion is expected to slow somewhat this year following an eight-year high in 2004. Growth is supported by improved macroeconomic policies, higher commodity prices, lower external debt burdens, progress with structural reforms and fewer armed conflicts. In 2006, growth is expected to accelerate to 5.9 percent, which, if achieved, would be the strongest expansion in the region since the early 1970s. However, to accelerate progress towards achieving the MDGs, major efforts are still needed to promote private sector activity, develop infrastructure, and strengthen institutions.

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III. THE FUND'S EFFORTS TO IMPROVE SURVEILLANCE AND GLOBAL FINANCIAL STABILITY

15. Surveillance remains central to the Fund's role in preventing crises, and must continue to evolve to keep up with the changing needs of the global environment. We have embarked on a range of reforms geared to enhancing the effectiveness of surveillance, in line with the conclusions of the 2004 Biennial Surveillance Review.[3] Recent changes include:

- issuing revised internal guidance on bilateral surveillance, to update and streamline our procedures and policies;
- requiring more in-depth internal discussion before beginning bilateral surveillance discussions, with the aim of improving the selectivity and focus of analysis;
- devising a new vehicle to apprise the Board of recent trends in trade policy, permitting Article IV consultations to treat these issues more selectively;
- giving greater prominence to the discussion of exchange rate issues in bilateral surveillance documents and expanding work on assessing equilibrium exchange rates;
- mainstreaming financial sector issues in surveillance work; and
- revising the Fund's framework for debt sustainability analysis to address concerns about overoptimistic projections and help integrate such analyses more fully into the surveillance process.

The strategic review has confirmed these changes and is expected to give new impetus to efforts to sharpen the focus of surveillance and ensure that the Fund's voice is heard.

16. The Fund is also giving more emphasis to regional surveillance to highlight spillover effects of country policies, and bring an analytical focus to regional issues. The increased use of regional surveillance to analyze economic and policy development, such as in Central America, Central and Western Africa, the Eastern Caribbean, the Pacific Islands and Asia, helps to inform bilateral surveillance and the Fund's engagement with country authorities.

17. The Fund continues to support timely and effective resolution of financial crises by encouraging the use of collective action clauses in international sovereign bonds and working on relevant issues aimed at helping ensure that it is in a better position to meet the challenges that future crises could pose. In this context, a recent report reviews advances in the adoption and design of collective action clauses, reports on recent cases of sovereign debt restructuring with private creditors, and discusses the evolution of the Evian approach and other Paris Club

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[3] Public Information Notice No. 04/95, August 24, 2004, *IMF Executive Board Reviews the Fund's Surveillance* (http://www.imf.org/external/np/sec/pn/2004/pn0495.htm).

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debt initiatives.[4] It also provides a brief update on progress by the Institute of International Finance in broadening the consensus among emerging market issuers and private sector creditors on the *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets*.

IV. Supporting Low-Income Member Countries

A. The Role of the Fund in Low-Income Member Countries

18. The Fund's principal contribution to implementing the development agenda remains the promotion of macroeconomic and financial stability—a precondition for growth and poverty reduction—through its policy advice, capacity building, and financial assistance. We thus remain fully engaged in efforts to help low-income member countries achieve the MDGs. To maximize its contribution, the Fund has undertaken a reassessment of its role in low-income countries, focusing on adapting its instruments to the particular needs of the low-income membership, as well as on better defining its role on the ground, particularly in the interaction with the authorities, civil society, and other development partners. The importance of efforts in these directions is underlined in the strategic review, with its accent on increased focus and flexibility. Recent work has concentrated on strengthening the instruments for engaging with low-income members, and helping members achieve and maintain debt sustainability. In addition, the Fund is a strong advocate of more and effective development aid and plays a role in supporting its coordination.

B. Supporting Low-income Countries' Efforts to Achieve the MDGs

19. The Fund has been working, with other development partners, to ensure that the Poverty Reduction Strategy (PRS) approach provides an operational tool for implementing and coordinating efforts to foster growth, poverty reduction, and progress towards the MDGs. A recent joint review with the staff of the World Bank concluded that the PRS approach is a useful framework for balancing domestic and external accountabilities for development results and providing a platform for scaling up country efforts to achieve the MDGs.[5] It also noted that alternative scenarios could overcome possible tensions between an operationally realistic PRS framework and more ambitious development plans, and suggested that Fund staff should play an active role in the development of such scenarios as well as in assisting countries manage higher aid flows.

20. The Fund is working with low-income country members and the international community to put in place appropriate policies and build capacity. It continues to assist countries in building sound institutions, which strengthens the capacity of the public sector to mobilize domestic revenue and improve budgetary management, which are essential for

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[4] *Progress Report on Crisis Resolution* (SM/05/342, 9/2/05).

[5] *Joint World Bank and IMF Report on Poverty Reduction Strategy Papers—Progress in Implementation* (http://www.imf.org/external/np/pp/eng/2005/020205.pdf).

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scaling up public services. The Fund also helps build institutions in the monetary and financial sectors. Moreover, in areas within its mandate and expertise, the Fund is helping member countries improve governance, including the legal and regulatory reforms which are important for a vibrant private sector. The Fund is also helping its members to observe best practices in fiscal transparency, including with respect to resource revenue management on which it issued a Guide, and supports the Extractive Industries Transparency Initiative.

C. Modalities for Financing the MDGs

21. Financing for the MDGs remains prominent on the international agenda in view of the reaffirmation by the UN World Summit that much more aid is needed and the decision made at the G-8 Summit to double aid to Sub-Saharan Africa by 2010. The Fund continues to advocate substantially higher aid flows, while recognizing that reforms are needed to ensure that absorptive capacity improves as aid is scaled up. Equally important is improving the quality of aid through firm implementation of the Paris Declaration on Aid Effectiveness. The Fund stands ready to help member countries adapt their macroeconomic policies to manage higher aid inflows.

22. While the most effective way to generate additional resources for the MDGs would be for donor countries and multilateral institutions to increase their ODA contributions, consideration is also being given to alternative mechanisms, including innovative modalities such as the International Finance Facility (IFF) and global taxes. Following up on a request from the Development Committee, Fund staff have contributed to a World Bank paper on development financing for the forthcoming Committee meeting.[6] A number of proposals have now been fleshed out, but some technical concerns still need to be addressed, and the challenge of mobilizing sufficient political consensus for implementation remains.

D. Refining the Fund's Policy Advice and Strengthening its Instruments

23. For some time now, the Fund has been considering how it could better serve its low-income members. While it is recognized that the Poverty Reduction and Growth Facility (PRGF) will remain the main instrument for assisting these members, its mission to support low-income members' efforts to secure and maintain macroeconomic stability and achieve sustainable growth and reduce poverty requires the institution to adapt as members' needs evolve.

24. The Fund recently completed its review of the design of PRGF-supported programs in "mature stabilizers."[7] While many low-income countries still need significant

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[6] World Bank, *Aid Effectiveness and Aid Financing,* background paper for the Fall 2005 Development Committee meeting.

[7] *Review of PRGF Program Design* (SM/05/304, 8/09/05, http://www.imf.org/external/np/pp/eng/2005/080805r.htm)

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macroeconomic adjustment, many others have achieved broad macroeconomic stability and sustained growth, often with the Fund's support. The review confirmed the importance of adequate policies—particularly those which would open the economy and avoid macroeconomic instability and exchange rate overvaluation—in initiating sustained growth even in countries with weak institutions. It also asked how fiscal space could be created for urgent spending needs, beyond what can be achieved through a better allocation of existing resources. Increases in grants clearly have the greatest potential in this regard, although even these must be managed carefully: the risk and consequences of real exchange rate appreciation must be recognized, but weighting these too highly can lead too quickly to an approach whereby aid is kept in international reserves and the additional external resources provided are not absorbed. The choice between the other means of financing higher public spending—taxation and borrowing—requires that attention be given to issues of crowding out and to implications for debt sustainability. As regards monetary policy, the study found support for targeting single-digit inflation rates, but also some room for looser monetary targets reflecting financial deepening.

25. *Shocks Facility*: The Executive Board has agreed in principle to the creation of a new window in the PRGF Trust for low-income members facing exogenous shocks.[8] This window would provide concessional support to low-income members without a PRGF arrangement, and act as a potential safety net for members that wish to exit continuous PRGF program engagement. It would thus complement the existing instruments available to assist low-income countries facing shocks, such as augmentations of PRGF access, the Compensatory Financing Facility, subsidized emergency assistance for natural disasters and post conflict cases, and the use of credit tranche resources.

26. *Signaling:* The Executive Board also recently agreed to establish a new non-financial mechanism, the Policy Support Instrument (PSI), which will be made operational shortly.[9] The PSI will be available to PRGF-eligible countries which do not need the Fund's financial assistance and which have a poverty reduction strategy in place and a policy framework appropriate for consolidating macroeconomic stability and debt sustainability, while deepening structural reforms in key areas that constrain growth and poverty reduction. A PSI will require country policies to meet the standard of upper credit tranche conditionality. Regular semiannual reviews by the Board of a PSI-endorsed program will provide a multidimensional assessment of policies in addition to a judgment on whether the program as a whole is on track. Publication of PSI-related documents will be voluntary but presumed. An on-track PSI would facilitate rapid access to concessional resources from the Fund in case of shocks, although quick access to Fund resources may not be possible for PSI users that choose not to undertake a safeguards assessment.

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[8] *Strengthening the Fund's Ability to Assist Low-Income Countries Meet Balance of Payments Needs Arising from Sudden and Exogenous Shocks* (EBS/05/88, 6/10/05).

[9] *Policy Support and Signaling in Low-Income Countries* (EBS/05/87, 6/10/2005).

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27. *PRGF Financing Needs:* In order to maintain adequate capacity of the PRGF instrument to meet future needs, work is underway on estimating the demand for PRGF financing over the medium term, incorporating the implications of potential debt relief and the introduction of the PSI and the shocks window. The Executive Board has emphasized the close linkages between the financing of the Fund's concessional lending operations and further debt relief, and agreed that the Fund needs to be adequately equipped to meet future financing demands associated with its role in supporting low-income countries. The Board has also underscored that additional financing for the proposed shocks window should be secured from donors, as needed.

E. Debt Relief and Debt Sustainability

28. There has been further progress in implementing the enhanced HIPC Initiative. In total, 18 countries have reached the completion point, and Burundi recently reached the decision point, bringing the total number of countries in the interim phase to 10. The Fund and World Bank Boards agreed last year to extend possible eligibility for the Initiative to 2006 to allow more countries to benefit from HIPC debt relief, while "ring-fencing" participation to avoid creating perverse incentives. The staffs have recently drawn up a preliminary list of 13 potentially eligible countries (including the additional countries that qualify based on end-2004 debt burden indicators) that have not yet reached the decision point. Grant resources are still needed to cover HIPC debt relief for the three protracted arrears cases, Liberia, Somalia, and Sudan, which are also potentially eligible countries.

29. The G-8 recently put forward a proposal for further debt relief for Heavily Indebted Poor Countries. The proposal envisages the cancellation of 100 percent of the claims of the IMF, International Development Association, and African Development Fund on the countries that have reached, or will reach, the completion point under the enhanced HIPC Initiative. According to the proposal, the cost to the Fund would be met from its own resources, drawing *inter alia* on existing funds earmarked to finance HIPC debt relief and PRGF operations.

30. The Executive Board has discussed the G-8 proposal on various occasions, and considered ways to implement it, focusing primarily on questions of uniformity of treatment, conditionality, and financing. There is a consensus that the proposal could go a long way toward eliminating the external debt burden of a number of the world's poorest countries, thereby freeing resources for achieving faster progress towards the MDGs. The Board has also emphasized the importance of not impairing the Fund's lending capacity for low-income members. In this regard, it has welcomed the G-8's commitments to provide additional resources to meet several needs: the resources necessary for the three protracted arrears cases; possible costs of debt relief to countries that may become eligible for HIPC assistance under the extended sunset clause; and up to US$350–500 million to meet other difficult to foresee costs.

31. However, to preserve the potential benefits of debt relief in the longer term, especially in light of many low-income countries' ongoing financing needs, it will be critical

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to help countries avoid excessive borrowing. The purpose of the new debt sustainability framework (DSF) for low-income countries that the Executive Boards of the Fund and the Bank adopted earlier this year is to help low-income countries avoid excessive build-up of debt in their pursuit of the MDGs.

V. DOHA NEGOTIATIONS AND AID FOR TRADE

32. An ambitious and timely conclusion to the Doha Round remains one of the most vital contributions that could be made to bolstering global growth, including for low-income members, over the medium term. It is important that countries use the December 2005 WTO Ministerial Conference meeting in Hong Kong to agree on a specific trade liberalization framework. Otherwise, when coupled with the tensions created by global imbalances, a failure of the Doha Round could exacerbate protectionism.

33. Fund and World Bank staff have formulated ways to provide stronger "aid for trade" as described in a joint report.[10] The intention is to help low-income countries achieve the full benefits of trade liberalization and alleviate the supply constraints to exploiting trade opportunities. An important component of such efforts would be scaling up and expanding the activities of the Integrated Framework (IF)—an inter-agency initiative to coordinate trade-related technical assistance and mainstream trade into national strategies—which also entails increased assistance in the form of grants and loans from an IF-supported trust fund. Staffs also propose to report to the Development Committee and IMFC at the 2006 Spring Meetings on the adequacy of existing mechanisms to address regional or cross-country trade needs and explore new mechanisms as appropriate. To address adjustment costs arising from trade liberalization, staffs propose a strengthened framework for assessing adjustment needs so that existing assistance mechanisms can be better utilized. The Fund's Trade Integration Mechanism (TIM) is already available to help countries address the pressures that may emerge from multilateral trade liberalization undertaken by other countries. Floating tranches under Fund arrangements could also be used to mitigate the balance of payments impact of trade reforms when the timing of those reforms is uncertain.

VI. VOICE OF DEVELOPING COUNTRIES AND COUNTRIES IN TRANSITION

34. The Fund's legitimacy and effectiveness depend crucially on members' perceived stake in the IMF as an institution. Our governance structure needs to continue to evolve to reflect the changing realities of the global economy, to ensure that all members have an adequate voice in the institution—including Asian and other emerging economies whose growing economic weight is not reflected in the Fund's governance structure, and African countries, where the Fund is heavily engaged.

35. The Executive Board explored in a seminar the options for moving forward in this area. The staff paper for this discussion notes that progress will require broad consensus

[10] IMF and World Bank, *Trade Progress Report: Doha Development agenda and Aid for Trade,* paper for the Fall 2005 Development Committee meeting.

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among shareholders and examines the scope for change, including in the absence of a general quota increase. Among the measures discussed are *ad hoc* increases for selected countries whose quotas are most out of line; voluntary adjustments in quotas among country groups or individual members, to better reflect members' relative positions in the world economy; and an increase in basic votes, to correct the erosion of voting power of the African countries and other countries with relatively small quotas. The future work program on this issue, including in the period leading to the 2006 Annual Meetings, will take careful account of the suggestions that emerged during the seminar.

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