Strengthening the International Financial Architecture

Report from G7 Finance Ministers

to the Heads of State and Government

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A. Introduction

1. Following a series of crises that began in Asia in 1997, conditions in the world economy have stabilized and prospects for expansion have improved. However, in view of the rapid changes occurring in the global financial landscape, and in particular in light of the opportunities and challenges presented by the increasing size and importance of private capital markets, the international community must continue to address the challenge of promoting greater stability in the international financial system as a platform for sustainable world growth and prosperity.

2. We, Finance Ministers of the G-7 countries, submitted a report on strengthening the international financial architecture to the Cologne Economic Summit last year and set out a number of specific proposals toward reform. Since then, we have made substantial progress :

   a) Many developing countries are making efforts to enhance their financial stability by, for example, strengthening financial sectors, adopting appropriate foreign exchange regimes, improving debt management, and adopting internationally agreed codes and standards. Many of them are also making substantial investments in the information they provide to financial markets.

   b) The IMF has taken steps to implement an assessment framework for internationally agreed codes and standards and to make operational our approach to private sector involvement (PSI) in forestalling and resolving crises. Private sector investors and lenders have been more involved in the financing of recent IMF-led programs. In addition, the IMF Executive Board has deepened its discussions on exchange rate regimes, countries' experiences with capital controls, and other important issues. The transparency of the IMF and the Multilateral Development Banks (MDBs) has been significantly improved, including through greater publication of documents.

c) The Interim Committee has been transformed into the permanent “ International Monetary and Financial Committee (IMFC) ”

d) The Financial Stability Forum (FSF) was created last year to enhance financial stability, improve the functioning of markets, and reduce systemic risk. As we requested, the FSF examined the issues of, and published reports this spring on highly leveraged institutions (HLIs), capital flows, and offshore financial centers (OFCs). The FSF also carried out work on the implementation of codes and standards on which it recently released a report.

e) The G-20 was established as an informal mechanism for dialogue among systemically important countries within the framework of the Bretton Woods institutional system. The first meeting of G-20 Finance Ministers and Central Bank Governors was held successfully in December of last year in Berlin. The next meeting will be held in October of this year in Montreal.

3. In this report, we discuss how we can further enhance our efforts to strengthen the international financial architecture, carrying forward the reform program that we identified in Cologne. Given the leading role of the International Financial Institutions (IFIs) in implementing a significant part of the Cologne reform program, this report focuses on i) reform of the IMF - especially reform of its facilities, the promotion of the implementation of codes and standards, the enhancement of governance and accountability, and private sector involvement; ii) reform of MDBs; iii) responses to the challenges posed by HLIs, OFCs and cross-border capital movements; and iv) regional cooperation.

4. We are determined to implement all the measures in this report, as well as the broad range of measures endorsed at the Cologne Summit. We will work together with other members of the international community to make steady progress.

B. IMF Reform

5. In view of the changing global financial landscape, and in particular the increasing importance of private global capital markets, we believe it is essential that the international community continues to examine the role and functioning of the IMF and other IFIs. We look forward to exploring this agenda further in Prague this fall at the next meeting of the IMFC and at the next Annual Meetings of the IMF and the World Bank .

<u>Key principles for reform of the IMF</u>

6. At our meeting with Central Bank Governors in April, we laid out the following key principles, which reflect our shared understanding of the IMF's role as we move forward:

   a) The IMF should play the central role in promoting macroeconomic and financial stability as an important precondition for sustainable global growth and should continue to evolve to meet the challenges of the future.

   b) The IMF is a universal institution which must work in partnership with all its member countries, based on their shared interests in these goals.

   c) To be effective, the IMF and its activities must be transparent to the public, accountable to its members and responsive to the lessons of experience and external and independent evaluation.

   d) In order to foster strong policies and reduce countries' financial vulnerability to crisis, preventing crisis and establishing a solid foundation for sustainable growth should be at the core of the IMF's work. Surveillance of economic and financial conditions and policies in member countries and the implementation of internationally agreed codes and standards are primary tools for accomplishing these aims.

   e) IMF's financial operations should continue to adapt to reflect the realities of global capital markets while preserving the flexibility to support all member countries, as appropriate, including those with no immediate prospects of market access. They should encourage countries to take preventive measures to reduce vulnerabilities and provide temporary and appropriately conditioned support for balance of payments adjustment, including in cases of crisis, and medium-term finance in defined circumstances in support of structural reform, while avoiding prolonged use.

f) IMF lending should not distort the assessment of risk and return in international investment. To this end, the IMF should take appropriate steps to ensure that the private sector is involved both in forestalling and resolving crises, which should help promote responsible behavior by private creditors.

g) While the World Bank is the central institution for poverty reduction, macroeconomic stability – a key tool for the achievement of poverty reduction and growth – is the responsibility of the IMF. The IMF has a crucial role in supporting macroeconomic stability in the poorest countries through the Poverty Reduction and Growth Facility, integrating its efforts with those of the World Bank in working with countries on poverty reduction strategies.

These principles will continue to guide our efforts on IMF reform moving forward in discussions within the IMF Executive Board and the IMFC, and in other fora as we work to implement concrete steps in advance of the Annual Meetings in Prague this fall.

Strengthening surveillance to prevent crises

7. There is consensus within the international community that, as we emphasized in our April meeting, strong surveillance must be at the center of the IMF's efforts to strengthen the world economy and the international financial architecture. In this regard, we reaffirmed the importance of a substantial qualitative shift in the nature and scope of the Fund's surveillance needed in light of globalization, large scale private capital flows, and the emerging framework of internationally agreed codes and standards.

a) The IMF should, in conducting its surveillance work, continue to sharpen its focus on macroeconomic policy, capital flows and structural issues which have an impact on macroeconomic stability, in particular in the financial sector, and on exchange rates with a view toward encouraging countries to avoid unsustainable regimes.

b) The IMF should continue to work to develop and make systematic use of indicators of national liquidity and balance sheet risks as a key part of the surveillance process. We believe that the IMF should begin publishing such indicators regularly together with relevant explanatory material.

c) The IMF has an important role to play in promoting transparency and the flow of information. We support the IMF in its efforts to promote the publication by countries of comprehensive, timely, high quality and accurate information in line with the Special Data Dissemination Standard (SDDS) and welcome the IMF's decision to highlight in a quarterly publication countries' achievement in this respect. We also support further actions to enhance the transparency of IMF surveillance through, inter alia, more general use of Public Information Notices following Article IV consultations and Reports on the Observance of Standards and Codes (ROSCs). In this respect, we support the principle of the release of IMF Article IV staff report, and look forward to the conclusions of the IMF Board review on the pilot project in this area.

Implementation of international codes and standards

8. We are determined to strengthen our efforts to promote the implementation of internationally agreed codes and standards as follows.

a) We confirm the IMF's leading and coordinating role in the assessment of countries' observance of international standards and codes and welcome the IMF's ongoing work in this area through Reports on the Observance of Standards and Codes (ROSCs) as well as through the joint IMF-World Bank Financial Sector Assessment Programs (FSAPs). We also welcome commitments by over 30 countries to undertake ROSC modules and the recent decisions by the IMF and the World Bank to expand the FSAP program. We look forward to consideration of the modalities for voluntary publication of Financial System Stability Assessment (FSSA) reports.

b) We agree that the assessment process should cover the 12 key codes and standards highlighted in the Financial Stability Forum's Compendium of Standards, and be carried out on a modular basis. The IMF and national authorities, in consultation with the standard-setting bodies where appropriate, should be responsible for identifying priority standards for implementation by individual countries within the framework of a country's overall economic reform agenda. To enhance credibility, we encourage countries to articulate publicly their adoption of standards, announce their plans of action and participate in IMF-led assessment programs. In this regard, we welcome the commitments by the G-20 Ministers and Governors and by the Western Hemisphere Finance Ministers.

c) We agree on the importance of addressing market and official incentives in promoting observance of codes and standards. In this context, we underscore the need for greater disclosure and transparency about countries' intentions and progress in implementing codes and standards. We call on the IMF to ensure that the results of assessments of observance of codes and standards are published, and to continue its work on integrating such assessments into its regular Article IV surveillance process. We look forward to the results of further work by the Financial Stability Forum (FSF) on promoting market and official incentives, specifically regulatory and supervisory incentives. We also call on the IMF to explore further ways of promoting compliance with codes and standards. We look forward to further progress on an overall framework for the implementation of codes and standards at this year's Annual Meetings in Prague.

d) We agree that work to implement codes and standards will be most effective if combined with further efforts to foster ownership across a broad range of countries for the codes and standards processes. The IMF and the World Bank should assist countries in the development of action plans for the implementation of codes and standards. We agree to work together and with the IFIs, the FSF, and international regulatory and supervisory bodies to provide technical assistance and training to emerging market and developing countries in this area.

e) In order to facilitate the conduct of consistent and objective assessments of countries' adherence to codes and standards, there must be regular, transparent, and constructive dialogue and cooperation between the institutions and agencies responsible. To this end, we call upon the IMF to chair a meeting of the relevant bodies to determine and report on how best to ensure that inputs from the relevant bodies concerned can be most effectively integrated in the surveillance process managed by the IMF.

Reform of IMF facilities

9. We reemphasize that the IMF's financial operations should continue to adapt to the globalization of capital markets, while preserving the flexibility to support all member countries, as appropriate, including those with no immediate prospects of market access, in light of their specific circumstances. Therefore, we attach priority to early progress in achieving a streamlined, incentives-based structure for IMF lending that encourages countries to develop stable access to private capital markets on a sustainable basis.

10. The IMF has already begun to simplify its facilities. Going forward, we continue to attach priority to the creation of a more effective structure for IMF lending consistent with this approach that would:

a) provide contingent support and incentives for countries to put in place strong ex ante policies to prevent crises, to observe internationally agreed standards and best practices, and to maintain good relations with private creditors (as is currently the case under the Contingent Credit Line (CCL)) ;

b) address temporary balance of payment imbalances as well as medium-term financing in defined circumstances in support of structural reform, while at the same time encouraging countries to move toward sustainable access to private capital(as is currently the case under the Stand-By Arrangement (SBA) and the Extended Fund Facility (EFF));

c) allow the IMF to respond rapidly and on an appropriate scale to systemic crises with appropriate terms to mitigate moral hazard and encourage rapid repayment (as is currently the case under the Supplemental Reserve Facility(SRF));

d) maintain a strong, focused role for the IMF in supporting sound macroeconomic policies in the poorest countries, integrating its efforts with those of the World Bank given the latter's responsibility for promoting poverty reduction and growth-oriented programs (as is currently the case under the Poverty Reduction and Growth Facility (PRGF)).

11. Specifically, we expect that reform of IMF facilities will be conducted as soon as possible based on the following:

a) The pricing of non-concessional IMF facilities should be fair and reflect their underlying objectives. The new pricing structure should establish more consistent incentives across facilities, encourage access to private capital, discourage prolonged use of, and deter inappropriate large scale access to IMF resources, thus contributing to their more efficient use. For all non-concessional facilities, the interest rate should increase on a graduated basis the longer countries have IMF resources outstanding. The possibility of adding a premium when the scale of financing goes beyond certain thresholds should be explored. In addition, for countries that continuously resort to IMF facilities, the IMF should make more intensive use of prior actions and limit access to its resources.

b) We also look forward to consideration of steps to encourage early repurchases once the IMF borrowers have returned to a sustainable economic and financial path.

c) We call upon the IMF to explore, in the context of the review of its facilities, appropriate uses of any resulting increase in IMF income within the existing framework of the Articles with the objective of targeting support to poorest countries.

12. Concerning specific IMF facilities:

a) The SBA should remain the standard facility to provide short-term assistance.

b) The EFF should be used in well-defined cases where medium-term structural reform is important, and longer-term maturity is appropriate due to the country's structural balance of payments situation and its limited access to private capital. This facility is expected to help countries to carry forward structural reforms necessary to achieve access to private capital over time.

c) The CCL should be reviewed with a view to enhancing its effectiveness without compromising the initial eligibility criteria. Specifically:

- The commitment fee for the CCL should be abolished.

- The initial rate of charge of the CCL should be reduced to a level below the initial rate of charge of the SRF. In this context, the progressive structure of the rate of charge of the CCL should be reviewed.

- The activation of the CCL should move to greater automaticity with regard to the initial drawing and within a predetermined limit, provided that appropriate reviews are conducted and that the ex-ante conditionalities are fully met.

- After approval of the arrangement committing CCL resources, frequent reviews, at least twice a year, on whether the user country continues to meet eligibility criteria should be conducted. A country should be required to exit the CCL when it becomes clear that eligibility criteria are no longer met. We call on the IMF to develop an appropriate exit strategy for these cases. If a country exiting the facility carries the risk of having a balance of payments problem, it should be encouraged to conclude an appropriate IMF program.

- In light of the abolishment of commitment fee, the reduction of the initial rate of charge and introduction of greater automaticity, the high standards for qualification should be maintained.

d) The SRF should retain its character as an emergency instrument to respond rapidly and on an appropriate scale to crises of capital market confidence, with appropriate terms to mitigate moral hazard and encourage rapid repayment.

We will work together with other members of the IMF to implement the specific changes proposed and other steps needed to put in place this simplified and incentive-based framework of lending instruments.

13. Going forward, conditions on IMF lending should be focused and address issues of macroeconomic relevance, while adhering to high quality standards. The IMF should sharpen its focus on macroeconomic policies, capital flows, structural issues having an impact on macroeconomic stability, in particular those in the financial sector, and exchange rate regime with the view toward encouraging countries to avoid unsustainable regimes. Success of IMF-led programs depends on strengthened ownership of borrowing countries.

Safeguarding IMF resources

14. The IMF's new framework for the conduct of safeguard assessments adopted last spring, strengthened measures to discourage misreporting and a requirement that countries making use of Fund resources publish annual financial statements independently audited by external auditors in accordance with internationally accepted standards should be implemented vigorously to ensure that IMF funds are used appropriately.

Post-program monitoring

15. It is important that the IMF enhances its capacity to monitor performance while funds are outstanding in order to help ensure that countries maintain strong policies and avoid the need to return to the IMF for financial support. We therefore attach priority to early action by the IMF to strengthen procedures and policies with respect to post-program monitoring.

Strengthening governance and accountability

16. We continue to stress that high priority be placed on increasing the transparency and accountability of the IMF.

a) The IMF should continue its efforts to make its documents public.

b) We welcome the recent decision to publish quarterly the financial transactions plan and encourage the IMF to take further steps to explore a mechanism for simplifying its financial accounting, in order to make its financial operations and statements more understandable to the public.

c) The involvement of the IMF Executive Board in the process leading to the formulation of country programs should be further enhanced. The Board should be briefed at an early stage on important and sensitive cases.

d) We welcome progress made toward establishing a permanent independent evaluation office inside the IMF, and urge that steps be taken to bring this office into operation by the time of the Annual Meetings in Prague. We look forward to reports on the result of the evaluation by the office to the Executive Board, and regular reports on the activity of the office to the IMFC.

e) For the IMF to maintain its legitimacy, credibility, and effectiveness as a global institution in the international financial system, it is essential that IMF's decision-making structure and its operation remain accountable. We take note of the effort now underway in the IMF to examine the formula for calculating country quotas, which need to be able to reflect changes in the world economy.

We look forward to discussing these proposals constructively and cooperatively with other members of the IMF.

Private Sector Involvement (PSI) in Crisis Prevention and Resolution

17. We welcome that private external creditors, including bondholders, have contributed to the financing of several recent IMF programs of policy reform and recovery. This has confirmed the importance of making operational the framework we laid out in our report to Heads in Cologne.

18. Private sector involvement is crucial for crisis prevention and resolution, and further efforts must be quickly made to implement the following measures;

    a) Emerging market economies participating in international capital markets and their private creditors should seek in normal times to establish a strong, continuous dialogue.

    b) The IMF should also encourage the use of appropriate measures, including collective action clauses, to facilitate more orderly crisis resolution.

    c) The use of collective action clauses in international bonds issued by emerging market economies in our own financial market should be facilitated.

    d) The World Bank and other Multilateral Development Banks are urged to work to have such clauses used in international sovereign bonds or loans for which they provide a guarantee.

19. The approach the international community adopts towards crisis resolution should be based on the IMF's assessment of a country's underlying payment capacity and prospects of regaining market access, informed by the country's economic fundamentals, payment profile, history of market access, and the market spreads on its debts.

20. All IMF programs need to include analysis of the country's medium-term debt and balance of payments profile, including a section explaining the assumptions taken about the sources of private finance.

    a) In some cases, the combination of catalytic official financing and policy adjustment should allow the country to regain full market access quickly.

b) In some cases, emphasis should be placed on encouraging voluntary approaches as needed to overcome creditor coordination problems.

c) In other cases, the early restoration of full market access on terms consistent with medium-term external sustainability may be judged to be unrealistic, and a broader spectrum of actions by private creditors, including comprehensive debt restructuring, may be warranted to provide for an adequately financed program and a viable medium-term payments profile.

21. In the case of c) above, where debt restructuring or debt reduction may be necessary, IMF programs should be based on the following operational guidelines.

a) Put strong emphasis on medium-term financial sustainability, with the IMF determining the appropriate degree of economic adjustment required by the country and the IMF and the country agreeing on a financing plan compatible with a sustainable medium-term payments profile.

b) Strike an appropriate balance between the contributions of the private external creditors and the official external creditors, in light of financing provided by IFIs. In cases where a contribution from official bilateral creditors (primarily the Paris Club) is needed, the IMF financing plan would need to provide for broad comparability between the contributions of official bilateral creditors and private external creditors. The Paris Club, if involved, should of course continue to assess the comparability desired and achieved between its agreement and those to be reached with other creditors.

c) Aim for fairness in treatment of different classes of private creditors and for involvement of all classes of material creditors. The IMF should review the country's efforts to secure needed contributions from private creditors in light of these considerations, as well as medium-term sustainability.

d) Place responsibilities for negotiation with creditors squarely with debtor countries. The international official community should not micromanage the details of any debt restructuring or debt reduction negotiations.

e) Provide greater clarity to countries at the start of the process about the possible consequences for their programs, including in terms of official financing, of any failure to secure the necessary contribution from private creditors on terms consistent with a sustainable medium-term payments profile. Such consequences could include the need for a program revision to provide for additional adjustment by the country concerned or the option of reduced official financing, or, conversely, a decision by the IMF to lend into arrears if a country has suspended payments while seeking to work cooperatively and in good faith with its private creditors and is meeting other program requirements.

f) When all relevant decisions have been taken, the IMF should set out publicly how and what certain policy approaches have been adopted, in line with the Cologne framework.

22. We look forward to further progress at the IMF by this year's Annual Meetings in Prague in making operational our approach, agreed last April, to PSI in the design of IMF programs so as to provide greater clarity to countries and market participants.

C. MDBs Reform

23. We affirm that accelerating poverty reduction in developing countries must be the core role of the Multilateral Development Banks (MDBs). An increased focus on poverty reduction should underpin all aspects of the MDBs' work, including in programs of policy reform, investment projects and capacity-building. MDBs need to adapt their organization and operations in order to fulfill this mission more effectively and consistently in a continuously changing international environment characterized by: a new understanding of the necessary elements of a more effective fight against poverty; growth of private financial markets in the developing countries; new opportunities and challenges arising from globalization; and stakeholders' stronger interest in efficient use of overall aid resources, and higher standards for transparency and accountability of MDBs.

24. Economic growth is the primary determinant of a country's ability to raise incomes and reduce poverty and inequality. Successful and equitable development also depends upon good governance, sound structural and sectoral policies, including social policy and trade liberalization, accountable and transparent institutions, and investment in human capital and public goods. Therefore MDBs should assist poor countries not only to meet such social priority as education and health, but also with economic and social infrastructure support where this has a clear additional impact on poverty reduction.

25. MDBs can also make an important contribution to poverty reduction in emerging market and/or middle-income countries. MDB activities in countries with access to private capital should be more selective in order not to supplant private capital. At the same time, in case of temporary closure of emerging market countries' access to capital markets, MDBs should stand ready to respond quickly by helping to cushion the effects of exceptional shocks on the poorest and most vulnerable groups.

26. In all cases, MDB multi-year operational frameworks should be established and should include clear commitments to increase support for core social investments such as basic health and education, clean water, and sanitation. They should respect appropriate country exposure limits.

27. MDBs should place high priority on good governance and the full commitment to the poverty reduction by recipient countries. They should allocate their support increasingly on the basis of borrower performance. Experience has shown that aid is only effective in reducing poverty where governments are committed to sound policies. In this regard, we stress the importance of the following:

a) the Comprehensive Development Framework (CDF) and the Poverty Reduction Strategy Papers (PRSPs) should become the basis for programs that have strong ownership by the recipient countries; and

b) performance-based lending frameworks, such as agreed under IDA-12, should be extended in an appropriate manner to all MDB programs.

28. In addition, MDBs should include support for capacity-building and structural and institutional reform in their broad-based approach to assistance for developing countries. In particular, they should:

a) strive to enhance the overall financing capacity of recipient countries themselves, including by increasing domestic saving and by helping catalyze private capital flows;

b) address institutional and structural issues that hamper poverty reduction, to ensure transparency, accountability, the rule of law, and appropriate social and human investments for the poor; and

c) strengthen the financial sector in recipient countries so as to help them prevent and manage financial crises.

Since Country Assistance Strategies (CASs) are comprehensive tools for effective and efficient MDB support for developing countries, MDBs should work to improve their quality and broaden their scope. These strategies should take full account of a borrower's policy environment including governance as well as the legal, institutional and regulatory frameworks. Public Expenditure Reviews should be an essential building block of the strategies. Every CAS should provide an assessment of the country's financial sector and governance.

29. MDBs should avoid competition with the private sector, assume a catalytic role and focus their activities more selectively on projects with clear development and/or transition impact. As the private sector increasingly finances projects traditionally funded by MDBs, more public resources are likely to be available for investment in social sector and public goods.

30. MDBs, and especially the World Bank (WB), should take the lead in facilitating the provision of global public goods, by deepening their engagement in global issues such as infectious diseases and environmental problems closely related to development. In this regard, the comparative

advantage of various international institutions, including UN agencies (e.g. such as World Health Organization (WHO) and Joint UN Programme on HIV/AIDS (UNAIDS)) and private institutions should be carefully reviewed given the scarcity of concessional resources.

31. MDBs should emphasize a selective, quality-oriented approach rather than a quantity-oriented or profit-oriented one on the basis of clear definition of their roles as public institutions and their development mandates. MDBs which provide resources to private sector should better define their roles, organizations and operations in this respect.

32. It is important for MDBs to look afresh at the instruments available to fulfill their development and poverty reduction mandate in light of the principles described in the preceding paragraphs and in view of the changing international financial environment. In this regard, we call for a prompt initiation of a comprehensive review of loan pricing policy, including the question of price differentiation for the different types of operation. MDBs should also explore the possibility of some separation of lending and non-lending services to enable a wide range of countries to continue to benefit from MDBs' expertise.

33. Concessional lending by MDBs, focused on the poorest countries, has a critical role in poverty reduction. Replenishment of the concessional funds of the MDBs should be based on the principle of fair burden sharing and we encourage new donors to participate actively.

34. The quality of aid may, in some cases, be improved through healthy competition between the WB and some Regional Development Banks (RDBs). It is nevertheless essential that these institutions strengthen collaboration and coordination in order to ensure efficient use of scarce aid resources. The CDF initiated by the WB and PRSP can be useful tools in coordinating of bilateral and multilateral donors. The WB and the RDBs should conclude Memoranda of Understanding to frame their coordination and closer partnership taking into account circumstances of each RDB. In this regard, we welcome the recent agreement between the WB and the African Development Bank (AfDB). Collaboration in the field is particularly important

and, in this respect, a comprehensive review of the progress of the decentralization of the WB operations and the impact of this process on cooperation with the RDBs and on the quality of its projects and its administration would be welcomed.

35. The IMF and the WB have different mandates and need to respect them. Nevertheless, the issues they deal with are increasingly interrelated and in some countries their activities are interdependent. In this respect, they should continue to work closely together to improve efficiency and exchange of information. This would require a clearer definition of their respective responsibilities and activities, and continued development of more effective mechanisms of cooperation.

36. Finally, we call for greater accountability to shareholders and those affected by MDB actions. We therefore support the recent substantial progress that MDBs have made toward this goal. Nevertheless, there is a clear need for additional progress in such crucial areas as information disclosure, public participation and accountability to the shareholders:

a) A greater range of operational documents should be released to the public, particularly all country strategies and evaluation reports, while paying due attention to the influence on the market.

b) Independent inspection panels should be in place in an appropriate manner in all institutions.

c) Each institution should establish a compliance unit to certify full compliance of project proposals with its policies prior to submission to the Executive Boards.

d) Monitoring and ex-post evaluation function, internal financial controls, procurement policies and practices and auditing procedures of each MDB should be strengthened and all MDBs should have strong and independent evaluation units.

D. HLIs, Capital Flows and OFCs

37. We stress the importance of the implementation of the recommendations set out in the reports of the Financial Stability Forum (FSF) Working Groups on highly leveraged institutions (HLIs), Capital Flows, and Offshore Financial Centers (OFCs), which were released last March. In this regard, we call on the IMF, World Bank and other bodies to contribute actively to the implementation of the various recommendations by the FSF Working Groups.

38. To respond to concerns about the potential consequences of the activities of HLIs, which may contribute to systemic risks or affect the dynamics of certain markets, it is important to promote the implementation of the following measures:

    a) Better risk management by HLIs and their counterparties.

    b) Better disclosure practices by financial institutions, including enhanced disclosure by HLIs and their creditors. We call on all jurisdictions to consider the adequacy of their own disclosure requirements and introduce, where necessary, appropriate changes to legislation or regulations to ensure that major hedge funds located in their jurisdictions are subject to disclosure requirements. This recommendation should apply, in particular, to offshore centers, since they currently host a significant proportion of unregulated hedge funds.

    c) Enhanced regulatory and supervisory oversight by national authorities of financial institutions which provide credit to HLIs.

    d) Enhanced national surveillance of financial market activity in view of concerns about systemic risk and market dynamics caused by HLIs' activities.

    e) Review by leading foreign exchange market participants of existing good practice guidelines for foreign exchange trading and the articulation of model guidelines for possible adoption by market participants in smaller economies.

f) Improved market infrastructure

We will review these measures and their implementation to determine whether additional steps are necessary. In this light, we note that the FSF considered in March, but did not recommend, at this stage, direct regulation of the currently unregulated HLIs, but emphasized that direct regulation would be reconsidered, if, upon review, the implementation of its recommendations were not adequately addressing concerns identified.

39. It is also important that each country manages debt-related risks appropriately. In this regard, we welcome the work being carried out by the IMF and World Bank, and urge prompt development of guidelines for public debt and reserve management, with special attention to the risk created by short-term foreign currency liabilities, and taking account of countries' vulnerability to capital account crises, including those vulnerabilities arising from the liabilities of the private sector. The establishment of efficient domestic bond markets is also important. Prudential limitations in the banking system to reduce the risk of excessive exposure to short-term capital flows may be appropriate in some circumstances.

40. Regarding offshore financial centers that do not meet international standards adequately, and therefore, that are potential threats to the international financial system, we welcome the identification by the FSF of priority jurisdictions, and urge the IMF to conduct quickly a specific assessment in these jurisdictions. We urge all the listed jurisdictions to demonstrate their commitment to improve their implementation of standards, for instance, through a public declaration of their intention to implement relevant international standards, completing assisted self-assessments of adherence to these standards, and eventually addressing shortfalls identified through detailed action plans.

41. To respond to risks caused by large and abrupt international capital movements, it will continue to be important for each country to pursue sound macroeconomic policies, proceed with structural reform for the better functioning of the market, strengthen the financial system, choose an

appropriate foreign exchange rate regime supported by consistent and credible macroeconomic policies and other measures, liberalize the capital account in a well-sequenced manner, and take other appropriate policies as needed.

42. Recognizing the crucial role of deposit insurance in contributing to confidence in the financial system, we look forward to further development by the FSF of guidance on deposit insurance schemes.

E. Regional Cooperation

43. As discussed above, IMF surveillance of, and appropriate financing support to, the member countries are important for the stability of the international financial system. In addition, member countries may strengthen, on a regional basis, their cooperation in these areas, in a way which is supportive of the IMF's objectives and responsibilities in the global economy, taking into account their common interests in international trade and investment and shared concerns about the risk of regional contagion. Such regional cooperation can improve regional stability and thus contribute to the stability of the global economy.

44. In this context, we welcome the recent developments in the area of regional cooperation at various levels. In the Asian region, frameworks for regional surveillance and for cooperation in finance including bilateral swap mechanisms have been expanded. In North America, a trilateral swap arrangement is maintained with a process for surveillance and regular consultation on economic matters.

45. Regional cooperation through more intensified surveillance can help contribute to financial stability by strengthening the policy framework at the national level. Cooperative financing arrangements at the regional level designed to supplement resources provided by the IFIs in support of IMF programs can be effective in crisis prevention and resolution.

46. In a different institutional context, economic and financial integration mechanisms, and monetary unification in Europe are also contributing to the economic and financial stability of the global economy.