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NEWS: IMF focuses on Niger relief

With 2.5 million people directly affected by Niger's severe food shortage, UN agencies have launched a series of appeals for international aid. The IMF is also playing a role, working closely with international donors to mobilize additional resources and encouraging the government to take every possible step to deal with the country's immediate needs. Within the next few weeks, an IMF mission is due to go to Niger to assist the authorities.

Finbarr O'Reilly/Reuters

235

COUNTRY FOCUS: The U.S. locomotive

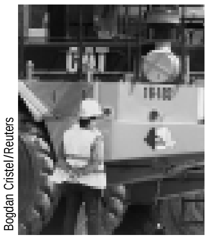
Energy costs have risen markedly, but the U.S. economy has proven resilient, remaining a force for growth in a period of global slack. Still, there is work to do. With strong short-term growth rates in prospect, the country is well positioned to begin to address some longer-term concerns. These include a historically low national saving rate and severe underfunding in key federal programs—Medicare and Social Security.

Chris Hondros/Newsmakers

237

REGIONAL FOCUS: FDI in Southeastern Europe

How significant a role do the right policies play in a country's ability to attract foreign direct investment (FDI)? Not as much as some policymakers might hope, but enough to suggest that the right policies can make a difference and their effects can vary above and below a certain FDI threshold. Southeastern Europe, which has attracted limited FDI, is a case in point, according to a recent IMF study. It stands to benefit from policies that encourage FDI, notably infrastructure reforms and a liberalization of foreign exchange and trade regimes.



Bogdan Cristel/Reuters

242

POLICY: Streamlined conditionality?

In the 1990s, the number of structural conditions attached to IMF lending rose sharply but concerns deepened about the strength of national ownership of Fund-supported policy programs. As a result of a major review, the IMF in 2002 began to place greater emphasis on streamlining. How well are the IMF's new guidelines on conditionality being implemented? A look at experience to date suggests that progress has been made in terms of clearer and more focused conditions. Ultimately, the new guidelines will be judged successful if they contribute to better economic outcomes, but it is too early to gauge whether this has been the case.

244

IN THIS ISSUE

What's on

AUGUST

22–26 IMF–Singapore Regional Training Institute seminar, "Creditor Rights in Emerging Economies," Singapore

24–September 2 APEC Small and Medium Enterprise Ministerial, Daegu, Republic of Korea

SEPTEMBER

3 IMF–Singaporean government high-level seminar on regional financial integration, Singapore

6–7 IMF high-level seminar, "Financial Stability—Central Banking and Supervisory Challenges," Washington, D.C.

7 IMF Managing Director Rodrigo de Rato to visit Seoul, Republic of Korea

8–9 APEC Finance Ministers Meeting, Jeju, Republic of Korea

8 IMF Economic Forum, "IMF Conditionality: Good, Bad, or Ugly?" Washington, D.C.

14–16 High-level plenary meeting, UN General Assembly, to review progress on UN Millennium Declaration commitments, New York

19–23 IMF seminar for parliamentarians from Bosnia and Herzegovina, Croatia, Macedonia, and Serbia and Montenegro, Joint Vienna Institute, Vienna, Austria

22–23 Global Forum on Tax Treaties and Transfer Pricing, OECD Center for Tax Policy and Administration, Paris

24–25 IMF and World Bank Annual Meetings, Washington, D.C.

26–30 International Atomic Energy Agency General Conference, Vienna, Austria

OCTOBER

4–7 Meeting of the International Task Force on the Harmonization of Public Sector Accounting, IMF, Washington, D.C.

19 IMF Book Forum, Pietra Rivoli, *Travels of a T-Shirt in the Global Economy: An Economist Examines the Markets, Power, and Politics of World Trade*, Washington, D.C.

NOVEMBER

3–4 IMF Jacques Polak Sixth Annual Research Conference, Washington, D.C.

4–5 Fourth Summit of the Americas, Mar del Plata, Argentina

16–18 World Summit on the Information Society, Tunis, Tunisia

27–29 World Economic Forum, India Economic Summit, New Delhi, India

DECEMBER

13–18 The Sixth WTO Ministerial Conference, Hong Kong SAR

IMF Executive Board

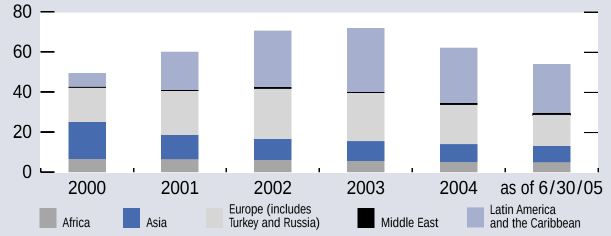
For an up-to-date listing of IMF Executive Board meetings, see *www.imf.org.external/np/sec/bc/eng/index.asp*.

At a glance

IMF financial data

Total IMF credit and loans outstanding, by region

(billion SDRs, end of period)



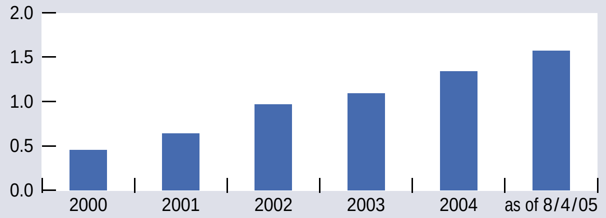
Largest outstanding loans

(billion SDRs, as of 6/30/05)

Nonconcessional		Concessional	
Brazil	14.21	Pakistan	1.02
Turkey	12.19	Zambia	.53
Argentina	7.69	Congo, Dem. Rep. of	.49
Indonesia	5.85	Ghana	.28
Uruguay	1.67	Tanzania	.26

HIPC debt relief[1]

(billion SDRs, end of period)

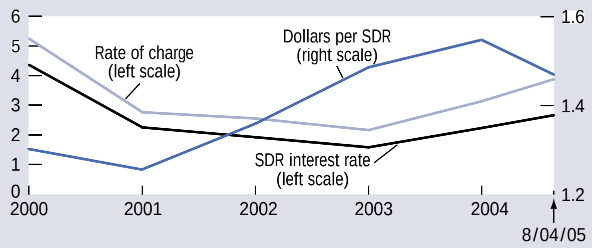


[1]Cumulative disbursements under the Heavily Indebted Poor Countries Initiative.

Related rates

SDR interest rate, rate of charge on IMF nonconcessional loans outstanding, and dollars per SDR

(percent, end of period) (dollars per SDR, end of period)



Note on IMF Special Drawing Rights

Special Drawing Rights (SDRs) are an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies.

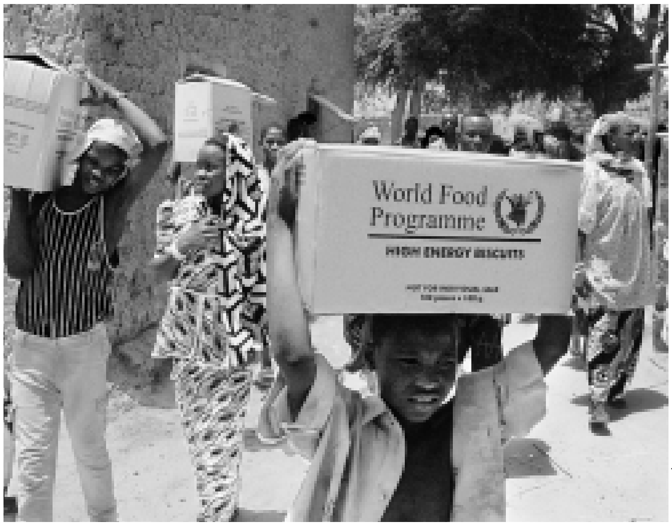
IMF joins the Niger relief effort

In recent weeks, the world's attention has been focused on the severe food shortages afflicting Niger as a result of the confluence of natural disasters: prolonged drought and a locust invasion. According to the United Nations, about 2.5 million of Niger's 12 million people are directly affected by the crisis.

UN agencies have launched a series of appeals for international donations totaling $57.6 million. While the initial response to the call for aid was slow, donations and assistance now are arriving more rapidly because of the intense media attention given to the issue.

Disaster relief is the responsibility of the whole international community, especially the UN agencies, the World Bank, and nongovernmental organizations. The IMF also is playing a role—working closely with international donors to mobilize additional resources to address the food shortages and assist long-term development. In addition, the IMF is in close consultation with the Nigerien authorities on a range of related issues. The IMF has encouraged the government to take every possible step to deal with the immediate needs, fully supporting all government spending aimed at addressing the food crisis and alleviating the effects of the drought.

In addition, the IMF has signaled that it is prepared to increase Niger's access to IMF financing if grant aid proves to be insufficient. An IMF mission is expected to visit Niger later this month to assess recent developments and to assist the government in its efforts to address the food crisis.



Martin Specht/WFP

Donations and assistance are now beginning to reach Niger, which has seen more than one-fifth of its population affected by a severe food shortage.

Toward debt and poverty reduction

The food crisis is occurring in a country that already faces many economic difficulties. One of the poorest countries in Africa, Niger has been working hard in recent years to address the needs of its population. Over the past five years, Niger has made significant progress in restoring macroeconomic stability and liberalizing its economy. In recognition of those efforts, the international community agreed to provide substantial debt relief when Niger reached the completion point under the Heavily Indebted Poor Countries Initiative in April 2004.

IMF policy advice to Niger draws largely on a Poverty Reduction Strategy (PRS) outlined by the Nigerien authorities in 2002 after consultation with the country's civil society. The PRS identifies priorities that are regarded as critical for strengthening economic growth and reducing poverty. In particular, it focuses on increasing spending on human capital, with an emphasis on access by vulnerable groups to basic social services, and on agricultural development. Niger's PRS also underscores the need to preserve fiscal sustainability. Efforts are aimed at strengthening revenue mobilization, improving public expenditure management, and ensuring that maximum government spending is directed toward pro-poor and pro-growth projects.

Since 2000, IMF financial support to Niger under the Poverty Reduction and Growth Facility (PRGF) has totaled $88 million. The IMF has also provided extensive technical assistance, especially in the area of fiscal management. The IMF-supported program mirrors the PRS's focus on agriculture by stressing the need for Niger to deal with the effects of unfavorable weather through the introduction of much needed irrigation systems. The authorities have been urged to expand their domestic revenue base and seek increased donor support. Notwithstanding relatively large donor financial assistance so far, it is recognized that Niger needs additional resources to make adequate progress toward the Millennium Development Goals, which target a halving of key poverty indicators by 2015.

Briefing the press on August 3, Thomas C. Dawson, Director of the IMF External Relations Department, said that as important as the long-term development issues are, the key challenge at this stage for the international community is to provide "all possible assistance as quickly as possible" to relieve the food crisis. And that, he added, "is what we intend to do." ■

In the news

IMF Executive Board reiterates commitment to further debt relief

IMF's Executive Directors reiterated their commitment to further debt relief as part of the "international support for low-income countries, including its poorest and most heavily indebted members," IMF Managing Director Rodrigo de Rato said on August 3. De Rato noted that the Directors had emphasized that the Group of Eight (G-8) proposal to cancel debt owed by the Heavily Indebted Poor Countries (HIPCs) "could go a long way to complete the process of debt relief for these countries by providing additional balance of payments support from the Fund," and this could, in turn, free up country resources to pursue the Millennium Development Goals.

In their discussion, the Directors stressed that to provide effective benefits to its recipients, debt relief must be designed and implemented carefully. There was a clear consensus among the Directors, de Rato said, on the importance of preserving the Fund's ability to provide concessional financial support to its low-income members and preserving the IMF's principle of uniformity of treatment for all low-income member countries.

Going forward, the IMF's staff will work on "potential modalities to implement the G-8 proposal as a basis for further discussions" by the IMF's Executive Board before the IMF–World Bank Annual Meetings on September 24–25.

The August 3 discussion provided Directors with the opportunity to explore in greater detail the financial, legal, and policy implications of the G-8 proposal for the Fund. This recent discussion also complemented the IMF's ongoing efforts to find ways to enhance its role in low-income countries—including through such proposals as a nonfinancial mechanism to support policies in low-income countries and the establishment of a financing facility to help countries facing exogenous shocks. The Board is also considering the continued financing for the concessional lending provided under the IMF's Poverty Reduction and Growth Facility. ■

The full text of IMF Managing Director Rodrigo de Rato's statement is available on the IMF's website (*www.imf.org*).

Kato highlights progress in Mozambique, Zambia

During a visit to Mozambique, July 24–27, IMF Deputy Managing Director Takatoshi Kato lauded the work of Centro de Investigação em Saúde de Manhiça, a health research institute that, he said, is providing groundbreaking research on the region's most critical diseases and helping improve health conditions in Mozambique. Kato told reporters that the IMF is very concerned about endemic diseases, such as malaria, HIV/AIDS, and tuberculosis, which have had a serious negative effect on African economies.

In meetings with President Armando Guebuza, Prime Minister Luisa Diogo, and other senior officials, Kato congratulated the country on its impressive progress in recent years, noting that sound macroeconomic policies had provided a solid underpinning for the economy's growth at an annual average 8 percent—a rate "well above its regional peers"—and declining inflation rates. To sustain this performance, he added, Mozambique needs to strengthen its revenue performance and pursue second-generation reforms focused on strengthening institutions and removing obstacles to private sector activity, so that the country can make a lasting reduction in poverty and achieve the Millennium Development Goals.

Joaquim Carlos Vieira for the IMF

A staff member of the Manhiça center briefs IMF Deputy Managing Director Takatoshi Kato (left).

On the second leg of his trip, Kato met with Zambia's President Levy Mwanawasa, Finance Minister Ng'andu Magande, other senior officials, and members of the donor and business communities, parliament, and civil society. He praised the country's "remarkable progress" in recent years and underscored the Fund's "strong support for the overall thrust and direction of the policies being pursued"—particularly the emphasis given to addressing social needs and improving conditions for investment and growth.

Looking ahead, Kato stressed the need to keep public spending under control, particularly during the remainder of 2005 and 2006, to sustain macroeconomic stability. He also pointed to the need to advance reforms to create an enabling environment for private sector development, including by strengthening public expenditure management and financial accountability, financial sector reform, and governance. ■

The full text of Takatoshi Kato's concluding remarks in Mozambique and Zambia are available on the IMF's website (*www.imf.org*).

U.S. locomotive: on track, but some curves ahead

The U.S. economy has proved resilient in the face of sharply higher energy costs, with its expansion and low interest rates providing a substantial boost to the world economy at a time of significant global slack. As the IMF's Executive Board recently noted, this strong short-term growth outlook leaves the United States well positioned to begin to address some longer-term concerns, including a historically low national saving rate and the severe underfunding of its Medicare and Social Security systems.

As recent indicators suggest, the U.S. economic expansion remains on track. While the economy slowed somewhat in recent quarters, growth continues to be above potential and seems set to speed up in the second half of the year. Household spending has been robust, fueled by rising asset prices, low interest rates, income growth, and steady improvements in employment. Growth remains broad-based, with a rebound in investment supported by low interest rates and strong corporate profits. There are also few signs of overheating in the labor market, despite an unemployment rate of only 5 percent. Inflation, too, remains contained, although in recent months higher energy prices have pushed headline consumer price inflation to 2½ percent.

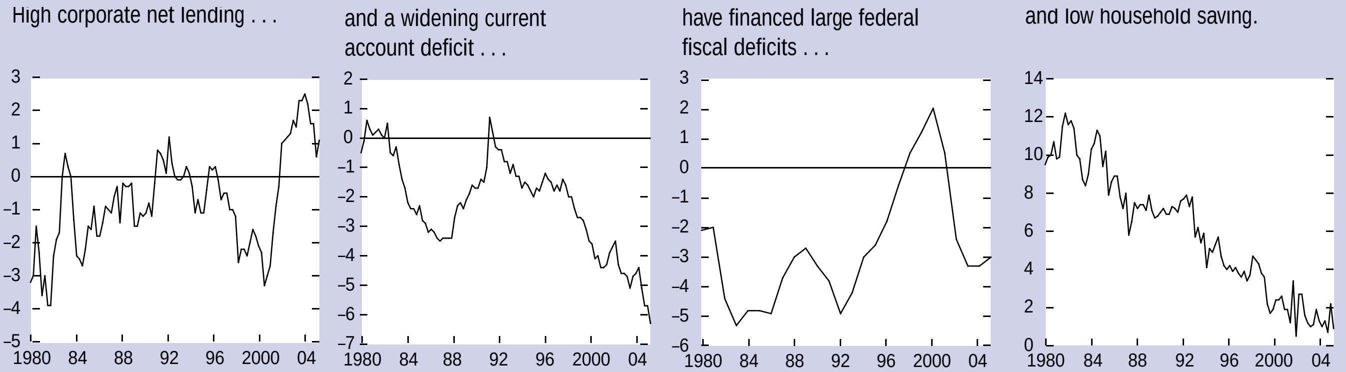
The global economy is likely to continue to benefit from the U.S. momentum. Net U.S. imports are estimated to have increased growth in the rest of the world by about ¼ percentage point a year since 2001. Favorable financial conditions in the United States have also helped to compress risk premiums on interest rates, lower interest rate spreads, and support activity across a wide range of emerging markets.

Unusual financial flows

The expansion has, however, been marked by a relatively unusual—and likely unsustainable—set of domestic and external imbalances that is characterized by:

- ***An unprecedented external current account deficit.*** With the U.S. economy outperforming most of its trading partners in recent years, the external current account deficit has widened to an unprecedented 6½ percent of GDP, compared to an average of around 2 percent of GDP over the past two decades. Despite the dollar's depreciation in recent years, import demand has remained strong, with higher oil prices also contributing to the trade gap.
- ***Massive foreign capital inflows.*** The counterpart of the high current account deficit has been massive foreign capital inflows, with U.S. net international liabilities estimated to have risen to over 20 percent of GDP—an unusually high level for large industrial countries.
- ***Record net lending by the corporate sector.*** Businesses have used high profits to strengthen balance sheets. This, along with large foreign inflows, has contributed to low long-term interest rates.
- ***Significant public sector borrowing.*** Tax cuts and government expenditure increases have turned the public sector into a significant borrower in recent years, with the federal government budget recording a 3½ percent of GDP deficit in FY 2004. Buoyant revenue growth, however, is likely to reduce the deficit appreciably over the medium term.
- ***Low household saving.*** The U.S. household saving rate has recently fallen to zero—a record low. Although partly reflecting a boost from strong asset markets (which tend to reduce the

Unusual flows (percent of GDP)



Data: U.S. Bureau of Economic Analysis and U.S. Federal Reserve Board of Governors.

incentive to save out of personal income), such a low saving rate is inconsistent with current levels of household income and wealth.

As a result, the U.S. economy is in the unusual situation of having foreign savings and domestic corporate profits financing a still-large government deficit and strong household consumption (see chart, previous page). The U.S. economy is, nevertheless, well positioned to sustain its strong performance in the next few years, underpinned by productivity growth, which—despite having eased somewhat as the recovery matured—remains above longer-term trends. Barring shocks, growth is projected to be around 3½ percent in 2005 and 2006. This is slightly above potential and should allow for some rebalancing of domestic financial flows. The current account deficit, however, is projected to remain around 6 percent of GDP, as growing foreign debt and higher interest rates increasingly weigh on the income balance.

On the policy side, the focus appropriately remains on the removal of stimulus. The U.S. Federal Reserve, which cut the federal funds rate aggressively over the downturn, reversed course as deflation risks receded. Since mid-2004, it has raised the rate by a cumulative 2¼ percentage points, and markets expect further cuts in the coming months. For its part, the U.S. Administration has made headway toward its commitment to reducing the budget deficit to below 2 percent of GDP by FY 2009 through rigorous spending restraint, and to making earlier tax cuts permanent. Moreover, an advisory panel to the President is working on proposals to streamline the tax system and strengthen incentives to boost private saving and investment.

Conditions in the financial sector remain conducive to economic growth. Equity prices have risen, long-term interest rates remain low, banks are well capitalized and highly profitable, and indicators of credit quality remain strong. Notwithstanding strong house price increases in many regions, securitization of mortgage debt has limited systemic financial sector risks by allowing significant diversification of real estate exposures (see box, below). That said, however, the robust

Solid growth projected

The U.S. growth momentum is expected to carry over into 2006, with the current account deficit stabilizing around its current level.

	2002	2003	2004	2005	2006
				Projections	
			(growth in percent)		
Real GDP	1.9	3.0	4.4	3.5	3.6
Household consumption	3.1	3.3	3.8	3.7	3.4
Unemployment rate (percent)	5.8	6.0	5.5	5.2	5.2
			(percent of GDP)		
Federal government deficit	–2.4	–3.3	–3.3	–3.0	–2.8
Current account balance	–4.5	–4.8	–5.7	–6.2	–6.1

Data: IMF Country Report No. 05/257.

Has mortgage securitization stabilized U.S. housing markets?

The U.S. housing market has boomed in recent years, with real estate prices in many regions rising considerably faster than personal incomes and rents. In 2005, increasing signs of speculative activity—including more widespread purchases of second homes and an uptick in the use of interest-only and other mortgage loans that defer principal repayment—have concerned regulators and fueled a debate over whether the market may be subject to a correction in the near future.

To better understand the attendant macroeconomic risks, IMF staff examined how changes in the structure of mortgage finance have affected the real estate market. It found that the shift from bank to market financing—particularly the development of a national securitized market for mortgages—has helped spread risk and may also help reduce the amplitude of boom-bust financing cycles, thus lowering the volatility of both real housing activity and prices.

What's changed

Until the late 1980s, mortgage lending was mainly a local business, and most mortgages were kept on the balance sheets of local depositories for the lifetime of the loan. The availability of mortgage credit depended on local financial conditions, including the level of deposits and capital at local banks and thrifts. In the aftermath of the savings and loan crisis in the 1980s, however, the U.S. mortgage market saw a dramatic shift from local to nationwide funding through mortgage securitization. This loosened the link between depository balance sheets and mortgage flows, and reduced the extent of stop-and-go credit cycles.

Changes in the structure of the mortgage market have also coincided with sharply lower volatility in real housing activity (see chart, next page). Residential investment spending exhibited pronounced cycles prior to the 1990s, with growth rates of 40 percent or more during booms, and similar declines during busts. This cyclical volatility has now diminished markedly, with housing activity growing at a more stable pace.

Housing fundamentals

Housing prices have shown a similar convergence toward more steady growth over this period, helped by securitization and less volatile lending conditions. With mortgage lending subject to (partly regional) boom-bust financing cycles prior to the 1980s, even qualified home buyers were at times unable to obtain financing. This may have induced households to pay a premium over a home's fundahousing market recently prompted financial regulators to tighten oversight of home equity and other residential loans.

Challenges ahead

The IMF's Executive Board saw broadly favorable prospects for the U.S. economy (see table, previous page). It noted some risks, citing continued higher oil prices (which could begin weighing more heavily on domestic demand) and an external current account deficit that is expected to remain large well into the medium term.

With slightly above-potential growth slowly eroding economic slack and real interest rates at low levels, Directors viewed the Federal Reserve's gradual removal of monetary stimulus as effective and appropriately balanced for achieving the twin goals of price stability and growth. They also noted that a key element of the strategy's success has been the combination of interest rate hikes with clear messages that more forceful action would be required if price pressures continued to intensify.

The Board welcomed the U.S. authorities' commitment to fiscal deficit reduction, as well as recent revenue-driven improvements in the budget outlook. Most Directors argued that the present cyclical strength of the U.S. economy provided an auspicious opportunity to accelerate the pace of fiscal consolidation, which is still critically important given the impending pressures on entitlement programs as the baby boom generation begins to retire. In this context, most Directors felt that options for revenue enhancements—including a broadening of the income tax base or consumption or energy taxes—should be explored, given the strict spending discipline already assumed in U.S. budget projections.

Fiscal consolidation would also help raise national saving—a U.S. Administration priority and a concern for the IMF Executive Board, which viewed the extremely low saving rate as a key policy challenge going forward. Directors stressed that complementary efforts were needed in other parts of the world to implement the agreed strategy for reducing global imbalances.

Directors continued to emphasize the need to address the severe underfunding of major entitlement programs, which would be key to restoring long-term fiscal sustainability. With public health care spending projected to triple as a ratio to GDP in coming decades, they called for further steps to improve the efficiency of the overall health care system. Directors also welcomed the Administration's recent support for specific measures to place the Social Security system on a sustainable basis, stressing that delays in legislative action would only increase the adjustments that will eventually be needed. ■

Kornélia Krajnyák and Martin Mühleisen
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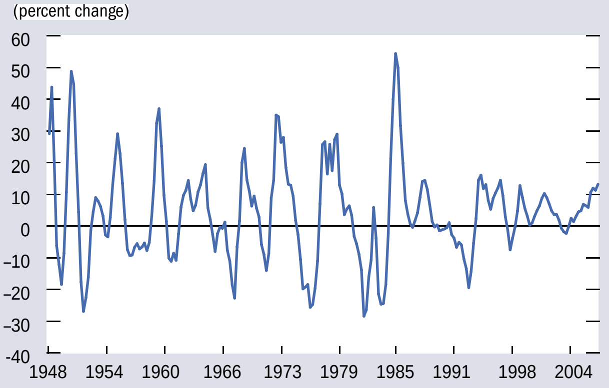
mental value during periods of easy financing, and vice versa. The shift in mortgage financing to a securitized national market has reduced the volatility of credit flows, lowering the incentive for such "over" and "under" payments, and possibly reducing swings in house prices.

Empirical evidence supports this hypothesis. The link between fundamentals—such as interest rates, income, and unemployment—and housing prices appears to have become tighter after the mid-1980s, with fundamentals accounting for a larger share of variation in housing prices in the 1990–2004 period than before. The unexplained portion of house price developments ("pricing errors") has also tended to shrink in the later period, suggesting the reduction was associated with mortgage market securitization rather than with an overall reduction in macroeconomic volatility.

This analysis should help allay some concerns about the housing market's future. It suggests, first, that current pricing errors are not particularly large and that rising incomes, employment, and low interest rates still explain much of the recent gains in housing prices. Second, recent above-trend growth in the real estate market follows a decade of negative surprises, especially on the coasts. This may mean that recent housing price gains partly reflect a catch-up of prices relative to fundamentals.

Housing activity has grown more stable

Before the 1990s, real residential investment in the United States was highly volatile, with booms and busts of 30 percent and more.



Data: U.S. Bureau of Economic Analysis.

Calvin Schnure
IMF Western Hemisphere Department

This article is based on IMF Country Report No. 05/258, *United States: Selected Issues.* Copies of the report are $15.00 each and can be ordered from IMF Publication Services. See page 248 for ordering information. The full text is also available on the IMF's website (*www.imf.org*).

Austria looks eastward

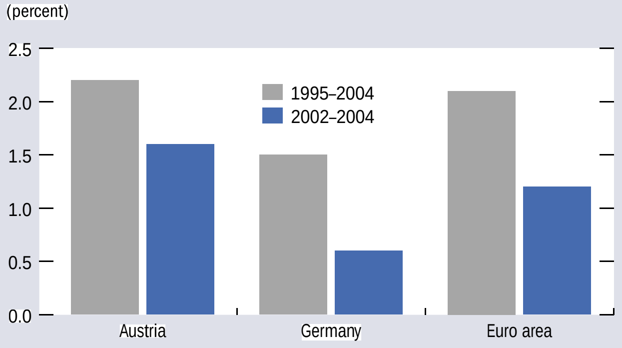
Situated at the heart of the European continent, Austria benefits from access to diverse markets, both mature and emerging. Historically, Austria's strong economic ties to Germany have provided a relatively stable growth path and a buffer against external shocks. Signs are emerging, however, that the Austrian economy is gradually becoming less dependent on Germany than before, while its links with the faster-growing economies of the Central and Eastern European countries are strengthening.

Austria's economic outlook is increasingly affected by its changing international economic and financial relationships. In particular, its growing economic and financial links with Central and Eastern Europe have helped diversify the economy and, recently, cushion it from relatively less favorable developments in Western Europe and Germany in particular. Indeed, among the European Union (EU)-15 countries, Austria is likely to have benefited most from Central and Eastern Europe's transition to market economies and the subsequent entry into the EU of 10 new member states.

Austria's early focus on building economic and financial relationships with Central and Eastern Europe, including through the banking, industry, and transport sectors, is now bearing fruit; it has increased its exposure to a relatively fast-growing area in Europe, while reducing its dependence on traditional trade partners. This diversification of the economy is likely to bolster both future economic growth and stability.

Stronger Austrian growth

In recent years, Austria's growth rate has outpaced its euro area counterparts.



Data: IMF, *World Economic Outlook*.

The Austrian-German connection

Austria's output growth rates averaged 2.2 percent annually over the past 10 years, in line with average growth rates in the euro area (see chart, this page). But, in recent years, Austria's real GDP has outperformed its euro area counterparts. Between 2002 and 2004, Austria's real GDP rose, on average, by 1.6 percent a year, compared with growth rates of 0.6 percent in Germany and 1.2 percent in the euro area.

For decades, developments in the Austrian economy have been closely associated with economic conditions in Germany, particularly on the trade side. Austria had much to gain from its close proximity to a large, prosperous economy. Over the past 20 years, Austria's exports to Germany more than tripled in constant U.S. dollar terms, accounting for just under 13 percent of Austria's GDP in 2004—roughly double the rate in the early 1980s. Today, Germany remains Austria's largest trading partner by far, responsible for about 31 percent of Austria's total exports.

Austria continues to enjoy increased exports to Germany as a percent of Austria's GDP, but with greater diversification of Austria's trade patterns, the intensity of trade with Germany has diminished. The share of Austria's total exports going to Germany has been trending downward steadily since the early 1990s. In terms of total trade intensity (exports and imports), Austria's trade with Germany has also been trending lower, even though the share of imports from Germany has remained relatively stable.

Less synchronization

German and Austrian business cycles also appear to be less synchronized than they once were. Estimates of the degree of comovement among key Austrian macroeconomic aggregates and the German economy suggests some decline in correlation of growth rates between the two economies. For example, the correlation between Austrian and German real GDP growth, calculated over a 10-year rolling window, has fallen in recent years, albeit moderately.

More revealing is the pronounced downward shift, since the late 1990s (see chart, next page), in the 10-year rolling correlation between the growth rates of Austria's real GDP and Germany's domestic demand. This development reflects the divergence in recent years between the growth rates of the Austrian economy, which averaged 1.6 percent between 2002 and 2004, and German domestic demand, which contracted in each of those three years.

Looking eastward

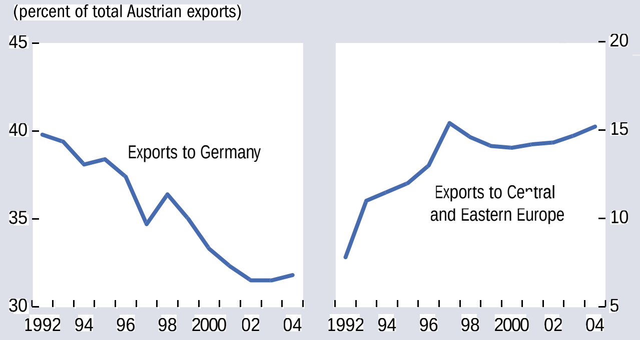
Austria's economic performance is increasingly influenced by its growing economic and financial links with Central and Eastern Europe, which have provided it with important new markets. Austrian foreign direct investment (FDI) in the region has also played an important role in the integration process, having risen significantly over the past decade and reaching close to €16 billion on a cumulative basis. On an annual basis, Austrian FDI in Central and Eastern Europe has risen to about 2 percent of Austrian GDP.

The role of Austrian FDI has been particularly crucial in the financial sector. Austrian banks' market share in Central and Eastern Europe, based on total assets, has reached approximately 20 percent, and in several countries this share is appreciably larger. Furthermore, in 2004, the three largest Austrian banks derived more than 40 percent of their pretax earnings from operations in the region.

Austria's stronger ties to Central and Eastern Europe appear to have coincided with reduced dependency on German economic conditions. On the trade side, Germany's market share of Austrian exports fell from nearly 40 percent in 1992 to about 32 percent in 2004. Conversely, Central and Eastern Europe saw its market share of Austrian exports roughly double to about 15 percent (see chart, right). Moreover, while comovement indicators between Austria and Germany have weakened, the correlation of macroeconomic aggregates between Austria and key Eastern European economies (particularly Hungary, Austria's largest trading partner among the Central and European countries) appears to show a steady increase in business cycle synchronization in recent years.

Central and Eastern European markets are rising in importance

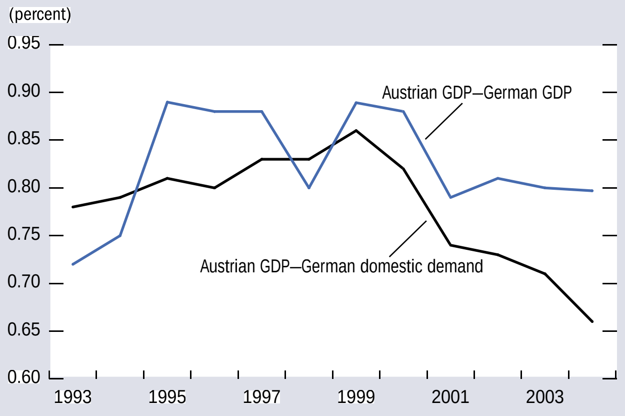
While Germany's share of Austria's exports has dropped by nearly 8 percentage points, Central and Eastern Europe's share has nearly doubled.



Note: The group of Central and Eastern European countries included here are Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, and Slovenia, representing the bulk of Austria's trade and investment links with the region.
Data: IMF, *Direction of Trade Statistics.*

Austria and Germany: growth divergence

Low correlation between Austrian growth and German domestic demand has highlighted the growth divergence.[1]



[1]Ten-year rolling correlation.
Data: IMF, *World Economic Outlook.*

Austria's success in sustaining positive growth rates, especially at a time when German domestic demand is contracting, is testament to the resiliency and flexibility of the Austrian economy and its ability to reorient itself to areas where potential growth rates are higher. Austrian companies have been looking not only to Central and Eastern Europe but more recently to Southeastern Europe to diversify their trade and investment opportunities.

That said, it is too early to say whether this process is temporary or reflects a more permanent structural shift. Once the transition economies have matured and become less of a magnet for new investment and export markets, Austria's trade intensity may well shift back in the direction of Germany and other Western European economies. ■

Natan Epstein
IMF European Department

This article is based on IMF Country Report No. 05/249, *Austria: Selected Issues*. Copies are available for $15.00 each from IMF Publication Services. Please see page 248 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

Southeastern Europe: attracting foreign direct investment

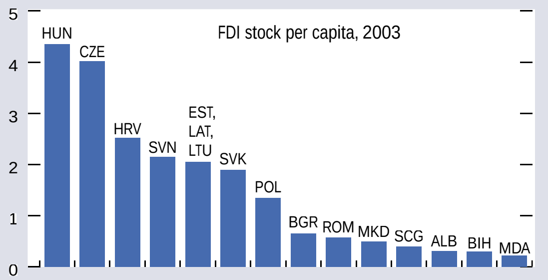
Policymakers trying to attract foreign direct investment (FDI) to their countries often have exaggerated expectations of what their efforts can accomplish. A recent IMF Working Paper confirms that factors outside the reach of policymakers are at least as important as policies. But policies do matter, and the paper discusses what influences FDI and what does not. It also argues that above a certain level of foreign investment, some policies lose significance while others become more important. By estimating "potential FDI" and contrasting this with actual levels of FDI, the paper tries to give authorities a more realistic expectation of what the right policies can achieve.

The benefits of FDI for a host country have long been recognized: knowledge and technology transfer, productivity spillovers, enhanced competition, and improved access for exports abroad, notably in the source country. But FDI can have negative aspects, too. Large foreign companies often try to coax concessions from host country governments, and sometimes abuse their dominant market position or use transfer pricing to minimize their tax obligations. On balance, however, the consensus is that the benefits of foreign investment tend to outweigh its costs, especially in transition economies that have extensive restructuring and modernization needs and limited domestic capital and other resources.

Leaders and laggards

Southeastern European countries have attracted less FDI than their Central European neighbors in per capita terms.

(thousands of U.S. dollars)



Note: ALB: Albania; BIH: Bosnia & Herzegovina; BGR: Bulgaria; HRV: Croatia; CZE: Czech Republic; EST: Estonia; HUN: Hungary; LVA: Latvia; LTU: Lithuania; MKD: FYR of Macedonia; MDA: Moldova; POL: Poland; ROM: Romania; SCG: Serbia & Montenegro; SVN: Slovenia; SVK: Slovakia.
Data: UNCTAD.

Southeastern Europe lagging

The decidedly mixed experience of the European transition economies provides an interesting case study (see chart, this page). Some Central European countries, like Hungary and the Czech Republic, have been very successful in attracting foreign investment, accumulating a stock of FDI per capita of $4,000–$4,500 by the end of 2003. Others, notably the countries of Southeastern Europe (Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia (FYR of Macedonia), Serbia and Montenegro, Bulgaria, and Romania) have been much less successful, with some barely reaching the level of $500 of FDI per capita. And the gap between Central and Southeastern European countries is persistent and significant whether FDI is measured in absolute dollar terms or in per capita terms.

What explains FDI patterns in Southeastern European countries—a region largely absent from the existing literature—and how can policies help? To examine this, the study assembled a database with bilateral FDI stocks and flows between 15 host countries (all of Central, Eastern, and Southeastern Europe plus the Baltics) and 24 source countries (the EU-15—the European Union's pre-expansion members—plus Croatia, Cyprus, the Czech Republic, Hungary, Poland, Russia, Slovenia, Switzerland, and the United States). Advanced economies of Central and Eastern Europe that received FDI in the 1990s and more recently have been sources of foreign investment appear in both groups.

The force of gravity

All previous empirical studies have found that gravity factors (size of the host country market and proximity to the source country) are the most important determinants of FDI. This study uses population—either alone or in conjunction with GDP per capita—as a proxy for market size, the distance between source and host capitals as a measure of geographic proximity, and a dummy capturing cultural or historical ties between source and host country as a proxy for "cultural proximity." Its findings confirm that gravity factors explain about 60 percent of FDI flows between countries—a sobering finding for policymakers eager to make their countries more attractive to foreign investors. Factors that they cannot influence, such as country size, location, and history, explain over half of the variation in foreign investment.

Do policies matter, then?

But there are steps that policymakers can take to improve their countries' chances of attracting FDI. The study finds that high unit labor costs, high corporate tax burdens, and, to a lesser extent, high import tariffs discourage foreign investment, whereas liberal foreign exchange and trade regimes and public sector infrastructure reforms, including deregulation to improve competitiveness, stimulate it. In contrast, tax holidays and domestic corruption do not seem to have a statistically significant impact. The results concerning institutional variables, however, should be interpreted with caution, because the indicators used as proxies are not always accurate.

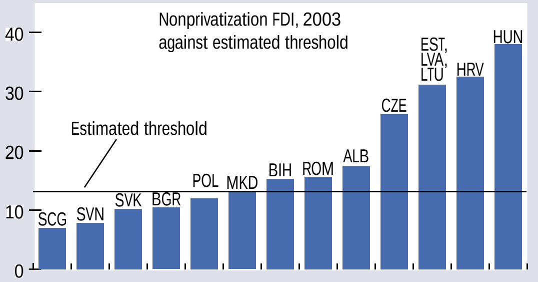
Taken together, these results provide a basis for evaluating the policies aimed at attracting foreign investors and highlight the limits of what these policies can achieve. Take, for example, the emphasis placed by international financial institutions and policymakers in Southeastern Europe and elsewhere on liberalizing the trade and foreign exchange regime and controlling labor costs. The findings suggest that these policies are indeed likely to have a direct impact on FDI. On the other hand, efforts to improve governance and combat corruption—their broader economic benefits notwithstanding—may not have a major *direct* impact on FDI. Of course, they could still stimulate foreign investment, indeed all investment, *indirectly* through their positive effects on the economy.

Identifying the policies that are most effective in attracting foreign investment in a large sample of countries is only half the story. The effect that policies have on FDI is dependent upon individual country circumstances. Using a quantitative technique that tests for "threshold effects," the study finds that policies have different effects once FDI increases beyond a level of around 12 percent of GDP (excluding privatization receipts), roughly that in Poland in 2003 (see chart, this page). When FDI is below that level, gravity variables and labor costs are the predominant determinants of foreign investment. As FDI rises above that level, however, the importance of these factors declines, and the host country's level of income and broader institutional factors increase in importance.

The FDI threshold

As FDI increases above a certain threshold, the impact of policies changes.

(percent of GDP)



Note: ALB: Albania; BIH: Bosnia & Herzegovina; BGR: Bulgaria; HRV: Croatia; CZE: Czech Republic; EST: Estonia; HUN: Hungary; LVA: Latvia; LTU: Lithuania; MKD: FYR of Macedonia; MDA: Moldova; POL: Poland; ROM: Romania; SCG: Serbia & Montenegro; SVN: Slovenia; SVK: Slovakia.
Data: Author's calculations.

This suggests that the nature of foreign investment changes as the host country attracts more of it. The initial wave of foreign investors is attracted primarily by market size, ease of access, and low labor costs. But once a "critical mass" of foreign investment is reached, a new kind of investor appears, drawn more by the level of development, the quality of the business environment, and the prosperity of the host country.

What the right policies can accomplish

Even if policymakers know exactly which levers to pull to attract FDI, there is a limit to the discretion they have. Tax or tariff rates cannot be driven to zero, even if this were beneficial. In the real world, policymakers often look over each other's shoulders and use the policies of their most successful neighbors and competitors as a benchmark.

To estimate the impact that policies can have on FDI, the study distinguishes between exogenous variables—the gravity factors—and endogenous variables that are under the policymakers' control. It defines a "potential" level of FDI for each country using the actual values of exogenous variables (size, location, and cultural links to source countries) and the best values of the policy variables across the entire sample of countries. In other words, it identifies the highest value of the foreign exchange and trade liberalization and infrastructure reform indices, and the lowest unit labor cost, tariff level, and corporate tax burden across the countries in Central and Southeastern Europe in 2003. The gap between actual FDI and this "potential" measures how much each country stands to gain from getting its policies right.

The comparison between "potential" and actual nonprivatization FDI at the end of 2003 shows that Bosnia and Herzegovina, Albania, the FYR of Macedonia, Croatia, and Serbia and Montenegro have the most to gain from getting their policies right. That margin is smaller for Romania and Bulgaria, which have already attracted considerable FDI.

This concept of "potential" FDI should, of course, be seen as a benchmark, not a ceiling. Using the best values of the policy variables across the sample does not mean that "better" values are not possible. But this approach can give policymakers an idea of the amount of FDI that could realistically be expected if each country emulated its most successful neighbors. To continue attracting sizable FDI inflows, countries that are closer to their "potential" should strive to go beyond the policy norms prevailing in the region. ■

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This article is based on the work of Balázs Horváth, Elina Ribakova, and Yi Wu, who, with Dimitri Demekas, authored IMF Working Paper No. 05/110, *Foreign Direct Investment in Southeastern Europe: How (and How Much) Can Policies Help?* Copies are available for $15.00 from IMF Publication Services. See page 248 for ordering details. The full text is also available on the IMF website (*www.imf.org*).

Has IMF conditionality really been streamlined?

In 2000–02, the IMF conducted a major review of the conditions it attaches to its lending—its conditionality—and replaced guidelines dating back as far as 1979. The new policy chiefly stems from concerns that there had been a large expansion of structural conditionality in the 1990s and that disappointing implementation suggested relatively weak ownership of IMF-supported programs by national authorities. New guidelines highlight the need for greater focus and streamlining, but has there been real progress? In many areas, yes, says Tessa van der Willigen (IMF Policy Development and Review Department). She summarizes here the findings of a recent IMF evaluation on the application of the new guidelines.

Conditionality remains a subject of controversy and debate. Some argue that conditions should be done away with altogether, but from the IMF's point of view conditionality is not optional. The IMF must be sure that its resources are supporting policies that help countries resolve their balance of payments difficulties and allow them to repay loans so that these resources can, in turn, be used by other countries. Conditionality also clarifies the terms on which future installments of IMF loans will be available, thus giving countries the confidence to embark on programs that could not be sustained without such support.

Of course, that conditionality is here to stay does not mean that it is, or has been, perfect. The new policy is the culmination of a long process of internal and external discussion that led the IMF to embark on streamlining. These efforts actually began in 2000, even before the new policy was formally in place, and in March 2005, the IMF's Executive Board assessed how much progress had been made.

The 2002 guidelines are based on five key principles: national *ownership* of policy programs; *parsimony* and *clarity* in the application of conditions; *tailoring* of policies to circumstances; and *coordination* with other multilateral institutions. These principles are intended to reinforce each other and improve program design and implementation. The guidelines depart from earlier practice primarily in that they call for streamlining structural conditionality and formulating programs in a way conducive to national ownership of policies. These issues were the focus of the recent review. Ultimately, the new guidelines will be judged successful if they contribute to improved economic outcomes, but it is too early to gauge whether this has been the case. This review sought instead to serve as an interim checkpoint, focusing on whether the guidelines are being implemented, and how that implementation can be improved.

What's being covered?

If structural conditionality is becoming more focused on those measures critical to program success, it should become more concentrated in especially relevant areas and it should be more strongly linked to the country's initial economic conditions. This is exactly what the review found has happened. Structural conditionality has shifted out of "noncore" areas and into "core" areas that are likely to be most closely linked to the goals of Fund-supported programs. Specifically, structural conditionality has become more concentrated in areas related to economic management and vulnerability, and less dispersed across sectors. Moreover, econometric evidence suggests that the link between the numbers of conditions in a particular area (such as fiscal management) and economic circumstances (for example, the level of the fiscal deficit) has become stronger, suggesting a sharper focus on priorities.

At the same time, the 2005 review points to some scope for further streamlining coverage. First, in examining staff reports on IMF loans, the review found that program strategies for those areas of action considered crucial are not always set out clearly. While this could be only a presentational issue, there is no doubt that focusing on a few key strategies in the process of developing a policy program is conducive to parsimonious conditionality. Second, greater care needs to be taken to set "structural benchmarks" in only critical areas. These differ from "structural performance criteria" in that disbursements of loan installments are not automatically interrupted if benchmarks are not observed. This makes it tempting to use benchmarks for less-than-critical measures when, in truth, they should be used for small steps in a critical process of reform, where a failure or delay in implementation of one step is not sufficient to derail the entire process.

Of course, streamlining the coverage of structural conditionality is not without risks. Clearly, conditionality has shifted away from growth- and efficiency-related reforms—even in low-income countries, where a focus on growth is especially needed. And World Bank conditionality does not appear to have stepped in to fill this "gap."

Is this something to worry about? Not necessarily, as country ownership, rather than conditionality, ultimately drives policy agendas forward. Gaps in analytical work, policy advice, or technical assistance would thus arguably be more worrisome. Still, the issue clearly deserves to be kept under review and assessed in more depth once the outcomes of "streamlined" programs are known.

Numbers and clarity

Intuitively, streamlining could be expected to produce fewer structural conditions. In fact, there has been only a small decline in the number of conditions associated with Poverty Reduction and Growth Facility loans and none at all with regard to nonconcessional loans. This is disappointing, but it is also necessary to recognize that numbers are a crude metric; indeed, sometimes a clearer focus on what is critical may bring with it a need for *more* conditions rather than fewer.

In fact, in the IMF's nonconcessional lending there has been a large increase in conditions related to financial sector vulnerability, reflecting the growing understanding of the importance of this area. Other factors may also keep the numbers of conditions high, including detailed specification of conditions and a tendency to set more conditions when countries have weak track records. Both tendencies are in accordance with the guidelines—and indeed some borrowing countries *prefer* conditions set at a high level of detail, as they function as helpful guideposts—but they should not be allowed to get out of hand.

The recent record is unambiguously positive on the clarity of conditions. The 1990s had seen boundaries blurred between measures critical for disbursements to continue and others that merely signaled IMF encouragement or the authorities' commitment. Five years into the streamlining initiative, program-related conditions are now almost always clearly specified and transparently distinguished from the rest of the authorities' program.

Evidence suggests that programs now suffer fewer irremediable interruptions, although temporary interruptions . . . and delays in . . . program reviews . . . have not declined.

Program implementation

Although it is too soon to judge whether IMF-supported programs under the new guidelines have contributed to better economic outcomes, some improvement is evident in program implementation. Early evidence suggests that programs now suffer fewer irremediable interruptions, although temporary interruptions and their counterparts—delays in completing program reviews—have not declined.

At first sight, developments in the implementation of structural performance criteria have been disappointing, although looking below the surface suggests a rather better picture. Performance criteria require waivers if they have not been implemented and if disbursements are to proceed. The review found that waiver rates have not fallen (and have even risen in nonconcessional loans). Tracking waived performance criteria through to the end of the arrangement, however, shows that an increasing proportion of these criteria is implemented eventually. This better implementation is in line with a greater focus on critical conditions, although waivers continue to be used to give the authorities leeway, in particular with respect to timing of implementation. Realistic timetables will be key to reducing waiver rates, while maximizing the assurance given to a borrowing country that it will be able to access IMF resources.

Ownership and process

The 2005 review looked at the process of program development in 10 country cases. While the evidence is preliminary—and the IMF Independent Evaluation Office (IEO) upcoming review of structural conditionality will go into greater depth—indications are that IMF staff are making serious efforts to implement processes conducive to ownership: for example, by establishing an active dialogue with the authorities and accommodating their preferences where possible, seeking to involve all the key officials responsible for implementation, and helping the authorities work toward broad public ownership of the policy program.

Of course, good processes do not guarantee ownership and, indeed, gauging the level of ownership is, and will remain, a major challenge. Similarly, whether to proceed with a loan in the presence of uncertain ownership remains a delicate matter of judgment. Certainly, substituting conditionality for ownership is not the answer. Conditionality, especially prior actions, can be used as a device for governments to demonstrate their commitment. But the review advises caution. In its findings, programs with many prior actions tended to have worse implementation of subsequent conditionality than average, leaving one to wonder about the extent of ownership as a whole and the durability and quality of implementation of even the prior actions. In some of these cases, rather than loading programs with conditions and prior actions, it may be preferable to exercise greater selectivity and, where possible, make use of staff-monitored programs to establish a track record of implementation.

The IMF will continue its efforts to implement the new policy, guided by the findings of this review and, no doubt, by the recommendations of the forthcoming IEO evaluation of structural conditionality. A new review of the 2002 conditionality guidelines will be conducted in 2008. By that time data on multiyear economic outcomes of a number of "streamlined" programs will be available. That will allow the 2008 review to ask the key question that eluded this year's review: have the new guidelines achieved their objective of helping borrowing countries reach better outcomes? ■

Demystifying hedge funds

When launched four decades ago to appeal to a select group of wealthy private individuals, the hedge fund industry went relatively unnoticed by both financial regulatory authorities and the general public. Much has since changed, however. Over $1 trillion in assets are now managed by more than 8,000 hedge funds, which share a fee structure whereby fund managers retain a portion—typically, 20 percent—of profits earned. Many funds today reach ordinary retail investors, with the minimum investment having fallen from an average $1 million to $25,000 and to as low as $2,500 for a few funds.

To increase public understanding of hedge funds, the American Enterprise Institute for Public Policy Research (AEI) is sponsoring a series of conferences. The first one, on the role these funds play in capital markets, was held June 26 and featured a panel of practitioners and academics discussing associated policy issues including prospects for regulating hedge funds and the industry's future direction. Adam Lerrick (AEI and Carnegie Mellon University) moderated the discussion.


Massoud Etemadi/IMF

Evolution of hedge funds

How did hedge funds come into being? The first hedge fund was set up in 1949 as a way to use (then) innovative investment strategies to seek to minimize risk while enhancing returns. But as John Makin (Caxton Associates) explained, the industry really took off in the 1980s as an alternative to the equity-focused, benchmark-evaluated mutual and pension fund industries. The largest hedge funds emerged around major traders in volatile markets for commodities, currencies, and fixed-income instruments.

But since 2000, the role of many new hedge funds has changed radically, Makin said, with increasing numbers of investors viewing them as "a kind of octane additive" to their pension and mutual fund portfolios. Today's numerous hedge funds follow a wide range of investment strategies, with some indistinguishable from mutual funds—although hedge funds are less stringently regulated.

Moral hazard problems

As with other investment activities, Makin pointed out, a moral hazard problem exists both across the industry and within hedge funds themselves. He warned that a scenario where a number of hedge funds simultaneously pursue a "shoot-for-the-moon" investment strategy could heighten systemic risk, as occurred with the collapse of major hedge fund Long-Term Capital Management (LTCM) in 1998.

Protecting unsophisticated investors

Arguing that LTCM should have been allowed to fail, Makin said the "only way" to protect unsophisticated investors is to "show them what happens if they don't do their homework." He cautioned against central banks and other authorities stepping in to accommodate liquidity needs in these situations because it could encourage some funds to again follow overly aggressive investment strategies.

In contrast, Chester Spatt (U.S. Securities and Exchange Commission) warned that regulation is needed for "issues involving the stability of the market" and to protect less sophisticated investors, particularly since the recent "retailization" of these funds means that newer investors often do not fully understand the risks involved. Some policymakers are also concerned, he added, because investment advisers may have incentives to substantially add to the risk their hedge funds bear if those risks are not fully understood or detected in the marketplace. Systemic risk—the possibility of correlated defaults across the economy—is another reason why hedge funds have been receiving increased attention from policymakers, Spatt said, also drawing on the example of LTCM's collapse.

Tanya Beder (Citigroup Alternative Investments) agreed that there are critical questions about how best to regulate such an industry, especially since she expects it to undergo some "massive changes" over the next few years to meet new demands. Beder took a more benign view of hedge funds, however, arguing that their activities can actually make for more stable markets, as hedge fund arbitrage trading has been known to help "smooth out" volatility during periods of high market turbulence. ■

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IMF External Relations Department

Stand-By, EFF, and PRGF arrangements as of July 31

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By				
Argentina	September 20, 2003	September 19, 2006	8,981.00	4,810.00
Bolivia	April 2, 2003	March 31, 2006	171.50	60.00
Bulgaria	August 6, 2004	September 5, 2006	100.00	100.00
Colombia	May 2, 2005	November 2, 2006	405.00	405.00
Croatia	August 4, 2004	April 3, 2006	97.00	97.00
Dominican Republic	January 31, 2005	May 31, 2007	437.80	385.26
Paraguay	December 15, 2003	September 30, 2005	50.00	50.00
Peru	June 9, 2004	August 16, 2006	287.28	287.28
Romania	July 7, 2004	July 6, 2006	250.00	250.00
Turkey	May 11, 2005	May 10, 2008	6,662.04	6,106.87
Uruguay	June 8, 2005	June 7, 2008	766.25	735.60
Total			**18,207.87**	**13,287.01**
EFF				
Sri Lanka	April 18, 2003	April 17, 2006	144.40	123.73
Serbia and Montenegro	May 14, 2002	December 31, 2005	650.00	62.50
Total			**794.40**	**186.23**
PRGF				
Albania	June 21, 2002	November 20, 2005	28.00	4.00
Armenia	May 25, 2005	May 24, 2008	23.00	19.72
Bangladesh	June 20, 2003	December 31, 2006	400.33	184.55
Burkina Faso	June 11, 2003	August 15, 2006	24.08	10.32
Burundi	January 23, 2004	January 22, 2007	69.30	35.75
Chad	February 16, 2005	February 15, 2008	25.20	21.00
Congo, Democratic Republic of	June 12, 2002	October 31, 2005	580.00	53.23
Congo, Republic of	December 6, 2004	December 5, 2007	54.99	47.13
Dominica	December 29, 2003	December 28, 2006	7.69	3.48
Georgia	June 4, 2004	June 3, 2007	98.00	70.00
Ghana	May 9, 2003	October 31, 2006	184.50	79.10
Guyana	September 20, 2002	September 12, 2006	54.55	27.79
Honduras	February 27, 2004	February 26, 2007	71.20	40.69
Kenya	November 21, 2003	November 20, 2006	225.00	150.00
Kyrgyz Republic	March 15, 2005	March 14, 2008	8.88	7.62
Mali	June 23, 2004	June 22, 2007	9.33	6.67
Mozambique	July 6, 2004	July 5, 2007	11.36	6.50
Nepal	November 19, 2003	November 18, 2006	49.91	35.65
Nicaragua	December 13, 2002	December 12, 2005	97.50	41.78
Niger	January 31, 2005	January 30, 2008	6.58	5.64
Rwanda	August 12, 2002	February 11, 2006	4.00	1.14
Senegal	April 28, 2003	April 27, 2006	24.27	13.86
Sri Lanka	April 18, 2003	April 17, 2006	269.00	230.61
Tajikistan	December 11, 2002	February 10, 2006	65.00	9.80
Tanzania	August 16, 2003	August 15, 2006	19.60	8.40
Uganda	September 13, 2002	December 31, 2005	13.50	4.00
Zambia	June 16, 2004	June 15, 2007	220.10	49.52
Total			**2,644.86**	**1,167.96**

EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals owing to rounding.
Data: IMF Finance Department.

IEO identifies priority topics for coming year

The IMF's Independent Evaluation Office (IEO) recently outlined its work program for FY 2006. In addition to a study on the IMF's structural conditionality that is already under way, it committed to review the following three topics:

Advice on exchange rate policy. While the IMF's Articles of Agreement clearly obligate member countries to "avoid manipulating exchange rates" and "follow exchange policies compatible" with an orderly and stable exchange rate system, clear and candid discussions of exchange rate issues remain a challenge. This partly reflects the market-sensitive nature of these issues as well as the lack of consensus about what constitutes a sustainable exchange rate under a given set of conditions. The IEO review will ask questions on both the IMF's policy advice on the choice of an exchange rate regime in various circumstances and the methodology the organization uses to assess or identify competitiveness, sustainability, and manipulation. The evaluation will examine a representative sample of developing, emerging market, and industrial countries in recent years.

The IMF's role in African countries. Calls for a sizable scaling up of aid to African countries have raised questions about just how that aid is accommodated in the IMF's policy advice and program design. How does the IMF gauge the sustainability of aid-financed fiscal spending, its effects on exchange rates and competitiveness, and the behavior of private sector savings and investment? The IEO will base its evaluation on in-depth case studies of a small number of sub-Saharan African countries, with a focus on the IMF's actual policy advice and program design inputs, the analytical basis for this advice, and the outcomes. More specifically, it will address the setting of the medium-term resource envelope, aid predictability, and related issues such as revenue erosion and "Dutch disease" (in which aid inflows make exports less competitive).

Bilateral surveillance. Surveillance is one of the IMF's core responsibilities, and its effectiveness has been a top priority for the organization's International Monetary and Financial Committee and Executive Board.

The IEO's evaluation will ask three questions: What value added does surveillance provide for domestic policymakers, the international community, and markets? How are bilateral (country) and multilateral (global) surveillance—especially for systemically important countries—integrated, and is there scope for adjusting the modalities so as to improve impact? And to what extent have the IMF's internal biennial reviews of surveillance translated into greater effectiveness?

The IEO study will draw on cross-country analysis and reviews of surveillance in various country groupings, including industrial, emerging market, and low-income developing. The precise scope of the country analysis, including the emphasis given to country groups, will be influenced by the findings of the earlier evaluation of multilateral surveillance.

Next steps

Following IEO practice, detailed issues papers or draft terms of reference will be prepared for each project. Before finalizing the scope of an evaluation, the IEO will seek comments from both IMF and external stakeholders, such as academics and civil society organizations. Final terms of reference will then be posted on the IEO website (*http://www.imf.org/external/np/ieo*) and interested stakeholders will be invited to submit inputs on any aspect of the subjects covered in the terms of reference. ■

For more information about the IEO, including the full text announcing its FY 2006 work program, please see the IEO website (*http://www.imf.org/external/np/ieo*).

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