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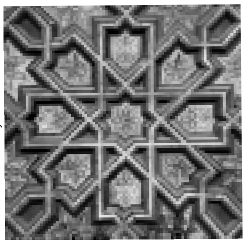
NEWS: Jobs key to Middle East future

High oil prices are a windfall for some Middle East economies, but throughout the region progress with tackling high unemployment and meeting pressing social needs remains frustratingly slow. As the region searches for ways to better integrate into the global economy, create jobs, and boost growth, Mohsin Khan, Director of the IMF's Middle East and Central Asia Department, sees signs of remarkable political changes that could be vital for a region that has frequently bewildered economists.


Henrik Gschwindt De Gyor /IMF

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COUNTRY FOCUS: Ukraine's turning point?

Ukraine's new government—which took office in January following a bitter election battle—has established as its top priorities rooting out corruption and putting the country on a path toward European Union accession. Fiscal discipline must be reestablished and extensive structural reforms will need to be implemented, but with investor interest running high and the international community standing ready to support serious reforms, this could be a watershed moment for Ukraine.


Itar-Tass/Ukrinform

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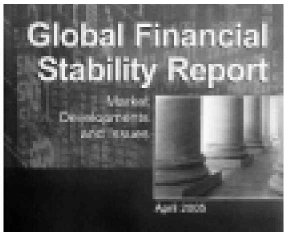
RESEARCH: World financial markets are healthier

Global financial markets have grown stronger and more resilient, according to the IMF's April 2005 *Global Financial Stability Report*. Solid growth and improved corporate and emerging market fundamentals are chiefly responsible for the good showing, although with interest rates and spreads so low, the risks are on the downside. Also spotlighted in the report are the transfer of risk to the household sector and trends in emerging market corporate finance.



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FORUM: Aid and its trade-offs

The development community is being spurred to consider a substantial increase in aid for poor countries. But larger aid flows, if they do materialize, can be a mixed blessing for recipient countries, particularly for those with limited absorptive capacity. The consensus at a recent high-level seminar in Maputo, Mozambique, was that aid can be excessive if, for example, bottlenecks prevent its effective use or if it adversely affects the recipient country's trade competitiveness.


J. Carlos Vieira/Mozambique

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What's on

April

5 IMF's *Global Financial Stability Report* (April 2005) released

5 IMF First Deputy Managing Director Anne Krueger to speak at Trinity College University, Dublin, Ireland

6 IMF Managing Director Rodrigo de Rato to speak at Georgetown University, Washington, D.C.

7 IMF's Spring 2005 *World Economic Outlook* (analytical chapters) released

8 IMF Book Forum, Thomas Friedman, *The World Is Flat: A Brief History of the 21st Century*, Washington, D.C.

10–12 Inter-American Development Bank Annual Meeting, Okinawa, Japan

13 IMF's Spring 2005 *World Economic Outlook* (Chapter 1) released

16–17 2005 Spring Meetings of the IMF and the World Bank Group, Washington, D.C.

18 ECOSOC High-Level Meeting: IMF, World Bank, WTO, and UNCTAD, UN Headquarters, New York

18–20 Asian Development Bank, International Conference on Achieving Results in the Private Sector, Manila, Philippines

19–20 IMF High-Level Seminar on "Asset Securitization and Structured Finance," Washington, D.C.

20–22 World Bank Civil Society Global Policy Forum, Washington, D.C.

20–22 WTO Public Symposium, "WTO After 10 Years: Global Problems and Multilateral Solutions," Geneva, Switzerland

May

4–6 Asian Development Bank Annual Meeting, Istanbul, Turkey

4–6 Third Ministerial Conference of the Community of Democracies, Santiago, Chile

16–25 World Health Organization World Health Assembly, Geneva, Switzerland

18–19 African Development Bank Annual Meeting, Abuja, Nigeria

18–20 IMF seminar for legislators and journalists, San José, Costa Rica

22–23 Annual Meeting of the European Bank for Reconstruction and Development, Belgrade, Serbia

29–30 IMF High-Level Seminar on "Macroeconomic Policy and Social Equity in Latin American Countries," Santiago, Chile

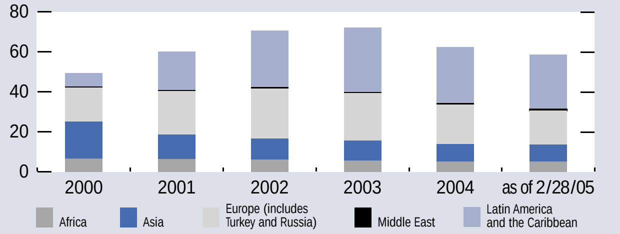
IMF Executive Board
For an up-to-date listing of IMF Executive Board meetings, see *www.imf.org.external/np/sec/bc/eng/index.asp*.

At a glance

IMF financial data

Total IMF credit and loans outstanding, by region

(billion SDRs, end of period)



Major currencies, rates per SDR

(end of period)

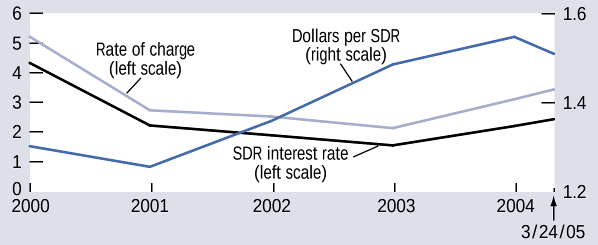
	March 2005	Year ago
Euro	1.165	1.211
Japanese yen	162.187	154.417
U.K. pound	0.803	0.807
U.S. dollar	1.511	1.481

IMF available resources

(one-year forward commitment capacity, billion SDRs)

Related rates

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



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.

Interview with Mohsin Khan

Boosting growth and tackling unemployment seen as key objectives for Middle East

After some 30 years at the IMF concentrating on economic research—including as Director of the IMF Institute and Deputy Director of the Research Department—Mohsin S. Khan, a Pakistani national, took over as Director of the Middle East and Central Asia Department in early 2004. The region, which continues to struggle with military conflicts, slow growth, high unemployment, and rapid population growth, has in many ways been sidelined from globalization and the benefits of closer economic links with the rest of the world. Khan recently spoke with Laura Wallace about some promising developments and what the region must do to bolster its economic prospects.

Michael Spilotro/IMF

Khan: "I don't think that anyone really has an answer to why the region has been growing more slowly on average on a per capita basis than most other developing country regions."

IMF SURVEY: Rapidly growing, youthful populations hold great potential but also risks for the Middle East, which in recent decades has experienced sluggish growth and job creation. Is it approaching a tipping point where something must be done to meet rising expectations or risk a social crisis?

KHAN: The idea that the region is reaching a tipping point is probably the right way to put it. It's not at a crisis point yet, because the states are still by and large able to support the present population with subsidies and jobs, and in many of these countries, public sectors can still grow even more. That's not a good idea. It's not good economics or good policy. But if they have the resources, they can do it. Right now, the region's biggest challenge is unemployment, and the answer to unemployment is faster economic growth—plus lower population growth, which then gets into cultural and social patterns. But I don't think that anyone really has an answer to why the region has been growing more slowly on average on a per capita basis than most other developing country regions, especially given its relatively abundant natural resources.

IMF SURVEY: In North Africa, growth is relatively strong but still insufficient to bring down high unemployment rates. What should the top priorities be for the Maghreb? How important is greater regional integration?

KHAN: The main challenge for the Maghreb countries, also, is unemployment, and there's a consensus between the IMF and Algeria, Morocco, and Tunisia that the priorities must be maintaining macroeconomic stability, developing financial sectors, and increasing integration into the world economy—with a focus on stepping up regional integration. Very little trade takes place between these nations, although they're trading much more with the European Union through association agreements. The argument for greater regional integration is that it could significantly boost growth rates (which now hover at 3–5 percent a year) and lower unemployment rates. The creation of a market of 75 million people would open up more opportunities for foreign direct investment. Investors could think: "If I set up in Algiers, I could easily sell in Rabat and Tunis." There's still a political problem between Morocco and Algeria on the Western Sahara, which I hope will be settled soon. The IMF plans to hold a seminar on regional trade facilitation in the fall for the Maghreb countries, and they've all agreed to attend.

IMF SURVEY: Iran, potentially a big player in the region, is reporting a growth rate that is higher than the Middle East average. How do you reconcile this with the country's persistently high unemployment rate?

KHAN: Iran has been growing well—largely thanks to oil price increases and economic reforms undertaken since 2002—but unemployment is still in double digits. The big question is: Could unemployment have declined by more, given the 7 percent rate that annual growth has averaged over the past few years? And what kind of growth rate is needed to make a significant dent in unemployment? This brings us back to the point that I was making earlier about unemployment and growth. If Iran's labor force is growing at an annual rate of 3½ percent, it has to create 500,000 to 750,000 jobs a year just to absorb the new workers—something that is very tough to do. One answer would be to limit the growth of the population and labor force, but that would entail cultural and traditional issues centering on the desired family size. The alternative would be to grow even faster—say at 8, 9, or 10 percent a year. But for that to happen, even more reforms would be needed to stimulate the private sector so that it could create the extra jobs.

IMF SURVEY: The IMF Managing Director and yourself recently attended the London meeting in support of the Palestinian National Authority (PNA). Foreign ministers agreed on a series of steps to help the PNA strengthen its governing institutions, combat corruption, and unify security forces, and $1.2 billion was pledged toward the reform efforts. What are the economic prospects for the West Bank and Gaza? What is the IMF's role in assisting the PNA? And how are we contributing to the peace efforts?

KHAN: The economic situation is grim. Real income per capita is 35 percent lower now than it was in 1999 before the intifada, half of the population is living in poverty, and unemployment averages about 27 percent in the West Bank and 35 percent in Gaza. Economic prospects are highly dependent on political and security developments. The good news is that there's an opportunity now for the Palestinian economy to strengthen and regain lost ground. At the London conference there was a clear sense of optimism.

How does the IMF fit in? We're playing our part in the peace process by contributing to economic development, which also feeds back and helps political and security developments. At this stage, we're focusing on technical assistance. We're supporting the PNA in building sound economic and financial institutions. We're also assisting with donor coordination by ensuring that everyone is aware of the overall macroeconomic objectives and financing needs.

IMF SURVEY: In a number of other Middle Eastern countries—Afghanistan, Egypt, Iraq, and Lebanon, among others—there have been movements toward democracy and more elections. What is the significance of this for the region's economic outlook? How important are democracy and political institutions for growth?

KHAN: These changes are pretty vital for the region. My own view is that giving people a stake in the country gives them a stake in the economy. It makes them more willing to invest labor and capital and take risks. I know it's sort of a loose connection, but that's where the connection lies. There are democracies that grow very slowly, and there are dictatorships that grow fast. But if you want a balanced private sector-oriented, market-oriented economic system, citizens need to be politically involved. They will push the government to be more efficient. We know that bad governance is bad for economic development, and good governance helps economic development. A democracy—no matter how poor it is—puts in place better governance.


Shwan Mohammed/AFP/Getty Images

High youth unemployment is a major problem for the MIddle East. Here, young men gather in Suleimaniya in northern Iraq.

IMF SURVEY: Where does the IMF stand on a loan for Iraq?

KHAN: In September 2004, the IMF provided Iraq with about $436 million in emergency postconflict assistance to help it strengthen its capacity to undertake wide-ranging reforms—such as modernizing the banking system, adopting appropriate budgetary processes, and developing more efficient methods of tax collection. There's been some progress and some setbacks, but the setbacks have mostly been connected with security and political developments. Iraq continues to suffer from shortages of fuel, gasoline, and electricity—which, in turn, give rise to inflation. Even so, we envision having an IMF-supported adjustment program in place by fall 2005, assuming that the election leads to a significant reduction in the security problems.

IMF SURVEY: In the past few years, Lebanon has been making efforts to deal with its large public sector debt. How do you assess its economic and financial prospects in the aftermath of the assassination of former Prime Minister Hariri last month and the ongoing political turmoil? Is the IMF assisting the Lebanese authorities in managing the current economic situation?

KHAN: This is yet another country where the culprit is politics; nothing has changed in the economic fundamentals. Even though Lebanon has some vulnerabilities, it has been very successful in attracting foreign financial inflows. Its financial system works on credibility, trust, and confidence. Despite the very high debt ratio, investors are ready to put their money into the country because of family ties and attractive interest rates. It has also become a very popular tourist spot, and its diaspora is extremely wealthy, continuing to send large amounts of money every year. At this point, the IMF is continuing to advise Lebanon on how to maintain macroeconomic and financial stability. Fortunately, Lebanon has some very smart people running it, and they seem to know what they are doing in this current critical situation.


Joe Raedle/Getty Images

Poppy production accounted for about 60 percent of Afghanistan's GDP last year.

IMF SURVEY: Another postconflict country, Afghanistan, has been seeing better growth, but it's still struggling to meet basic needs and reduce poverty—not to mention diversify away from poppy production. What steps does Afghanistan need to take?

KHAN: The poppy figures are pretty amazing. The drug economy was about 60 percent of GDP last year, which is unparalleled anywhere. In Latin America, people have always thought 10 percent was huge. However, tackling the drug economy almost poses a moral dilemma: you know it has to be eliminated, but if this were to happen very quickly, it would have dire consequences for the population in terms of employment and wages. It would be a horrendous macro shock. So we're trying to help the authorities evaluate the macroeconomic impact of poppy production on the balance of payments, exchange rates, the fiscal situation, and so on. Basically, two approaches are being taken: eradication and finding alternative livelihoods in agriculture. But it's a slow process.

IMF SURVEY: Libya is among a number of countries in the region that have been making efforts to reform and open up their economies. How do you evaluate these efforts?

KHAN: I'm cautiously optimistic. Libya has asked the IMF, along with the World Bank, to take the lead role in developing a comprehensive reform program as it moves from being a planned to a market economy. Unlike most transition economies, however, it has oil, and that can be both a blessing and a curse. On the plus side, the country wants to reform and is ready to use that oil wealth to soften the impact of the reforms on the population, but the very existence of the wealth makes some people reluctant to reform. The bottom line is that you must have committed reformers who have the ear of people in power. Fortunately, there appears to be such a group of reformers in Libya, including the son of Colonel Qaddafi, who are well placed to carry out their reform plans.

IMF SURVEY: Of course, the oil-producing countries have been enjoying large increases in revenue from the high energy prices. What is the outlook for these countries? How about the oil-consuming nations in the region?

KHAN: Oil prices are going to remain high for a while, because there's a lack of global capacity, and demand continues to grow, particularly in China and the United States. Eventually, this may hurt oil-consuming countries, but so far, we've seen little impact on their growth and balance of payments because they've been able to boost exports.

As for the oil producers, this is a boom. They're going to be awash with revenues. The big question for them, and also a question for the IMF, is what they should do with this wealth. Some say they should save it for a rainy day. Others argue that if the oil price increase is permanent, they should spend it—wisely, of course. Some of these oil producers have aging infrastructures and pressing social needs. Moreover, it's very difficult from a political economy perspective to convince a country with 20 percent unemployment (and maybe 30 percent youth unemployment) to save the wealth for later. It's a pointless argument, given political realities. Even if the country contracts out to foreign companies, it can always insist that a certain percentage of the labor force be hired locally. So there are ways of generating private employment through government spending.

IMF Survey: Is there any good news out of the relatively poorer Central Asian transition economies?

Khan: Definitely. In all of the countries—even though it's a very diverse group, including some oil producers—there's broad macroeconomic stability, low inflation, very stable exchange rates, manageable debt loads, and in contrast to the rest of the region, very impressive growth rates. Of course, they came from a low base, so much of this is catch-up. Their economies collapsed after the fall of the Berlin wall. But growth rates have averaged 6–10 percent or even higher, and we're talking about several years of this kind of growth. The challenge will be to reach a sustainable growth rate, probably in the 6–8 percent range. That should help reduce poverty and unemployment, which are still high but declining.


Jean Blondin/Reuters

Mohsin Khan (left) with Morocco's Central Bank Governor Abdellatif Jouahri and IMF Managing Director Rodrigo de Rato during a trip to the Maghreb region in late February 2005.

IMF Survey: You've had the benefit of an extensive research background and some time in country operations. What do you see as the most important unanswered questions relating to the region's economic performance?

Khan: I would say, unfortunately, that the questions concern perhaps the most important variable of all—economic growth. At the IMF and the World Bank, we're constantly pushing growth and poverty reduction, but we don't truly have a good handle on what drives growth. Before moving to the Middle East and Central Asia Department, I thought that we really knew what would stimulate growth in countries, and in a general sense we do. But when you try to turn that knowledge into operational policies, it can be very difficult. For example, some people believe that one of the most important factors in determining growth is geography—where you're located, whether you have a coast or not, whether you're landlocked or not. Well, that's a good way of categorizing countries, but it has no policy relevance whatsoever. I mean, what are you going to tell a country that is landlocked? Get yourself a coast? And these days it's fashionable to say that institutions drive growth. That's certainly very plausible, and I'm sure, in theory, it's true. And long-term empirical analyses probably show that countries with better institutions grow faster than countries with relatively worse or no institutions.

But when you sit down with a government official who wants to know *which are the critical institutions*, you come to the problem. Rule of law? Property rights? Better judicial and legal systems? The reality is that we don't have a firm handle on that yet. It makes me realize that many results that are interesting in research, and which seem relevant and applicable, have little operational value in practice until you take them further. So I can see why sometimes there is a disconnect between what goes on in the IMF's research and what goes on in its country operations. I know it may come as a surprise to hear this from someone who has spent so much time doing research, but it's true. I believe I'm still learning.

IMF Survey: We have talked a lot about what the region must do to boost growth, reduce poverty, and increase the standard of living. What do you see as your biggest challenge in your efforts to help?

Khan: The late Rudi Dornbusch—a person whom I, like many others, admired greatly—said to me in 2003 that the Middle East and North Africa would be the most interesting region for an economist to work on over the next decade. As in many things, he was absolutely right. This is clearly the most interesting and challenging assignment I have had in the IMF. My objective is to ensure that we offer the countries in the region, including Central Asia, the best possible economic analysis and advice. I hope to be judged by that objective. ■

IMF–World Bank Spring Meetings set for April 16–17

Solid global expansion—but with increased unevenness in growth among some major countries and large and chronic payments imbalances—will provide part of the backdrop as the world's finance and development ministers and central bank governors gather for the April 16–17 Spring Meetings of the IMF and the World Bank.

The International Monetary and Financial Committee (IMFC), the primary advisory committee of the IMF's Board of Governors, will open the meetings on April 16. The session, which will be chaired by U.K. Chancellor of the Exchequer Gordon Brown, is expected to discuss prospects for the global economy. IMF Managing Director Rodrigo de Rato will also report to the IMFC on the organization's policy agenda. The joint World Bank–IMF Development Committee will meet on the following day and is expected to take up the findings of the *Global Monitoring Report, 2005: From Consensus to Momentum*.

De Rato will give a speech on April 6 at Georgetown University that is expected to anticipate some of the themes of the Spring Meetings. Likely to be covered are the state of the world economy and IMF efforts to help low-income countries promote higher growth and reduce poverty. De Rato is also expected to discuss what the IMF is doing to better prepare itself to meet the continuing challenges of supporting financial stability and balanced growth and furthering international monetary cooperation.

On April 13, IMF Economic Counsellor and Research Department Director Raghuram Rajan will brief the press on the latest *World Economic Outlook* projections for global, regional, and country growth. Also in advance of the Spring Meetings, the Group of 24 developing country finance ministers will meet on April 15. ■

The schedule of the IMF–World Bank Spring Meetings is available on the IMF's website *(www.imf.org)*. The full text of Rodrigo de Rato's Georgetown University speech and the transcript of Raghuram Rajan's press conference on the *World Economic Outlook* will be posted shortly after these events take place.

Cyprus enjoys higher growth, but must meet EU challenges

For Cyprus—one of 10 countries to join the European Union (EU) last year—EU accession poses significant challenges, but also offers substantial economic opportunities, according to the IMF's bi-annual assessment of the economy. Economic growth rebounded to about 3½ percent in 2004, driven mainly by increased domestic demand, and is expected to rise to almost 4 percent in 2005, reflecting an improved external environment. The IMF's Executive Board commended the authorities for achieving low inflation, near full employment, and stronger growth. It also welcomed the authorities' plan to join ERM2—the exchange rate mechanism that countries wanting to adopt the euro must participate in for two years before they can join the EU's Economic and Monetary Union. The Board cautioned, however, that joining ERM2 and preparing for euro adoption will require sustained fiscal adjustment.

Cyprus has tightened its fiscal policy following a slippage in 2003. The recently adopted Convergence Program aims to reduce the general government deficit to 2.9 percent of GDP in 2005, thereby bringing it in line with the 3 percent limit set out in the EU's Stability and Growth Pact. Substantial progress has also been achieved in adopting structural reforms that would allow Cyprus to conform with current EU legislation. The Board noted that these reforms—which include tax reform, capital account liberalization, and strengthening financial sector legislation in line with EU directives—will help lay the foundation for sustained economic growth in the future. But it also encouraged the country to further strengthen competitiveness, including by modernizing the governance structure of public enterprises, considering privatization where appropriate, and enhancing labor market flexibility.

The Board expressed support for the central bank's cautious monetary policy but stressed that continued vigilance would be necessary in the face of possible inflationary pressures leading up to adoption of the euro. ■

Cyprus	2001	2002	2003	2004	2005 Projections
			(percent change)		
Real GDP growth	4.1	2.1	1.9	3.7	3.8
			(percent)		
Unemployment	2.9	3.2	3.5	3.6	3.2
			(percent of GDP)		
General government					
Overall balance	–2.3	–4.5	–6.3	–4.2	–3.0
Public debt	61.9	65.2	69.8	71.9	69.5

Data: IMF staff report, March 2005; and Cyprus Statistical Service.

In the news

Malaysia's impressive recovery provides basis for high growth

In recent years, economic growth in Malaysia took off significantly. Initially, strong exports led the expansion, but then robust private domestic demand drove the recovery from the 2001 slump, backed by rising consumer borrowing, higher proceeds from commodity exports, low unemployment, and strengthened confidence. This is among the findings of the IMF's latest annual economic review. Inflation has generally been subdued, but nudged up in late 2004, partly reflecting higher petroleum product prices and tobacco and alcohol taxes. The IMF Executive Board praised the authorities' pragmatic macroeconomic management and decisive efforts to deepen structural reform.

Fiscal consolidation is proceeding but at an adjusted pace. Although lower than in 2003, the 2004 federal government deficit is estimated to have been higher than originally budgeted. The Board welcomed the government's commitment to fiscal consolidation and its plans to introduce a broad-based value-added tax by 2007, streamline tax incentives, and further strengthen revenue administration. The Board also supported additional measures, including tightened current expenditures, more efficient public investment, and better financial results of government-linked companies. The consolidated public sector deficit, meanwhile, is estimated to have declined in 2004 and is projected to turn into a surplus in 2005. Total public debt has remained high but is manageable. The trade and current account surpluses have remained large.

Bank Negara Malaysia's prudent monetary policies have bolstered the credibility of the currency peg, although most Directors noted that over time, a well-prepared move to greater exchange rate flexibility would benefit Malaysia. On structural reforms, progress has been made to improve financial and corporate sector soundness as well as the business climate. Capital adequacy of banks is strong; the ratio of nonperforming loans is declining further; and capital markets remain relatively deep by regional standards. ■

Malaysia	2001	2002	2003	2004 Prel. Est.	2005 Projections
			(percent change)		
Real GDP	0.3	4.1	5.3	7.0	6.0
Real domestic demand	0.0	6.1	3.7	9.3	5.9
			(percent of GDP)		
Federal government overall balance	–5.5	–5.6	–5.3	–4.5	–3.7
Total public sector debt[1]	69.1	69.4	69.0	68.3	62.9

[1]Excludes financial public enterprises and nongovernment-guaranteed domestic debt of nonfinancial public enterprises.
Data: IMF Public Information Notice No. 05/33.

Namibia enjoys steady growth, but needs to tackle HIV/AIDS, poverty

Namibia's macroeconomic performance has been strong in recent years with rising GDP growth, declining inflation, and a strengthening external current account surplus, the IMF said in its annual economic assessment. Nevertheless, Namibia's per capita income growth has lagged behind regional growth and has not generated sustained poverty reduction. Unemployment continues to exceed 30 percent and more than one-fifth of the population is infected with HIV/AIDS. The IMF Executive Board urged the authorities to continue implementing their strategy to combat the HIV/AIDS pandemic and broad-ranging structural reforms to promote private sector activity, generate employment, and address income inequality.

The fiscal deficit widened sharply recently, reflecting tax administration problems, a collapse in mining taxes, and a higher wage bill. However, the deficit is projected to fall in 2004/05 as tax administration problems are being addressed, customs union receipts are experiencing a one-time windfall, and nonpriority spending is being curtailed. The Board welcomed the authorities' intention to bring the public debt ratio close to their fiscal rule target of 25 percent of GDP over the medium term. To rein in nonessential expenditure, firm action will be required to reduce the wage bill and support for public enterprises, which together account for nearly half of total spending.

Namibia's external current account surplus widened further in 2004, partly reflecting an increase of exports to the rand area. The Board said the Namibian dollar's peg to the South African rand has served the country well, but, given the potential for further rand appreciation, it underscored the need to improve the productivity and flexibility of the economy. More developed domestic financial markets should provide better investment opportunities for the rapidly growing pension funds and insurance companies, and help contain capital outflows. Namibia's banking system is strengthening, but the Board urged careful monitoring of the surge in consumer lending. ■

Namibia	2000	2001	2002	2003	2004 Estimates
			(percent change)		
Real GDP	3.5	2.4	2.5	3.7	4.2
CPI (end-of-period)	10.8	8.3	13.6	2.0	5.0
			(percent of GDP)		
Overall fiscal deficit[1]	–1.4	–4.5	–3.5	–7.8	–2.0
Public debt[1]	23.1	26.2	25.0	30.9	30.1

[1]Figures are for fiscal year, which begins April 1.
Data: IMF staff report, January 2005.

For more information, refer to Public Information Notices No. 05/39 (Cyprus), No. 05/33 (Malaysia), and No. 05/29 (Namibia) on the IMF's website (*www.imf.org*).

Ukraine: Now is the time for serious reform

After a tumultuous presidential election that brought the country to the brink of financial crisis, hopes are running high that Ukraine's new government will usher in a new era of economic reform and prosperity. President Viktor Yushchenko has declared rooting out corruption and putting Ukraine en route toward European Union accession his two policy priorities. At the same time, faced with a surging fiscal deficit and rising inflation, the new government's immediate challenge is to restore macroeconomic stability. This article sketches the roots of Ukraine's current policy challenges and the new government's evolving agenda.

After declaring independence in 1991, Ukraine tumbled into a deep and prolonged depression. The country's initial conditions were clearly unfavorable, and this was nowhere more evident than in its oversized, energy-intensive industrial sector, which produced goods in little demand and provided a habitat for rent seeking and corruption. Amid initial bursts of hyperinflation, Ukraine saw its output slide by 55 percent from 1991 to 1999.

As a result of several stabilization and reform programs, implemented from late-1994 onward and supported by IMF financing, Ukraine gradually managed to bring inflation under control, but the country remained traumatized by incoherent policy gradualism. Drifting stop-go structural policies, exemplified by on-off credit support for politically well-connected sectors, left Ukraine's economic and political systems caught in an "under reform" trap. Rampant corruption, high taxes, and burdensome regulations fueled a rapidly expanding shadow economy and rent-seeking activities that, in turn, stymied the buildup of the market-supportive institutions required for high and sustained catch-up growth. The low point was reached when Russia's financial crisis hit in 1998, and Ukraine was forced to devalue its currency steeply and restructure its external debt.

A surprising growth spurt

Confounding expectations, Ukraine boomed during 2000–2004, with annual GDP growth averaging 8½ percent. The boom seems to have been ignited and sustained by four main factors:

• A new reform-minded government led by then-Prime Minister Yushchenko embarked on a set of limited but well-targeted structural reforms focused on cutting enterprise-specific subsidies and rooting out the pervasive nonpayment culture.

• Strict macroeconomic discipline, partly enforced by the lack of financing after the financial crisis and helped by persistent positive growth surprises, restored confidence and sparked rapid remonetization and a banking sector boom.

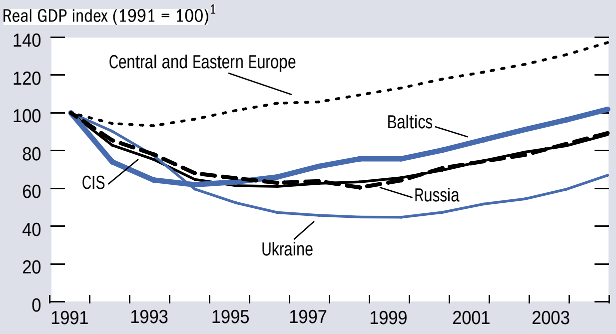
• The sharply depreciated currency and lower real wages following the Russian crisis meant increased international competitiveness and export growth facilitated by substantial idle capacity.

• A sharp improvement in the terms of trade added further momentum to the boom, as Ukraine benefited tremendously from rapid increases in global prices for its exports of steel, other metals, and chemicals.

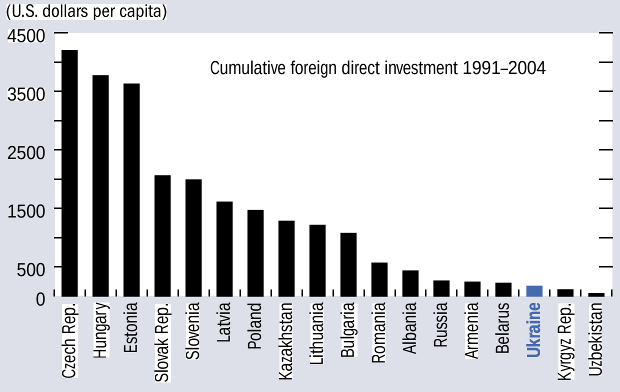
But this success has brought new challenges. Combined with inadequate policy reactions, the growth boom gave rise to serious internal and external macroeconomic imbalances. In 2004,

Halting first steps

Ukraine's delayed recovery . . .



. . . reflects, in part, the economy's poor business and investment climate.



[1]Unweighted average.
Data: Ukrainian authorities; IMF, *World Economic Outlook;* and IMF staff estimates.

in the run-up to the presidential election, the incumbent government embarked on a highly procyclical expansionary fiscal policy in an already overheating economy. Reflecting mainly a massive hike in pensions, the fiscal deficit swelled to 4½ percent of GDP. Moreover, partly owing to the authorities' maintenance of a significantly undervalued de facto currency peg vis-à-vis the U.S. dollar, the external current account surplus widened to 11 percent of GDP, forcing partly unsterilized intervention in the foreign exchange market by the National Bank of Ukraine. As a result, inflation has picked up, reaching over 13 percent in the year to February 2005—the highest 12-month rise in consumer prices in four years.

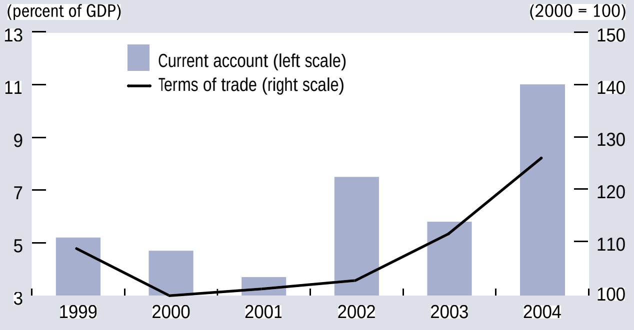
First things first

Reestablishing fiscal discipline now needs to be the number-one priority to restore macroeconomic stability. The unprecedented sudden hikes in pensions by the previous government are estimated to have pushed Ukraine's public pension bill from 9 percent to 16 percent of GDP—very high by international standards. If this problem is left unaddressed, the pension system's future financing needs will crowd out other spending priorities (particularly on education, health care, and infrastructure) and impose a massive additional tax burden on an already overtaxed formal economy.

At the same time, there is only limited room for tightening monetary policy as long as Ukraine continues to operate its de facto exchange rate peg. Looking forward, more favorable risk-return perceptions regarding Ukrainian assets could cause a further pickup in net capital inflows, thus adding to the challenge of sterilizing foreign exchange intervention.

Trade matters

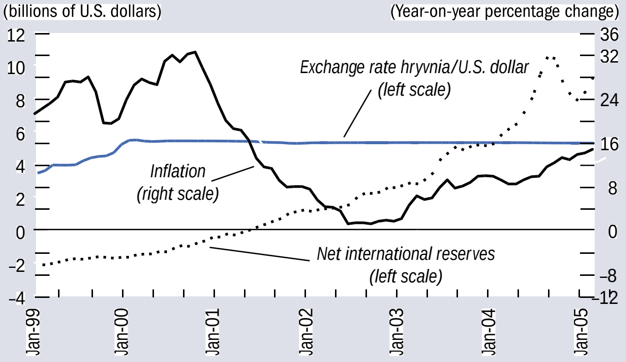
Favorable terms-of-trade shifts have spurred Ukraine's export-led turnaround.



Data: Ukrainian authorities; IMF, *World Economic Outlook*; and IMF staff estimates.

Imbalances have hurt

Under the de facto peg of the exchange rate, external and internal imbalances have added to inflationary pressures.



Data: Ukrainian authorities; IMF, *World Economic Outlook*; and IMF staff estimates.

The IMF has for some time now recommended that Ukraine allow more exchange rate flexibility.

And then the hard part

While putting Ukraine's fiscal house in order is a vital first step, the current growth spurt is liable to peter out without far-reaching structural reforms to protect property rights, enforce contracts, and build institutions in support of a well-functioning market economy. By all indications, corruption and rent seeking remain endemic. Ukraine ranks 122 out of 146 countries in the corruption index compiled by Transparency International, and its privatization efforts have been notorious for allegedly brazen insider deals.

Naturally, foreign investors had shunned such a difficult business environment, with foreign direct investment totaling less than $8 billion since independence. The lack of transparency and convoluted ownership structures have also resulted in more specific risks to the Ukrainian economy. In particular in the banking sector, where related-party lending has been a widespread practice, the true state of credit quality and of bank financial conditions remains opaque. The evolving strategy of the new government therefore rightly focuses on increasing transparency and tackling institution building.

The scope of the challenges is huge, but the time is propitious for a watershed in Ukraine's transition to a market economy. Ukraine's economy and currency are strong, investor interest is unprecedented, and the international community stands ready to support serious reform efforts. ■

Andrea Schaechter
IMF European Department

Global Financial Stability Report

World markets grow more resilient

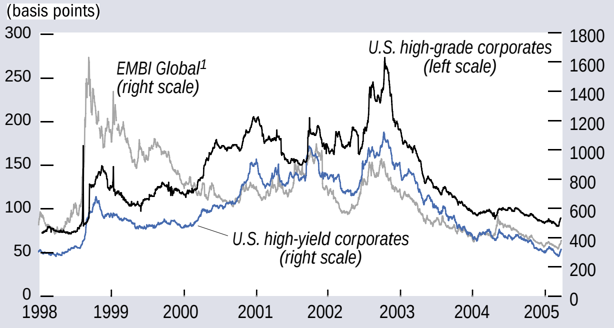
Thanks to solid global growth and improved corporate and emerging market fundamentals, the global financial system has become healthier and more resilient, according to the April 2005 *Global Financial Stability Report*. Improved fundamentals—combined with ample global liquidity, which has encouraged leverage (borrowing to finance higher-yielding investments) and risk taking—have also bolstered asset values. The IMF report, which is published twice a year, notes that risks remain, however, including from potential investor complacency and the possibility of faster-than-expected increases in U.S. interest rates. The report also examines the implications of transferring risk to the household from the financial sector and trends in corporate finance in emerging markets.

In part because of the transparent communication strategies of major central banks, world financial markets have remained orderly as short-term interest rates have been raised in the United States and some other mature markets. Despite these hikes in short-term policy rates, yields on long-term bonds have stayed low and financial markets have experienced little volatility. Low long-term government bond yields, particularly in the United States, have partly been the result of low demand for net credit by the corporate sector, shifts in the preferences of pension funds toward fixed-income investments, and strong official foreign demand for U.S. treasury and agency securities.

Low interest rates have encouraged investors to move out along the risk spectrum in a quest for higher yields, thus buoying asset valuations and compressing credit spreads (see chart below).

Credit spreads remain low

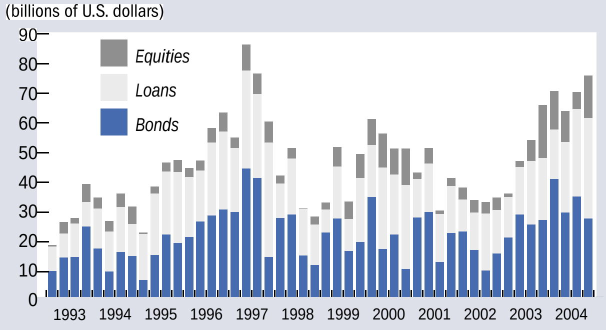
Low interest rates have helped compress credit spreads in both mature and emerging markets.



[1]Emerging Market Bond Index Global.
Data: J.P. Morgan & Chase Co.; and Merryl Lynch.

Emerging markets have thrived

Emerging markets have enjoyed buoyant access to capital market financing.



Data: Capital Data.

Though it is hard to estimate the degree of leverage, there remain strong incentives for investors to borrow at low short-term rates to fund positions in higher-yielding assets. Investors have also been encouraged by improved corporate and emerging market sovereign fundamentals. Corporate balance sheets are generally healthy, and defaults are at cyclical lows. Key emerging market countries continue to improve their resilience by building reserves, implementing sound macroeconomic policies, and undertaking beneficial debt-management operations.

Positive prospects for emerging markets

For their part, emerging markets have continued to experience a largely healthy expansion of their investor base, including U.S. and European pension funds and insurance companies. Emerging market sovereigns have used this strong investor appetite well, completing a substantial portion of their external borrowing needs for 2005—and in some cases even for 2006—at low cost (see chart above).

Global investors have also shown a greater appetite for local market instruments, such as domestic government bonds, which has, in turn, allowed emerging market borrowers to reduce currency risks by meeting more of their needs through local currency borrowing. The recent, albeit still very limited, global issuance of local currency emerging market bonds is encouraging. Also welcome is the fact that some countries have been able to issue local fixed-rate bonds in longer maturities than before, and that local currency sovereign emerging bonds are being included in benchmark global bond indices.

Tight valuations leave downside risks

The recent period of high liquidity and low volatility may, however, have led to some complacency and reduced investor discrimination—both of which suggest that the balance of risks is likely to be on the downside. Inflationary pressures in the United States could, for example, prompt faster-than-expected hikes in U.S. interest rates, which could, in turn, widen credit spreads and lead investors to reconsider their appetite for risk. Possible adverse developments in U.S. corporate bond markets could also spill over to emerging bond markets.

Other risks stem from the need to reduce global payments imbalances. Global financial flows have been giving policymakers time to implement corrective policies, and the real effective depreciation of the dollar that has occurred since early 2002 should support adjustment of the U.S. external deficit, which would be further facilitated by greater flexibility among key Asian currencies. However, should markets lose patience with the pace of change, asset prices could start to play a more forceful role in bringing about adjustment. One potential trigger could be a market reassessment of the likely pace of accumulation of U.S. dollar reserves by central banks, particularly in Asia.

Household balance sheets

In its final installment of a series exploring the transfer of financial risk, the report examines the implications for the household sector. While households have always been the ultimate bearers of financial risks, these risks have traditionally been intermediated by governments and private financial and nonfinancial institutions. A key message of the report is that government policies that seek to improve the financial stability of important financial institutions, such as the introduction of risk-based capital or similar prudential standards, should also take into account the consequent transfer of risks to households and their ability to absorb or manage such risks.

In recent years, households have benefited in various ways from a significant growth in net worth relative to income. This has been associated with a shift in the composition of household wealth from relatively stable bank deposits to more volatile and market-sensitive assets, which has exposed various age and income cohorts to greater risks. Moreover, planned reforms of public and private retirement benefits may give households even greater responsibility for their long-term financial affairs. These reforms confer certain benefits, such as the greater portability of pension plans, but also increase the direct exposure of households to investment and market risks, and even to the risk that they may outlive their financial plans and assets.

The report suggests that in these circumstances, new instruments may be needed to facilitate long-term household savings for retirement. It also points out the importance of consistent government policies, including stable tax policies, for encouraging long-term savings. The issuance of long-dated bonds, index-linked bonds, and longevity bonds related to the actual lifespan of a given population could help households deal with the financial implications of uncertain life expectancy and convert long-term savings into a dependable income stream.

In addition, as more households come to rely on defined contribution pensions, there may be need for greater financial education of households to increase their ability to manage risks. Governments have an important role in developing communication strategies to inform households about their retirement challenges and in coordinating with the private sector to provide financial education. It will also be important to improve household sector data so that particularly vulnerable groups can be identified.

Emerging market corporate finance

Recent data on emerging market corporate finance indicate an increase in bond issuance and a stagnation or decline in bank lending and equity issuance, but, in general, a continued scarcity of market-based sources of funding. An analysis in the new report finds that the culprit is general weaknesses in corporate governance rather than firm-level problems. Important gaps remain, for example, in implementing and enforcing widely accepted principles of corporate governance. A growing number of recent studies demonstrate how weak corporate governance practices, such as inadequate minority shareholder protection and a lack of independent directors or external auditing committees, are magnified by weaknesses in contract enforcement, the rule of law, and judicial systems. Disclosure regulations are also vital in facilitating market discipline.

When emerging market corporates lack adequate and diversified sources of funding, they typically turn to a heavier reliance on foreign currency and short-term debt instruments, which leads to well-known vulnerabilities. Based on firm-level data, the report provides new estimates of how balance sheet mismatches develop and a better basis for understanding corporate sector behavior. The analysis also combines these mismatches with traditional financial ratios and bankruptcy risk indicators to assess the overall fragility of the corporate sector.

Ultimately, the report emphasizes, assessing vulnerabilities in emerging market corporate sectors will require a more integrated approach—one that accounts for interactions between interest rate, foreign exchange, and credit risks. ■

Elie Canetti, William Lee, and Jorge Roldos
IMF International Capital Markets Department

Aid effectiveness

Poor countries need to look gift horses in the mouth

Spurred by two recent reports—the UN Millennium Project Report (the "Sachs Report") and the Commission for Africa Report (the "Blair Report")—the development community is talking about substantially increasing aid flows to low-income countries. But apart from the question of whether larger aid flows will materialize, there is also the question of whether recipient countries will be in a position to make good use of them. As part of an ongoing IMF effort to raise awareness of absorption issues and to discuss the macroeconomic issues that can arise from increased aid inflows, the IMF Institute and the African Department organized a high-level seminar in Maputo, Mozambique, on March 14–15.


J. Carlos Vieira/Mozambique

Mozambique's Prime Minister Luisa Diogo (left) speaks with the IMF Institute's (left to right) Peter Isard and Leslie Lipschitz, in Maputo.

Both the Blair and Sachs reports advocate a large and rapid scaling-up of aid to finance expenditures that would help low-income countries reach the UN Millennium Development Goals. In the past, however, development assistance has had mixed results, and evidence on the effects of aid on growth remains elusive and contradictory. Moreover, even if some benefits of aid are undisputed, managing these flows effectively is fraught with challenges.

The Maputo seminar, cofinanced by Germany's Internationale Weiterbildung und Entwicklung and the U.K.'s Department for International Development, sought to explore the macroeconomic implications and policy challenges of a substantial increase in foreign aid. Participants included ministers with finance and development portfolios and central bank governors from Cameroon, The Gambia, Ghana, Malawi, Mali, Mozambique, Nigeria, Rwanda, Senegal, and Sierra Leone as well as other senior officials from Benin, Burkina Faso, Democratic Republic of Congo, Côte d'Ivoire, Kenya, Niger, South Africa, Uganda, and Zambia. The seminar's sessions examined the varied complications posed by constrained absorptive capacity, the effects of aid flows on real exchange rates, the macroeconomic strains arising from the volatility and unpredictability of aid, the complex interaction of aid flows with debt and fiscal policy, and the implications of increased aid for the recipient country's governance and political economy.

Elusive impact on growth. The role that aid has played or could play in stimulating growth has long been a topic of debate in development circles. In Maputo, the argument continued unabated and without resolution. Steve Radelet (Center for Global Development) presented new econometric evidence suggesting that infrastructure spending and short-term-impact aid have made significant contributions to promoting economic growth, albeit with diminishing returns. Other participants—notably Aart Kraay (World Bank) and Arvind Subramanian (IMF)—took issue with this assessment, arguing that aid explains a very small component of the variation in growth and poverty reduction.

Good institutions are vital. Something that nearly all participants agreed on was that the critical determinants of success lie elsewhere—in institutions, governance, policies, and exogenous events—and success will depend upon countries' ability to sustain effective and efficient governments and good policies. A paper by Simon Johnson (IMF) and Arvind Subramanian addressed the many challenges involved in promoting institutional change and acknowledged the well-known limits associated with trying to import institutions. The authors joined Kraay in focusing on how external interventions, including aid, could help build strong institutions that in turn will set up the right conditions for growth.

The unsettled matter of competitiveness. Economic theory posits that large-scale increases in aid, like other exogenous inflows of foreign exchange, can reduce an economy's competitiveness and adversely affect the tradable goods sector if the aid flows, spent on nontradable goods, fuel an appreciation of the real exchange rate. Reduced net exports can, in turn, limit opportunities for efficiency gains through international interaction and thus exert a detrimental effect on long-run growth.

While the validity of the theory is widely recognized, there is much disagreement among economists on the empirical extent of the problem. David Bevan and Christopher Adam (both from Oxford University) suggested that while government

J. Carlos Vieira/Mozambique

Oxford University's David Bevan saw aid as having the potential to enhance productivity and competitiveness in the tradable goods sector.

spending underwritten by aid flows may induce some initial real appreciation, it can—even if targeted to nontradable goods and services (for example, infrastructure)—enhance productivity and competitiveness in the tradable-goods sector over the longer run. In Subramanian's view, though, the original theory had it right. He presented new econometric evidence, based on a recent and extended sample, that suggested that aid has tended to adversely affect the competitiveness of tradable-goods industries and thus dampened prospects for export-led growth.

Managing volatile aid flows. As Aleš Bulíř and Javier Hamann (both IMF) documented in their paper, aid flows have been persistently volatile, and discrepancies continue between donor commitments and disbursements. Their research also showed that aid has been largely procyclical. Less clear-cut is the extent to which this volatility and unpredictability stem from recipient country noncompliance with program conditions as distinct from the failure of donors to make stable commitments and abide by them. Whatever the cause, many seminar participants said, volatile and unpredictable aid flows pose major difficulties for recipient countries.

Efforts are afoot, however, to address these fluctuations. Paul Isenman (OECD) reported that the OECD Working Party on Aid Effectiveness and Donor Practices has recently endorsed a set of measures designed to address the problems that donor behavior poses for aid recipients. At the same time, Alan Gelb (World Bank) and others argued that policymakers in recipient countries should focus more on using aid to build reserves and develop fiscal cushions. These resources would then allow them to avoid disruptions in important expenditures. Participants expressed widespread support for allowing—indeed encouraging—aid recipients to exercise a greater latitude in the timing of aid-financed expenditures.

Looking ahead

Given possible substantial increases in aid flows to low-income countries and the likelihood of bottlenecks and real exchange rate appreciation, what are policymakers to do to better prepare their countries? There was broad agreement at the seminar that policymakers should watch very carefully for signs of absorptive capacity constraints at the micro level—that is, price jumps, wage increases, or profit shifts in traded-goods sectors. Such developments should prompt a reevaluation of government spending, whether aid-financed or not, and perhaps also a reevaluation of monetary policy.

By the same token, policymakers would do well to adopt spending plans that are sensible in light of their perceptions of constraints on absorptive capacity. They should not allow donors to dictate an excessive allocation of resources to donors' "flavor-of-the-day" sector if this will lead to bottlenecks. As both Nancy Birdsall (Center for Global Development) and Goodall Gondwe (Malawi's Minister of Finance) pointed out, having donor activity crowded into one or two sectors—even crucial sectors such as education and health care—can have serious consequences for the effective usage and absorption of this aid, and, potentially, for resource allocation in the broader economy.

Analyzing the supply-side response is also critical in determining the best macroeconomic management of future aid flows. Gelb pointed out that there is considerable scope for enhancing Africa's export competitiveness by improving its infrastructure. There are broad and substantive benefits to be reaped from a more reliable supply of electricity, for example, and from the more efficient delivery of other services for businesses. Well-designed policies that provide incentives for entrepreneurship will, over time, strengthen the supply responses of low-income economies and should allow them to grow more rapidly and reduce poverty by capitalizing on global markets.

The seminar led to a general understanding that in formulating policies, it will be important, too, for the authorities to keep in mind the trade-off between the expected benefits of aid-financed expenditures in reducing poverty and the potentially negative effects that aid flows can have on a country's competitiveness. The IMF can play a role in helping recipient countries recognize the potentially adverse macroeconomic effects of large aid flows and in identifying likely issues and trade-offs. ■

Boriana Yontcheva
IMF Institute

The full text of all the papers presented at the Maputo seminar are available on the IMF's website at *www.imf.org/FAMM*.

HIPC debt relief (status as of March 24, 2005)

IMF member	Decision point	Completion point	Amount committed	Amount disbursed[1]
			(million SDRs)	
Heavily Indebted Poor Countries (HIPC) Initiative				
Under original 1996 initiative				
Bolivia	September 1997	September 1998	21.2	21.2
Burkina Faso	September 1997	July 2000	16.3	16.3
Côte d'Ivoire	March 1998	--	16.7[2]	--
Guyana	December 1997	May 1999	25.6	25.6
Mali	September 1998	September 2000	10.8	10.8
Mozambique	April 1998	June 1999	93.2	93.2
Uganda	April 1997	April 1998	51.5	51.5
Total original HIPC			**235.3**	**218.6**
Under the 1999 enhanced initiative				
Benin	July 2000	March 2003	18.4	20.1
Bolivia	February 2000	June 2001	41.1	44.2
Burkina Faso	July 2000	April 2002	27.7	29.7
Cameroon	October 2000	Floating	28.5	5.5
Chad	May 2001	Floating	14.3	8.6
Congo, Democratic Republic of	July 2003	Floating	228.3[3]	2.3
Ethiopia	November 2001	April 2004	45.1	46.3
Gambia, The	December 2000	Floating	1.8	0.1
Ghana	February 2002	July 2004	90.1	94.3
Guinea	December 2000	Floating	24.2	5.2
Guinea-Bissau	December 2000	Floating	9.2	0.5
Guyana	November 2000	December 2003	31.1	34.0
Honduras	June 2000	Floating	22.7	8.8
Madagascar	December 2000	October 2004	14.7	16.4
Malawi	December 2000	Floating	23.1	6.9
Mali	September 2000	March 2003	34.7	38.5
Mauritania	February 2000	June 2002	34.8	38.4
Mozambique	April 2000	September 2001	13.7	14.8
Nicaragua	December 2000	January 2004	63.5	71.2
Niger	December 2000	April 2004	31.2	33.8
Rwanda	December 2000	Floating	33.8	14.4
São Tomé and Príncipe	December 2000	Floating	--	--
Senegal	June 2000	April 2004	33.8	38.4
Sierra Leone	March 2002	Floating	98.5	62.0
Tanzania	April 2000	November 2001	89.0	96.4
Uganda	February 2000	May 2000	68.1	70.2
Zambia	December 2000	Floating	468.8	351.6
Total enhanced HIPC			**1,590.3**	**1,152.6**
Combined total for 28 members			**1,825.5**	**1,371.2**

Definitions

Decision point: Point at which the IMF decides whether a member qualifies for assistance under the HIPC Initiative (normally at the end of the initial three-year performance period) and decides on the amount of assistance to be committed.

Completion point: Point at which the country receives the bulk of its assistance under the HIPC Initiative, without any further policy conditions. Under the Enhanced HIPC Initiative, the timing of the completion point is linked to the implementation of pre-agreed key structural reforms (that is, floating completion point).

[1] Includes interest on amounts committed under the Enhanced HIPC Initiative.
[2] Equivalent to the committed amount of $22.5 million at decision point exchange rates for March 17, 1998.
[3] Amount committed is equivalent to the remaining balance of the total IMF HIPC assistance of SDR 337.9 million, after deducting SDR 109.6 million representing the concessional element associated with the disbursement of a loan under the Poverty Reduction and Growth Facility following the Democratic Republic of the Congo's clearance of arrears to the IMF on June 12, 2002.

Data: IMF Finance Department.

Another tool for preventing crises

Over the past decade, a series of major crises in emerging market economies has forced analysts to look anew at the tools they use to identify macroeconomic vulnerabilities. One important contribution to our understanding of how capital account crises occur is the "balance sheet approach." This analytical framework examines the stocks of assets and liabilities in an economy's main sectors for maturity, currency, and capital structure mismatches. It is intended to complement the IMF's traditional flow-based analysis, which assesses variables such as external current account and fiscal balances for potential vulnerabilities.

Choo Youn-Kong/AFP

In 1997, a foreign exchange dealer reacts as the South Korean won plunges to a new low.

The balance sheet approach helps to highlight how even domestic problems in one sector can spill over into other sectors and eventually trigger an external balance of payments crisis. Such a crisis can result from a plunge in demand for the financial instruments of one or more sectors as creditors lose confidence either in a country's ability to earn foreign exchange to service external debt, or in the government's ability to service its own debt, in the banking system's ability to meet deposit outflows, or in corporations' ability to repay bank loans and other debt, or in some combination of these.

If one sector finds itself unable to attract new financing or roll over existing short-term liabilities, it must then either find the resources to pay off its debts or seek a restructuring of them. Ultimately, a plunge in demand for a sector's liabilities leads to a reallocation of demand to foreign assets and/or to assets denominated in foreign currency, touching off problems for other sectors and, sometimes, an entire economy or regional group of national economies. Massive outflows of capital, a sharp depreciation of the exchange rate, a large current account surplus, and a deep recession are often the necessary counterparts to a sudden decline in investors' willingness to hold a country's accumulated stock of financial instruments.

Work in progress

At this stage, applications of the balance sheet approach are being focused on member countries where balance sheet weaknesses, particularly currency mismatches, appear largest and where the IMF's efforts will add the most value in reducing vulnerabilities. These include emerging market countries and those of systemic importance where balance sheet developments can generate negative regional or international externalities. The IMF will also continue to work with industrial countries to refine balance sheet analysis and to integrate their assessments into Article IV consultations, specifically in staff studies of potential risks from equity and housing price bubbles in mature countries.

More work on the balance sheet approach is also envisaged at both the analytical and operational levels. The IMF's First Deputy Managing Director, Anne Krueger, summing up an October 2004 Executive Board discussion on the balance sheet approach, underscored that it cannot be applied mechanically, and added that there is no intent at present to make it a standardized element of IMF surveillance. Data limitations and other constraints complicate application of the balance sheet approach to many countries. Nevertheless, staff's work suggests that a great deal of insight can be gleaned from even partial data. Going forward, the IMF will work with member countries to improve the statistical basis for its assessment of balance sheet vulnerabilities. An initial step toward operationalizing the balance sheet approach would be the development of simple ratios that can be easily calculated and compared across countries and time. ■

The full text of "Debt-Related Vulnerabilities and Financial Crises—An Application of the Balance Sheet Approach to Emerging Market Countries" is available at *www.imf.org/external/np/pdr/bal/2004/eng/070104.htm*.

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