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Challenge now to accelerate African growth

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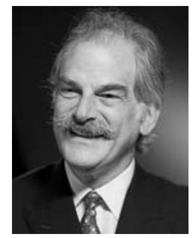
If Africa can seize current opportunities and sharply increase growth, it can start making real inroads into reducing poverty, says John Lipsky on his first visit to Africa since taking over as the IMF's First Deputy Managing Director. He visited Mali, where he voiced support for fairer access to global markets for African farmers, and South Africa, where he spoke about the need to develop the continent's financial sectors to support stronger growth.



Eugene Salazar/IMF

"Vigorous" outlook for Latin America

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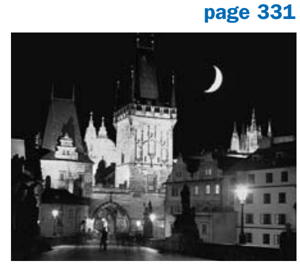
The economic recovery that began in 2002 in the Latin American and Caribbean countries should continue through at least 2007, according to the IMF's *Regional Economic Outlook: Western Hemisphere*. As a result, employment has been rising and poverty has been falling. Inflation is also expected to remain relatively low, testimony to the growing credibility of the region's central banks. The outlook was launched at the Latin American and Caribbean Economic Association meeting in Mexico City.

Eliseo Fernandez/Reuters

Central and eastern Europe see EU halo effect

page 331

The IMF has just completed a regional outlook for the EU's new and prospective members from central and eastern Europe (CEE-10). The analysis shows strong growth, low inflation, and large current account deficits. The CEE-10 are also paying less on their external debt than other comparable emerging markets. In an interview, Susan Schadler, Deputy Director of the IMF's European Department, discusses the prospects for these countries.



Dallas & John Heaton/Newscom

Understanding the IMF's quota debate

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As part of its medium-term strategy, the IMF is seeking to reform its governance structure. It recently increased the quotas of four severely underrepresented countries and is now looking to redefine the formula that is used to calculate members' quotas and voting power. The IMF's former Secretary, Leo van Houtven, provides a historical perspective to the current debate over quota reform, maps out the different players, and examines their arguments.

IMF Photo

What's on

November

20 Long-Run Fiscal Sustainability in Germany, symposium organized by the IMF, Bertelsman Foundation, and the Institute for Economic Research, Berlin, Germany

22–23 9th Central European Initiative, Summit Economic Forum: Fostering Reforms and Innovation for Sustainable Growth, Tirana, Albania

23–24 World Economic Forum, "Connecting Regions—Creating New Opportunities," Istanbul, Turkey

26–28 World Economic Forum, "India: Meeting New Expectations," New Delhi, India

29–30 Group of Eight International Conference on Improving Financial Literacy, Moscow, Russian Federation

December

7–8 1st Meeting of the Organization for Economic Cooperation and Development (OECD) Forum on African Public Debt Management, Amsterdam, Netherlands

14 143rd (Extraordinary) Meeting of the OECD and Development Conference, Abuja, Nigeria

January 2007

5–7 Annual Meeting, American Economic Association, Chicago, Illinois, United States

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*.

16–17 12th Euromoney Central and Eastern European Forum, The CEE: Separating Rhetoric from Reality, Vienna, Austria

24–28 World Economic Forum Annual Meeting, Davos, Switzerland

February

7–8 2nd OECD Forum in Mexico: International Forum on Public Policies for the Development of Mexico, organized by OECD, World Bank, UNDP, Inter-American Development Bank, and ECLAC, Mexico City, Mexico

March

4–6 Institute of International Bankers' 2007 Annual Washington Conference, Washington, D.C.

New Perspectives on Financial Globalization
Call for Papers
IMF, Washington, D.C.,
April 26–27, 2007

The conference, sponsored by the IMF's Research Department and Cornell University, aims to provide a forum to present recent theoretical and empirical research on the macroeconomic implications of financial globalization.

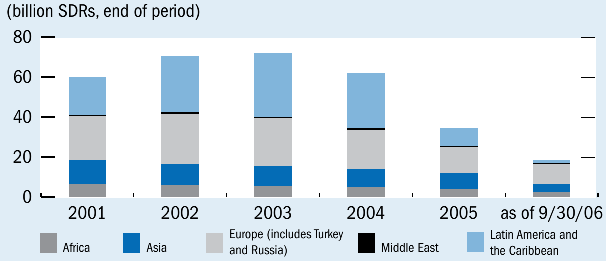
Interested authors should submit either a draft of the paper or a detailed abstract by December 1, 2006, to *globconf@imf.org*.

For details, see *www.imf.org.external/np/seminars/eng/2007/finglo/042607.htm*.

IMF financial data

Total IMF credit and loans outstanding, by region

(billion SDRs, end of period)



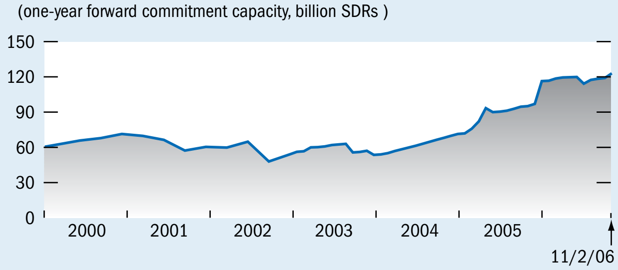
Largest outstanding loans

(billion SDRs, as of 9/30/06)

Nonconcessional (GRA)		Concessional (SAF/PRGF)	
Turkey	7.82	Pakistan	0.96
Indonesia	2.15	Congo, Dem. Rep. of	0.55
Uruguay	0.73	Bangladesh	0.28
Ukraine	0.60	Yemen, Republic of	0.15
Dominican Republic	0.33	Georgia	0.15

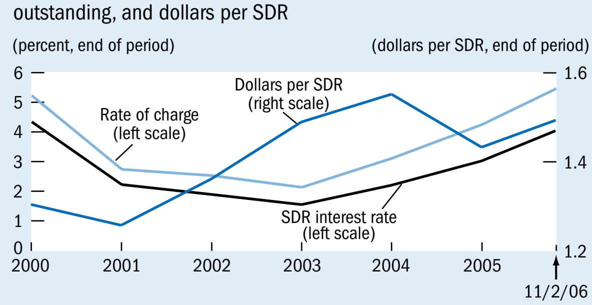
Available IMF resources

(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: 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.

Challenge now is to step up African growth, says Lipsky

Africa needs to accelerate its current period of strong growth so that it can start making real inroads into reducing poverty, said John Lipsky, on his first visit to Africa since taking over as the IMF's First Deputy Managing Director in September. The IMF projects real GDP growth in sub-Saharan Africa to slow to 4.8 percent in 2006 from 5.6 percent in 2005, but to pick up to almost 6.0 percent the following year—its strongest performance in decades.

"I believe this is a moment of great opportunity for Africa, where many countries have taken advantage of solid global economic growth and of debt relief to successfully implement reforms," Lipsky said at the end of his visit to Mali. "These reforms, in turn, are improving economic performance. The goal is to create a virtuous circle of reform and faster growth, paving the way for sustained poverty reduction."

In an address on November 10 to ministers of the West African Economic and Monetary Union, meeting in Mali's capital, Bamako, Lipsky said average inflation in the region was the lowest in a quarter century, and growth in the past two years has been the highest in a decade. "I do not mean to downplay the enormous problems still to be dealt with, but this is a significant achievement. It speaks volumes about the efforts governments, the private sector, and civil society organizations are making in so many African countries," Lipsky said. "The real challenge now is to accelerate and sustain this growth. That is the only way we can make substantial progress toward reducing poverty."

In a three-day visit, he had talks with President Amadou Toumani Touré, Prime Minister Ousmane Issoufi Maïga, President of the National Assembly Ibrahim Boubacar Kéïta, and Minister of Economy and Finance Abou-Bakar Traoré. During a trip to a cotton plant, Lipsky voiced support for fairer access to global markets for Africa's farmers, saying liberalization was important for poverty reduction.

Bolstering the financial sector

Lipsky started his trip in South Africa, where he emphasized the importance of financial sector development in supporting African growth. He took part in a seminar on the challenges of deepening financial sectors in Africa, cosponsored by the IMF and the United Kingdom's Department for International Development.

The experience of the emerging market countries, he emphasized, underlined the fundamental importance of deepening and broadening financial sectors as a precondition for growth. "A financial sector is not a luxury but a necessity," he declared. "Yet in many African countries, financial sectors are not functioning well. Few businesses—and even fewer households—have access to formal bank financing. Small and medium-size enterprises are the source of employment and growth in many emerging market countries. But in most African countries they are largely excluded from the formal financial sector."


Martin Rhodes

Lipsky, with the Director of the IMF's African Department, Abdoulaye Bio-Tchané (left), visits a house in Soweto, a township in Johannesburg, South Africa.

He said that while some obstacles to developing the financial sector had been removed, other constraints remained. "For instance, too often there are still distortions in monetary and fiscal policy settings that discourage bank lending. This is particularly true where domestic borrowing by the government is high, allowing banks to earn sufficient returns from relatively less risky credit," said Lipsky, who rejoined the IMF after several jobs on Wall Street.

Structural obstacles included the absence of adequate property rights, weaknesses in the business environment, and small and segmented markets that limited competition.

South Africa's performance

Lipsky said that South Africa's economy was expected to grow by some 4.2 percent this year and at a similar rate in 2007. While growth had been impressive by South Africa's historical standards, it has not been enough to make significant inroads into unemployment, poverty, and underdevelopment. "The acute income and wealth disparities inherited from the apartheid era are still painfully evident, poverty is still widespread, and, as in many other African countries, the HIV/AIDS epidemic is extracting a heavy social and economic toll," he stated.

The success of South Africa has important implications for the rest of Africa. South Africa is a major driving force in the region. It is by far the largest market and an increasingly important source of investment. Lipsky, who began his visit with a trip to Soweto, met with Finance Minister Trevor Manuel and South African Reserve Bank Governor Tito Mboweni, and held in-depth discussions with representatives of the private sector and civil society. ■

IMF sees continued "vigorous expansion" in Latin America

Latin America has been growing rapidly, well above its historical average, with low inflation and rising employment, and is expected to continue on this favorable path next year, according to the IMF's *Regional Economic Outlook: Western Hemisphere*, released in Mexico City on November 2.

Anoop Singh, director of the IMF's Western Hemisphere Department, told reporters that Latin American and Caribbean countries are experiencing "their most vigorous three-year expansion since the 1970s." In 2006, real growth is expected to average around 4¾ percent, about ½ of 1 percentage point higher than in 2005. Growth is expected to recede slightly to about 4¼ percent in 2007, in line with a more measured global expansion, the likely easing of commodity prices, and the maturing of recoveries within the region (see Chart 1).

The ongoing recovery has led to rising employment rates and declines in poverty in a region that suffered severe economic dislocations in the final two decades of the 20th century. The IMF said that during 2005 and the first six months of 2006, employment growth accelerated in many countries and unemployment fell toward 10 percent, on average.

The portion of the population living in poverty—which is defined in terms of the ability to purchase a basket of basic consumption goods—fell across the region from about 44 percent in 2003 to 40 percent in 2005, with sizable declines in South America's two biggest economies, Argentina and Brazil.

Speaking at the annual meeting of the Latin American and Caribbean Economic Association in Mexico City (see page 329), Singh emphasized that this expansion is more solid than earlier ones. Although there is regional variation, inflation has generally remained subdued and is expected to decline moderately further, to a regional average of about 5 percent in 2007, testimony to the growing credibility of central banks in the region (see Chart 2). External current accounts and primary fiscal balances are generally in surplus, and exchange rates are more flexible than in previous expansions. The structure of public debt has become safer, with lower shares of short-term and foreign currency debt in most large countries.

Eliseo Fernandez/Reuters

In Chile's Valparaiso port, a worker prepares a shipment of copper bound for Asia.

Potential risks

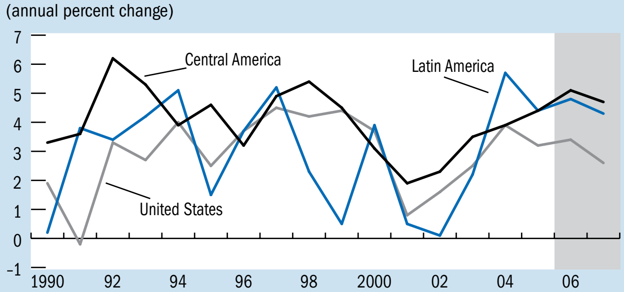
Still, the IMF's report emphasizes that a number of factors warrant monitoring.

Chart 1

Economic growth continues

Latin American economies, including Central America, will remain strong next year, but growth will taper off in the United States.

(annual percent change)



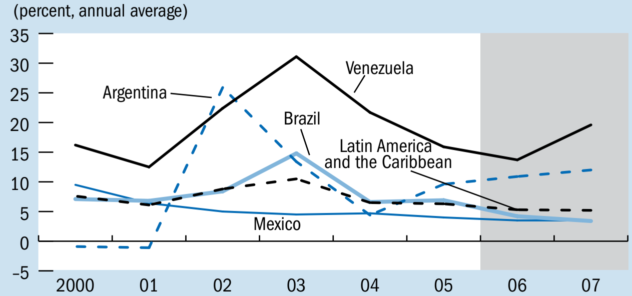
Note: Shaded area respresents projections.
Data: IMF staff estimates.

Chart 2

Prices remain generally stable

Although there is regional variation, inflation has generally been subdued and is expected to decline further in 2007.

(percent, annual average)



Note: Shaded area represents projections.
Data: IMF staff estimates.

Uruguay to repay IMF loan

Uruguay said it plans to repay early all outstanding obligations to the IMF, amounting to SDR 726.7 million (about $1.08 billion). IMF Managing Director Rodrigo de Rato welcomed the decision. "This decision reflects the quick recovery of Uruguay from crisis, supported by the international community and the Fund, and its renewed access to international capital markets," de Rato said on November 8. "The track record of sound macroeconomic policy management has provided the basis for the consolidation of market confidence, strong economic outcomes, and an improved profile of public debt."

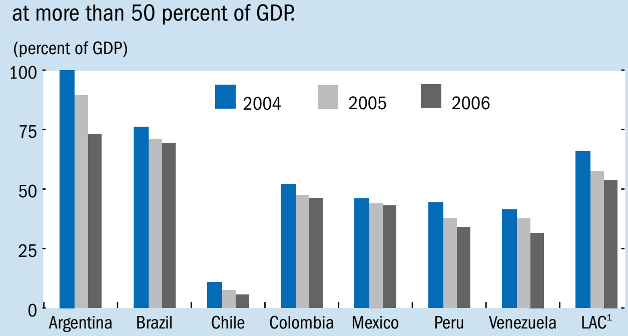
Total drawings by Uruguay under its two Stand-By Arrangements were equivalent to SDR 2.25 billion (about $3.35 billion). Uruguay made three early repayments between September 2005 and August 2006, amounting to SDR 1.14 billion ($1.69 billion). Under the original schedule, the final repayment of outstanding loans from the IMF would have taken place in 2010.

• External risks to the outlook include a sharper-than-expected slowdown in U.S. growth; an unexpected tightening of global financial markets; commodity price volatility (particularly sharply lower non-oil commodity prices); and trade pressures following the erosion of preferential access in the Caribbean and lack of progress on agreements to liberalize trade further.

Chart 3

Public debt remains a concern

Public debt has come down but on average remains high, at more than 50 percent of GDP.



[1]Latin America and the Caribbean, weighted average.
Data: IMF staff estimates.

• Some domestic vulnerabilities remain. Public debt remains relatively high, at more than 50 percent of GDP on average (see Chart 3). Budgets remain rather rigid, with a high proportion of mandated expenditures and a large share of earmarked revenues. Government spending in a number of countries has recently accelerated, and lower commodity prices could erode fiscal surpluses. Public revenue remains low in some countries, particularly in light of social needs. And, although not yet a source of concern in most countries, high real credit growth requires close monitoring.

Policy challenges

To entrench macroeconomic stability and raise growth, it is important to address the long-standing causes of crises in the region, including high income inequality (see Chart 4). Singh emphasized that there need not be any contradiction between reforms that are good for equity on the one hand and reforms that promote growth and stability on the other. Such reforms include fiscal reforms to make the tax system fairer and focus public spending on social programs for the poorest, labor market reforms, and other reforms that extend public services and economic opportunity to disenfranchised groups.

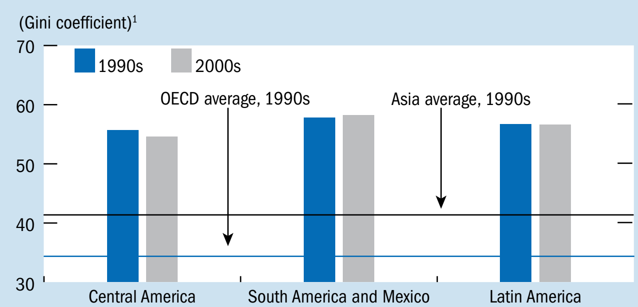
Singh also pointed out that investment rates in Latin America remain far below those in the most dynamic emerging market economies. Higher investment and productivity growth are likely to be linked to efforts to make Latin American economies more open and competitive. ■

The full text of the *Regional Economic Outlook: Western Hemisphere* (November 2006) is available on the IMF's website (www.imf.org)

Chart 4

Income inequality still widespread

There are too few "haves" and too many "have-nots," especially compared with Asia and industrial countries.



[1]The larger the number, the greater the income inequality. For Latin American countries, 1990s represents the observations closest to 1990, and the 2000s are the most recent available observations.
Data: Economic Commission on Latin America and the Caribbean, *Social Panorama*, March 2006.

Investment and productivity are key to Latin America's prospects

Latin America and the Caribbean have recorded impressive growth in recent years, but it should have been stronger, Mexico's President Vicente Fox and Finance Minister Francisco Gil Díaz said in opening the first joint conference of the Latin American and Caribbean Economic Association and the Latin American Meeting of the Econometric Society. The event, held in Mexico City November 2–4, spotlighted what needs to be done to boost growth, maintain stability, and enhance social welfare.

In search of higher growth

How can the region turn relatively strong growth into dynamic, sustained growth? Central to this transformation, said Robert Lucas (University of Chicago), are higher returns on human capital accumulation. Once these higher returns are recognized, people will invest more in themselves and in their children, and that, in turn, will lead to higher per capita income. Policies and institutions, he emphasized, should be geared toward raising the return on human investment. Income transfers simply cannot produce the kind of sustained increase in per capita income that is needed.

Jeffrey Sachs (Columbia University) argued that the region's priorities should be investing in better-quality education and health care and facilitating technological innovation, including through greater trade openness. The region continues to lag behind Asia—a situation he attributed to time lost in pursuing inward-oriented policies and in remaining focused on market reforms rather than on productivity-enhancing technological progress.

Inefficiencies in the labor and financial markets mattered, too. José Scheinkman (Princeton University) found that excessive regulatory burdens and weak institutions encourage informality in economic activity, and informal activities tend to perpetuate themselves, hindering advances in productivity. Arturo Fernández (Instituto Tecnológico Autónomo de México) called for regulatory reforms to help shift resources from the informal to the formal sector, while Andrés Velasco, Chile's Finance Minister, called for pathbreaking research on industrial organization and labor economics for the region.

Taming volatility

In recent decades, recurrent crises have set back the region's quest to boost per capita income. The current expansion, however, has been on firmer ground, according to Anoop Singh, who presented the IMF's economic outlook for the region (see page 328). He underscored that the current benign external environment affords an opportunity to entrench macroeconomic stability through fiscal reforms that reduce budget rigidities, improve equity through tax and labor market reforms, and reduce structural impediments to investment and entrepreneurship.

While acknowledging the region's relatively solid performance, Guillermo Calvo (Inter-American Development Bank) called on policymakers to remain alert to the possibility of sudden stops in capital inflows if the current environment deteriorates. The region has adjusted reasonably well to competition from China and India, Guillermo Perry (World Bank) observed, but more could be done to promote trade and investment with the two countries and to accelerate the region's shift toward natural resource and knowledge-based sectors.

Amid progress in strengthening monetary policy institutions, multiple sessions took up central banking issues. André Minella (Banco Central do Brasil) and Claudio Soto (Banco Central de Chile), for example, presented quantitative models of inflation targeting for their home countries. Further work, they said, is under way to improve the usefulness of these models for monetary policy analysis.

Enhancing social welfare

Pension reforms in the region have garnered much attention, but have they produced fiscal benefits? The answer, Laurence Kotlikoff (Boston University) suggested, lies in whether government consumption has declined, the distribution of resources across and within generations has improved, and the incentives to work, save, and join the formal economy have increased. Unfortunately, he said, nothing much has changed, and the reforms have imposed substantial social costs. A true accounting, however, awaits systematic assessments of these reforms.

In a provocative lecture on the welfare implications of health investments, Gary Becker (University of Chicago) estimated that very large gains have accrued from reducing mortality. Between 1970 and 2000, these gains amounted to \$95 trillion for the United States and \$240 trillion for the advanced economies. His calculations suggest potentially substantial welfare gains from enhancing the quantity and efficiency of health investments. For Latin America, where inequality is high, this seems to argue for increasing access to quality health care for all, especially the young.

More broadly, Mauricio Cárdenas (Fedesarrollo) raised concerns about severe inequities and inflexibility in fiscal expenditures and about conditional cash transfer programs. These programs were meant to be temporary but now risk becoming permanent. That, he warned, would leave fiscal policies in the region even more inflexible. ■

Rishi Goyal
IMF Western Hemisphere Department

4 page briefing

Central and eastern Europe

Assessing the early benefits of EU membership

In May 2004, the European Union (EU) undertook its most significant enlargement to date, accepting Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia as new members. With the recent announcement that Bulgaria and Romania will join in 2007, the EU will soon comprise no fewer than 27 states. Apart from Cyprus and Malta, all the new members are located in central and eastern Europe (CEE-10).

Two years on, what is the verdict on EU membership for those eight countries in central and eastern Europe that joined in 2004? And what is the outlook for Bulgaria and Romania? The IMF's European Department has just completed a Regional Economic Outlook for the CEE-10 (see growth table). As part of this undertaking, IMF staff compared recent economic performance and financial market developments in the CEE-10 with other emerging market countries (see Charts 1–6).

Economic performance has been strong in the new EU members. But these generally low-saving countries are relying heavily on capital inflows to finance high levels of investment. This produces large current account deficits—in contrast with most other emerging market countries. Current account deficits usually raise red flags, but financial markets generally seem impressed by the performance of the CEE-10: the IMF's analysis shows that many of the CEE-10 are paying, on average, 50–100 basis points less on their external debt than other emerging markets with comparable policies and economic conditions. This indicates there may be an "EU halo effect"—EU membership and the expectation that the CEE-10 will eventually adopt the euro reduces the perceived investment risk. Camilla Andersen of the *IMF Survey* spoke with Susan Schadler, a Deputy Director of the IMF's European Department, about these and other findings.

Quick facts

CEE-10 comprises Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

Population	102 million
GDP (2006)	$866 billion

EU-15 comprises Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom.

Population	387 million
GDP (2006)	$13,458 billion

Data: IMF, World Economic Outlook database, and staff estimates.

CEE-10: Growth at a glance

(real GDP, annual percent change)

	Actual 2004	Actual 2005	Proj. 2006	Proj. 2007
CEE-10[1]	6.6	6.2	6.6	6.1
Baltics[1]	**7.8**	**9.2**	**9.1**	**7.8**
Estonia	7.8	9.8	9.5	8.0
Latvia	8.6	10.2	11.0	9.0
Lithuania	7.0	7.5	6.8	6.5
Central Europe[1]	**4.9**	**4.7**	**5.2**	**4.7**
Czech Republic	4.2	6.1	6.0	4.7
Hungary	5.2	4.1	4.5	3.5
Poland	5.3	3.4	5.0	4.5
Slovak Republic	5.4	6.1	6.5	7.0
Slovenia	4.2	3.9	4.2	4.0
Southeastern Europe[1]	**7.1**	**4.8**	**5.5**	**5.8**
Bulgaria	5.7	5.5	5.6	6.0
Romania	8.4	4.1	5.5	5.5

[1]Unweighted average.
Data: IMF, *World Economic Outlook,* September 2006.

IMF Survey: What has EU membership meant for the eight countries from central and eastern Europe [CEE-8] that joined in 2004?

Schadler: We are still in the early days of assessing the impact of EU membership, but signs are that there has been a considerable boost to growth. The CEE-8 have, on average, increased their per capita GDP growth from just below 5 percent in the years prior to membership to about 6 percent now. In some countries, it is much higher. Membership has brought major opportunities, most obviously in the form of transfers, comprising both investment and income support from the EU. On a more general level, it has made these countries more attractive as bases for offshoring and outsourcing from the 15 original members of the EU [EU-15]. Most of the CEE-8 are also experiencing rapid export growth and strong export penetration into the EU-15.

IMF Survey: When to adopt the euro is a burning issue for the new members. Some remain keen on joining the euro area as quickly as possible whereas others now want to wait. What is the IMF's advice to the new member states?

Schadler: We see euro adoption as a major opportunity to enhance growth prospects for all the new members. Most researchers agree there are gains associated with joining a currency union, especially for emerging market countries, although just how large these gains are is in dispute. One such gain comes from increased trade. IMF research shows that the establishment of the euro area has resulted in significantly higher trade among the 12 current euro area members than would have occurred had the single currency not been introduced.

Given their status as emerging market countries, the new members will be able to enjoy two other significant advantages once they adopt the euro. First, they will be able to substantially lower the emerging market risk premium they currently pay for their externally issued debt. This represents a substantial gain because all the CEE-8 countries are currently paying a risk premium relative to debt issued by advanced countries. Second, because people are anticipating euro adoption, they are starting to change their behavior. Both households and businesses are increasingly borrowing in foreign currencies—especially in euros—because they can get lower interest rates and because they anticipate that, by the time they have to repay, they will be receiving their income in euros. Now, all this is fine as long as the new member states actually do adopt the euro. But if expectations about the timetable for euro adoption turn out to be too optimistic, the foreign currency exposure of households and businesses will create a significant risk in the event of turmoil in global markets. This is why these countries need an exit strategy. Euro adoption is tailor made for this purpose.

IMF Survey: Some politicians from new members have called for a change in the criteria for joining monetary union, saying the current rules are too strict. Do they have a case?

Schadler: Yes and no. In our view, euro area membership offers major opportunities, but to be a success, macroeconomic policies need to be right. We especially emphasize the need for strong fiscal positions—and by this I mean a balanced budget or even a surplus.

EU membership appears to have had a positive effect on new members' growth rates—and this boost should become even more pronounced once they join the euro area. In this kind of setting, a brake on activity is typically warranted. By limiting the growth of the public sector's participation in the economy, the countries will create room for private investment. Countries should also ensure that conditions in their labor and product markets are sufficiently flexible so that any shocks to the economy that do not affect the rest of the euro area can be absorbed by internal adjustment.

Once these conditions are in place, we would place less importance than the Maastricht criteria do on inflation as a guarantor of future performance in the euro area (see box). That said, the EU has set the rules of the game, and they are very unlikely to change. So regardless of the economic merits of this discussion, the new members will need to meet the Maastricht criteria. The sooner they do it, the better.

Eugene Salazar/IMF

Schadler: "I see the enlargement of the EU as a localized version of globalization."

IMF Survey: With expectations of a rapid transition to full membership of monetary union fading, is it risky for new member states to extend their stay in ERM2, the exchange rate arrangement that is a prelude to euro adoption?

Schadler: These risks are fully manageable as long as an end point is in sight. For the countries with currency boards and fixed exchange rates, not much has changed with ERM2 membership. However, while the risks are not major at this time, that could change. As I said, the prospect of euro adoption is encouraging households and businesses to borrow in euros. If their expectations about euro adoption were to change radically, the situation could become risky.

IMF Survey: The three Baltic countries have all enjoyed high growth. Estonia in particular is doing well. What accounts for the relative success of the Baltics?

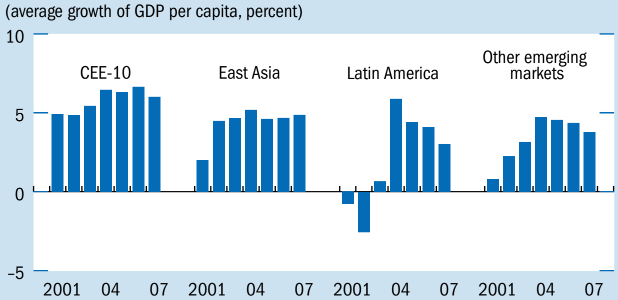
CEE-10 countries: How they compare with other emerging markets (2006 and 2007 data are projections)

Chart 1

Growing fast

The CEE-10 are growing at a rapid pace, even compared with other emerging market countries.

(average growth of GDP per capita, percent)



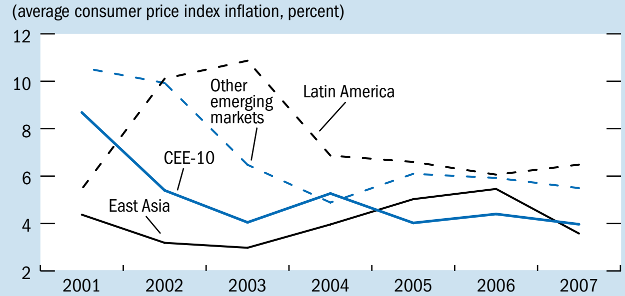
Data: IMF, *World Economic Outlook*, September 2006.

Chart 2

Doing well on the inflation front

Average inflation is low in the CEE-10 as countries adjust policies to meet the Maastricht criteria.

(average consumer price index inflation, percent)



Data: IMF, *World Economic Outlook*, September 2006.

Schadler: It is important not to read too much into differing performances, even over a period as long as five years. All of the CEE-8 have gone through a transition where GDP dropped quite sharply and then rebounded. The rebound has occurred with varying strength across time in different countries. That said, the Baltics, for the past 10 years, do have a slightly stronger growth record than the larger countries. IMF research also shows the Baltics are well positioned for growth somewhat above that in the other CEE countries over the next few years. Why? First, their lower average per capita GDP means that there is more catch-up potential. Second, the Baltic countries have relatively low population growth, and that helps in terms of increasing the productivity of the labor force. Third, these countries have developed strong trade ties with some of the more vibrant markets in Europe. This has stimulated competition and increased efficiency, thereby creating conditions for stronger growth. Fourth, education systems are relatively good.

IMF Survey: The three larger countries—Poland, the Czech Republic, and Hungary—have a more uneven track record. Why are these early reformers having problems?

Schadler: Again, it is important not to read too much into a few years' experience. It is also worth emphasizing that central Europe is a very mixed bag of issues. All of these countries are experiencing some difficulty in setting a clear path for their governments to follow. That has created political uncertainty—particularly in the past year or so. But the countries are different in many other respects. In Hungary, government expenditures are much higher than revenues, and that has resulted in rising public debt that has now reached high levels by emerging market standards. So the sustainability of fiscal policy is in doubt, and that has affected market confidence. Poland is a little different. While it also has fiscal weaknesses, its public sector deficit and debt are not as high as in Hungary. The Czech Republic has a much smaller public sector deficit and debt, but because it started from a per capita income level that was much higher than in Hungary and Poland, its growth potential is lower.

All three have lost reform momentum. Ten years ago, there were active changes taking place in the Czech Republic, forced by a banking sector crisis; in Hungary, by turmoil in the balance of payments; and, in Poland, by a change in government. Today, the slowdown in structural reform means not only that conditions

Requirements for adopting the euro

All EU countries (apart from Denmark and the United Kingdom, which have opt-outs) are required to adopt the euro. But before doing so, they must comply with criteria set out in the 1993 Maastricht Treaty. Compliance with the Maastricht criteria is assessed for each country by the EU's Council of Ministers, based on reports by the European Commission and the European Central Bank. Assessments are carried out every two years or when member states request them. The criteria, which are evaluated on the basis of the most recent data releases, are as follows:

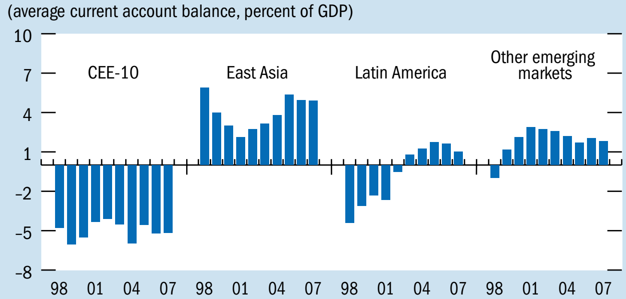
- Year-average inflation must not exceed by more than 1.5 percentage points the average of the three "best-performing" EU members in terms of price stability.
- The nominal interest rate on a 10-year government security must not exceed by more than 2 percentage points the average in the same three countries.
- The fiscal deficit on a calendar-year basis must not exceed 3 percent of GDP.
- The stock of government debt must not exceed 60 percent of GDP.
- Countries must participate in ERM2 for at least two years, with the currency remaining within "normal fluctuation margins" around the agreed central parity.

Chart 3

Running large current account deficits

In contrast to most other emerging market countries, the CEE-10 all have large current account deficits.

(average current account balance, percent of GDP)



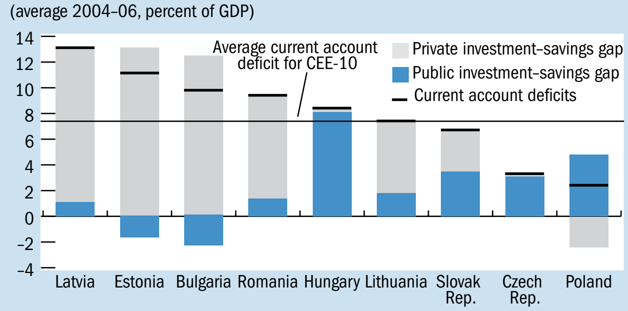
Data: IMF, *World Economic Outlook*, September 2006.

Chart 4

Private imbalances dominate

Most current account deficits reflect private investment-savings gaps rather than government deficits.

(average 2004–06, percent of GDP)



Data: IMF, *World Economic Outlook*, September 2006.

for potential investors are not improving but also that current investors are wondering where these countries are headed.

IMF Survey: Most of the EU newcomers are running large current account deficits. Is that something to worry about?

Schadler: In general, when we see current account deficits in the double digits, as they are in some of these countries, red flags go up. No question. So it is absolutely critical that the situation be watched carefully and that signs of acute vulnerabilities be caught as soon as they arise.

But in some countries, these current account deficits are different from what we have seen elsewhere in the past. The CEE-8 decided some time ago to fully open their capital accounts—and this in an environment of strong growth potential. These countries sit right next to one of the wealthiest parts of the world, but they have much lower wages and therefore offer profitable investment opportunities. In our globalized world, this combination of open capital accounts and attractive investment opportunities can only lead to large current account deficits—capital flows in and investment pushes up imports and consumption.

This is how incomes are equalized across countries. We are talking about countries that typically have low savings rates, and it makes sense for them to use foreign savings to increase their investment rates and smooth consumption. This is the essence of globalization. But it also means these countries are exposing themselves to changes in market sentiment. Their high-growth strategies need to be managed carefully with strong policies. There is no room for big mistakes.

IMF Survey: Rapid credit growth poses a risk to financial stability in many of the CEE-10. What should they do to keep such risks under control?

Schadler: The ultimate protection is strong bank supervision. These countries all started out with repressed financial conditions—small banking sectors and low household indebtedness. Opening the capital account means that money has come in and that borrowing opportunities for households and businesses have grown. So rapid credit growth is part and parcel of the strategy these countries are following.

But it does create risks, and bank supervisors need to be fully on top of what is going on. They must ensure that banks are managing risk well so as to catch problems before they translate into nonperforming loans. Borrowers also need to be made aware of the risks.

IMF Survey: The original EU-15 tend to focus on the negative aspects of enlargement. What are the positive aspects?

Schadler: There are a number of positive aspects, although people tend to lose track of them in the short term. But they will become increasingly apparent if they are allowed full play over the medium term. The opportunities for offshoring and outsourcing may at first excite political resistance in the EU-15 as jobs are relocated to central and eastern Europe. But over time, people in western Europe will realize that moving some activities offshore will make their companies stronger in a fiercely competitive global environment, allowing companies that would otherwise have to close down to stay in business.

At the same time, it is going to put pressure on western Europe to move its labor force into areas requiring more advanced skills. I see the enlargement of the EU as a localized version of globalization where companies can take advantage of the synergies between a very advanced part of the world and a part of the world that still has substantial catch-up potential. ■

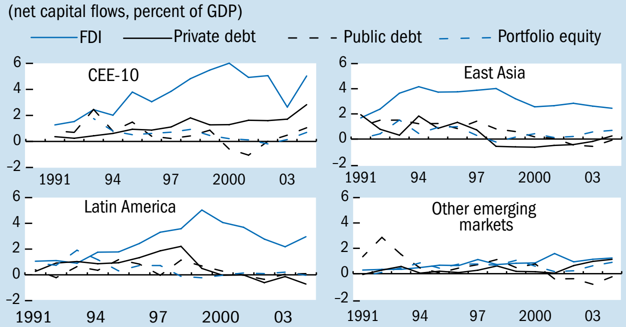
Some of the findings in this article will be published as an IMF Working Paper, "Do Economists' and Financial Market Perspectives Differ for the New Members of the EU?" by Pipat Luengnaruemitchai and Susan Schadler (forthcoming).

Chart 5

Attracting a lot of foreign direct investment (FDI)

FDI inflows are big, which makes the large current account deficits look less worrisome. However, debt-creating inflows are also rising.

(net capital flows, percent of GDP)



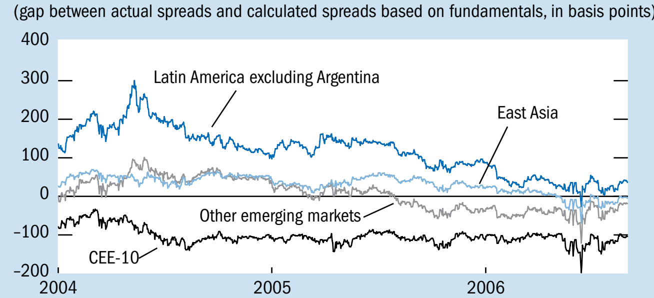
Data: World Bank, Global Development Finance database.

Chart 6

Paying less to service debt

The CEE-10 are paying 50–100 basis points less to service their debt than what economic fundamentals would seem to warrant.

(gap between actual spreads and calculated spreads based on fundamentals, in basis points)



Data: IMF staff calculations.

Albania looks to translate impressive gains into sustained growth

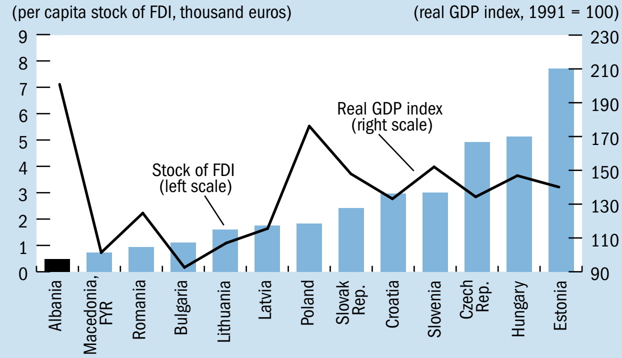
Albania has made impressive progress over the past 15 years. When the country began its transition to a market economy, it had the lowest level of per capita income, trade openness, and market development in Europe. It is still among Europe's poorest countries. But, notwithstanding some setbacks since 1991, the rapid growth engendered by a concerted series of structural reforms and by a strong commitment to macroeconomic stability has more than doubled Albania's per capita income and steadily reduced the income gap with its neighbors.

A wide range of macroeconomic indicators signal progress. Public debt as a percent of GDP is declining, inflationary expectations are firmly grounded at low levels, financial intermediation is rising, confidence is steadily increasing, and in the virtual absence of capital controls, the freely floating exchange rate continues a trend appreciation. With its development strategy designed to contain the size of government and seek private sector–led solutions for all but essential core government functions, Albania's fiscal management has found an effective anchor, and the privatization process for the remaining large government assets is reaching its final phase.

The government's strong policies are chiefly responsible for this success, but the IMF has also played an integral role. The Fund has lent support through most of the transition process—first through its low-income country Poverty Reduction and Growth Facility (PRGF) and, more recently, in view of the rapid rise of incomes, through a blend of PRGF and Extended Fund Facility financing. Equally important, technical assistance—particularly in the monetary and fiscal areas—has been generous, in part reflecting the unusually high degree of implementation.

Foreign capital needed

Albania has had strong growth but must now improve its business climate to compete with its neighbors for foreign direct investment.



Note: 2005 data.
Data: IMF, World Economic Outlook database; and Vienna Institute for International Economic Studies.

On to the next step

One measure of Albania's success to date is that the authorities—supported by IMF staff and the Executive Board—now envisage graduating from program status in early 2009 with the expiration of its current financing arrangement with the IMF. The challenge ahead will be not simply to maintain high growth but also to ensure its quality and sustainability over the longer term. With early efficiency gains from transition largely exhausted, more permanent sources of growth will be needed to ensure success and further reduce the income gap with its neighbors.

Expanding the export base and improving both infrastructure and regulatory frameworks are key, and here the issue of institutional quality becomes paramount. By most available measures of corruption, law and order, and bureaucratic quality, Albania lags behind the middle-income, high-growth countries it aspires to emulate. A reflection of these issues is that both foreign investment and exports remain very low as a percentage of GDP (see chart).

Albania's success after 2009 will depend to a significant degree on its ability to sustain implementation of strong policies, improve its investment climate, and reduce its still-considerable vulnerabilities. Those areas that fall within the Fund's core competencies therefore constitute important pillars of the current program. For example, comprehensive reforms—with key actions supported by the conditions that the IMF attaches to its lending—are currently being implemented to strengthen banking supervision, tax administration, and debt management. With strong technical assistance support from the IMF, significant advances have been achieved, and the country's fiscal and other institutions are expected to be markedly stronger by 2009.

A substantial reform agenda will remain after graduation in 2009. Donors with appropriate expertise are expected to help Albania tackle medium-term priorities, such as infrastructure development, anticorruption measures, legal and regulatory reforms, and formalizing ownership relationships. Efforts in these areas will support and be supported by the recent approval of the Stabilization and Association Agreement with the European Union and prospective membership in the North Atlantic Treaty Organization. ■

Geoffrey Oestreicher
IMF European Department

After years of strong economic performance, risks increase for Belarus

Following years of strong macroeconomic growth and progress in reducing inflation, the Belarus economy is facing serious risks, and the IMF, in its annual report on the country's economic policies, called for a fundamental change of course.

The good recent performance of the centralized, state-dominated economy—average GDP growth of 8.2 percent in 2002–05 and a gradual slowing of inflation to less than 7 percent—reflected, among other things, prudent fiscal and monetary policies and strong growth in the nation's trading partners. But favorable outside conditions also helped. Belarus owed much of its strong growth to its ability to import energy from Russia at below-market prices while the prices for its energy-intensive exports grew markedly. Belarus used the trading gains to pay large wage increases, subsidize state enterprises, and finance large-scale investment projects that had underpinned a "policy of strong government interference in the economy," according to the IMF's review.

But the outlook is now much less favorable. Energy price projections suggest that beginning in 2007 there will be no further gains in the country's terms of trade and that subsidized energy imports could be lower, imparting "a considerable downside risk to the outlook." Also of concern is Belarus's declining market share within the Commonwealth of Independent States, its large and growing non-oil current account deficit, its low level of international reserves, and a diminishing output gap. Underutilization of capacity, as well as price controls, helped moderate inflationary pressures in the past.

Belarus	2003	2004	2005	Proj. 2006	Proj. 2007
			(percent change)		
Real GDP	7.0	11.4	9.3	7.0	4.5
Consumer prices (end of period)	25.4	14.4	8.0	9.0	9.0
			(percent of GDP)		
Government revenues	45.8	45.7	48.4	48.3	47.1
Budget balance	–1.4	0.0	–0.7	–0.1	–1.2
			(annual percent change)		
Terms of trade index	0.1	2.6	12.8	8.8	–1.5

Data: Belarus authorities and IMF staff estimates.

Executive Directors called for immediate fiscal tightening to enable Belarus to cope with the budgetary implications of a stabilization in the terms of trade, followed by broader structural reforms. Reforms should be implemented while the economy is still strong. Directors argued for phasing out directed bank lending, bringing on budget all remaining state subsidies to enterprises, limiting the "golden share" rule (through which the state can regain control over privatized enterprises) to a handful of preannounced strategic cases, and phasing out price controls. ■

Rebounding Morocco should now make fiscal consolidation a top priority

Morocco has started to reap the benefits of its reform efforts, but raising living standards to the level observed in other emerging economies still constitutes a challenge. Macroeconomic conditions continue to strengthen and the 2006 outlook is favorable. A bumper wheat crop and strong activity in services and construction are ushering in a recovery, following a slowdown in growth caused by bad weather in 2005. Inflation remains low.

In its annual review of the economy, the IMF said the external current account is expected to record its sixth consecutive surplus, thanks to strong tourism and workers' remittances. At more than $18 billion, external reserves exceed the total stock of public external debt. Morocco's fiscal position is improving, but the ratio of public debt to GDP, though declining, remains high.

Despite a buoyant revenue performance, the fiscal deficit is likely to be close to the 2006 budget target of 4.1 percent of GDP (down from 5.9 percent in 2005) because of expenditure pressures related to oil and food subsidies. With the objective to reduce the fiscal deficit to 3 percent of GDP and the public-debt-to-GDP ratio below 60 percent by 2009, the Moroccan authorities have started to curb wage bill growth through an early retirement scheme. They also plan to continue to gradually align domestic petroleum prices with international prices and to reduce the fiscal cost of food subsidies by better targeting them to the most vulnerable groups. Banking sector conditions have improved following significant write-offs of nonperforming loans and the near-completion of the restructuring of two state-owned banks.

Morocco	2003	2004	2005	Proj. 2006	Proj. 2007
			(percent change)		
Real GDP	5.5	4.2	1.7	7.3	3.3
Consumer prices	1.2	1.5	1.0	2.5	2.0
			(percent of GDP)		
Current account balance[1]	3.4	1.7	1.5	0.9	–0.1
Total external debt	35.1	30.8	29.0	26.1	24.6
			(million dollars)		
Gross reserves	13,716	16,298	16,080	18,768	20,044

[1]Excluding official transfers.
Data: Moroccan authorities and IMF staff estimates and projections.

IMF Executive Directors commended the authorities on implementing sound macroeconomic policies and structural reforms. They also agreed with the authorities that recent achievements provide an opportunity to advance the reform process and accelerate growth to support increased employment and reduce poverty.

Fiscal consolidation should be the top policy priority, Directors said, and they welcomed ongoing efforts to broaden the tax base and increase revenue, and supported the possible transition to a flexible exchange rate regime. ■

For more information, please refer to IMF Public Information Notices Nos. 06/101 (Belarus) and 06/115 (Morocco) on the IMF's website (*www.imf.org*).

Putting too many eggs in one basket?

The widening U.S. current account deficit and the associated large positions that foreigners are amassing in U.S. bonds and equities—roughly $5 billion—have garnered much attention from academics, policymakers, practitioners, and the financial press. There are many structural reasons for this accumulation. For portfolio equity investors, few countries protect the rights of outside investors more vigorously. For fixed-income investors, U.S. bond markets offer unparalleled depth and liquidity. But these large positions also leave foreigners exposed to fluctuations in U.S. asset prices. In an IMF Working Paper, Francis E. Warnock addresses this aspect of foreigners' U.S. positions by assessing how a rapid decline in U.S. financial market prices could impact foreigners across a wide range of countries.

He traces out the composition of exposure to U.S. securities markets and investigates its potential implications by studying the effect on wealth (in dollar terms and as a share of investor-country GDP) of an unexpected 10 percent decrease in U.S. bond and equity prices as well as in the value of the dollar against other currencies.

Big exposure

Foreign positions in U.S. long-term securities have increased sharply in recent years.

	Total Holdings	Equities	Bonds
	(million dollars, June 2004)		
Developed countries	3,443,553	1,416,156	2,027,397
Euro area	1,367,630	526,284	841,346
Belgium	302,679	18,089	284,590
Luxembourg	360,243	130,038	230,205
Other Europe	826,685	465,506	361,179
United Kingdom	471,348	249,945	221,403
Other developed	1,249,238	424,366	824,872
Japan	898,100	162,408	735,692
Emerging markets	1,612,565	447,201	1,165,364
Latin America	87,922	20,311	67,611
Emerging Asia	566,038	15,806	550,232
China	322,810	2,523	320,287
Financial centers	807,427	333,778	473,649
Caribbean financial centers[1]	627,740	239,743	387,997
Emerging Europe	29,766	952	28,814
Other emerging	121,412	76,354	45,058
World	5,056,118	1,863,357	3,192,761
of which: Reserves	1,320,000	134,000	1,186,000

[1]Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Netherlands Antilles, and Panama.
Data: Author's calculations.

Potential losses

Taking into account the currency composition of foreigners' U.S. holdings, Warnock finds that for every 10 percent drop in U.S. bond markets and in the exchange value of the dollar, foreigners' wealth losses would amount to 2.5 percentage points of foreign GDP. If, in addition, U.S. equity markets also declined by 10 percent, foreigners would incur another 1.5 percentage points of GDP in wealth losses. Thus, for every 10 percent decline in the dollar, U.S. equity markets, and U.S. bond markets, foreign wealth losses would amount to 4 percentage points of foreign GDP. Foreigners are also exposed through their positions in dollar-denominated bonds issued by foreign countries; bringing these holdings into the analysis puts the total wealth loss at nearly 5 percentage points of GDP—or roughly $1.2 trillion in foreign currency terms of financial wealth.

Narrow focus

Warnock used two datasets for the study. The first measures foreign holdings of U.S. securities as reported in the June 2004 comprehensive U.S. benchmark liabilities survey. The second data source is the IMF's December 2004 *Coordinated Portfolio Investment Survey* (CPIS), which Warnock uses to compute implied U.S. liabilities (the amount of U.S. securities residents of each country are reported to own). He notes more than a few caveats to his analysis. The study focuses very narrowly on the first-order effects of the dollar exposure of portfolio assets on foreign wealth, while the particular scenario Warnock uses may or may not be realistic. Some may see the projected consequences of a disorderly unwinding of global imbalances as too conservative, whereas others may believe a simultaneous decline in the dollar and U.S. stock and bond markets to be improbable.

That said, Warnock finds that the exposure to U.S. security markets of almost every developed country has increased over the past decade. Taking Canada as an example, he shows that 10 percent declines in the dollar and in U.S. bond and equity prices in 2004 would lead to wealth losses for Canadian investors of 6¼ percentage points of Canadian GDP, whereas in 1994—when Canadian positions were smaller relative to GDP—the impact on Canada's wealth would have been only 2 percentage points of GDP. The evidence for emerging markets, such as China, is similar. ■

This article is based on IMF Working Paper No. 06/170, "How Might a Disorderly Resolution of Global Imbalances Affect Global Wealth?" by Francis E. Warnock. Copies are available for $15.00 each from IMF Publication Services. Please see page 340 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

Taking the IMF's governance reform forward

At the recent IMF–World Bank Annual Meetings in Singapore, the IMF's 184 Governors debated Managing Director Rodrigo de Rato's proposal for governance reform. His strategy, endorsed by an overwhelming majority of the governors, involved ad hoc quota increases for four countries—China, Korea, Mexico, and Turkey—whose calculated quotas are most seriously out of line with their actual quotas, and a two-year work program on a new quota formula. The IMF is hoping that its Executive Board will reach agreement by the fall of 2007 on a new formula to be implemented by the 2008 Annual Meetings.

In recent years, the media, policymakers, international observers, and nongovernmental organizations have repeatedly questioned whether the mandate and governance structure of the IMF adequately serves the needs of all its members. The critics argue that management and decision making in the IMF—a global institution in which industrial countries control more than 60 percent of the capital—should be reformed to make it more legitimate, participatory, and accountable. The initiative of the Managing Director reflects the importance of ensuring that the IMF remains an effective institution in the globalized economy of today.

What experience tells us

Quotas determine the voting strength of each IMF member in decisions made by the Board of Governors and the Executive Board (see box). Changes in quotas require the backing of 85 percent of the membership. A quota also cannot be reduced without a member's consent.

Past experience has shown that a redistribution of quotas and quota shares has the greatest chance of winning approval if it is presented as part of a package that includes a general quota increase and other elements in which all members find more to vote for than to vote against. In January 2003, the Fund concluded its twelth general review of quotas without increasing them—deeming it had sufficient liquidity to meet members' lending needs. Since then, the Fund's liquidity position has improved further as a result of a rapidly growing world economy and liquid capital markets. At the same time, several members have prepaid large outstanding loans to the IMF.

These factors have reduced the demand for the Fund's financial resources, making a general quota increase seem unlikely. Instead, a quota reform package could rely on further ad hoc increases for those members whose actual quotas are significantly out of line with their calculated quotas—a step that a majority of the IMF's membership now seems willing to support.

In earlier Board discussions, broad support has emerged for a transparent quota formula that would be based on no more than three or perhaps four variables. These include GDP; openness (defined as the total of current external receipts and current payments); variability of current receipts and net incoming capital flows; and, possibly, official international reserves.

A look at the players

The *United States* has the largest quota share (17.1 percent), which gives it the ability to veto any quota reform package. The U.S. government has welcomed the Managing Director's proposed strategy, making it clear it thinks the new quota formula should give greater weight to GDP, which is known to favor quota calculations for industrial countries. "Greater weight to GDP" can be interpreted as implying "less weight to openness" on the part of the United States. The present U.S. position also seems to imply a willingness to accept some reduction in its voting power—as long as its quota remains above 15 percent of the total voting power, thus allowing it to maintain its veto over decisions requiring an 85 percent majority.

The Managing Director's proposals have raised the expectations of *developing countries* for a significant reduction in current quota imbalances. At present, more than 61 percent of total votes are held by 23 industrial countries, whereas 161 developing countries, accounting for about 80 percent of the world's global population, hold less than 39 percent. The developing countries prefer using GDP purchasing power parity (PPP) data, which favor quota calculations for countries with large populations. The Executive Board had earlier rejected using PPP data, but develop-

How the IMF is governed

The IMF's top decision-making forum is the Board of Governors, which consists of one governor (usually the finance minister or central bank governor) from each member country. All governors meet at the IMF–World Bank Annual Meetings. A subset of 24 governors sits on the International Monetary and Finance Committee, which meets twice each year and provides strategic guidance for the IMF. The day-to-day work of the Fund is conducted at its Washington, D.C., headquarters and is overseen by its 24-member Executive Board.

Quotas determine countries' voting strength in the IMF. Each member has 250 basic votes plus one additional vote for each SDR 100,000 of quota. Apart from voting strength, quotas also determine countries' ability to access IMF resources. Various economic factors are considered in determining quotas, including GDP, current account transactions, and official reserves.

IMF Photo

IMF Executive Directors meet in the early days of the Fund.

ing countries may well wish to have it revisit that question. Since one set of GDP data favors industrial countries, and the other set favors developing countries, it would make sense to include both sets of GDP calculations in a revised quota formula.

For their part, the *European Union (EU) countries* have emphasized that a quota reform should focus on correcting the limited number of member quotas that remain seriously out of line. They have stressed that they do not wish to see a weakening of the EU's position in the IMF and are known to favor heavy weights for openness and GDP at market prices, which tend to favor them. EU members have also emphasized that a unification of the chairs held by European members in the Executive Board should not be considered an option at this time.

Another central objective of the reform package is to enhance the participation and voice of *low-income countries*. A straightforward manner to protect the voting power of the IMF's small and poor members is through an increase in the 250 basic votes that were provided to each member in the Articles of Agreement (the IMF's charter). In 1945, basic votes accounted for 11.3 percent of total votes; today, they account for only 2.1 percent. Earlier attempts to correct the erosion of basic votes failed because an amendment of the Articles of Agreement is required to do so. Today, however, there is strong willingness among the membership to at least double the share of basic votes.

Some thoughts about the road ahead

The EU is represented by seven chairs in the IMF Board. Belgium, France, Germany, Italy, the Netherlands, the Nordic group, and the United Kingdom all have their own Executive Directors, although some of them represent groups of countries, not all of which are members of the EU. The aggregate voting power of those seven chairs is 33.55 percent—nearly the same as the combined voting power (33.91 percent) of the 12 chairs held by the developing countries (calculations based on pre-Singapore data). The EU's voting power is also nearly twice as large as that of the United States. The basis for Europe's voting strength was laid in the early postwar period, when the western European members obtained large quotas because they were expected to need financial assistance from the Fund. Developing countries were generally treated less liberally because of data inadequacies and because they would be able to obtain loans from the World Bank. From then on, the quota formula and manner in which general quota increases were carried out favored Europe as it grew at a rapid pace and integrated its economy. During this period, Europe also contributed a large share of the financing of the Fund. Moreover, the diversity of views held by the European countries enriched the deliberations in the Executive Board and helped build consensus.

At present, however, governance issues have moved to the forefront in the management of the international monetary system, and the uniquely large voting strength of Europe is now seen as a major distortion. Moreover, the regional trade of the European countries has, de facto, become internal trade—conducted mostly in euros—rather than international trade. This, in turn, has become an important argument for reducing the weight of openness in the new quota formula. At the same time, a more systematic coordination of European policies and voting positions would greatly strengthen the region's influence in global affairs.

The challenge of agreeing on a new quota formula will require everybody to look beyond their short-term interests and rally behind an outcome that strengthens the legitimacy of the IMF while being respectful of all countries' standing within the institution. As a group, EU countries constitute the IMF's prime shareholder. They are therefore uniquely placed to work with other member countries and the Managing Director to ensure the success of governance reform. The resulting loss of quota shares would be modest and would not affect the viability of the seven EU chairs in the near term.

Looking further ahead, the strengthening of the EU's voice and influence in the IMF will depend on EU members' ability to coordinate their positions on Fund issues. Once that has been achieved, the unification of all 27 EU members in a single chair will be the next logical step. That, in turn, would open the way for close cooperation with the United States and other IMF members to create a more compact and powerful decision-making instrument in which the industrial countries would hold a reduced voting majority while the developing countries would hold a majority of chairs. The effective—and generous—collaboration of EU countries and their chairs in this endeavor would yield enormous benefits for the world community. And Europe itself would be a major beneficiary from an IMF that has regained legitimacy among all its members. ■

Leo Van Houtven
President of the Per Jacobsson Foundation
and former IMF Secretary and Counsellor to the Managing Director

Adjusting for growth

Sound, sustainable government finances can play a crucial role in promoting macroeconomic stability and growth, but good fiscal policy is hardly static. Particularly in an age of intensifying globalization, it requires frequent adaptation in the form of policy adjustments and strengthened institutions. Intensifying globalization has sped up this process, and *Fiscal Adjustment for Stability and Growth*—a new IMF pamphlet—examines the major changes of the past 15 years and counsels a pragmatic approach. The pamphlet, which updates a 1995 publication, explores when adjustment is needed, how the fiscal position should be assessed, what makes adjustment successful, how adjustment should be carried out, and what types of institutions can help.


Kham/Reuters

Ford plant in Vietnam. With increasingly mobile factors of production, countries are rarely able to impose high corporate tax rates, because companies can seek out countries with lower costs.

New challenges

What has changed? For starters, globalization has become a defining issue, says James Daniel, one of the pamphlet's coauthors. On the revenue side, for example, it is now much more difficult for countries to tax mobile factors of production (such as international businesses) at the high rates they once could. Globalization has also proved a double-edged sword for emerging market economies—providing far greater access to international capital markets but also punishing overly lax fiscal performance swiftly and severely.

For many poor countries that no longer have to service heavy foreign debts and can look forward to much more aid, the period ahead could be a golden opportunity. Fiscal policy can and should help countries meet their development goals. But, Daniel cautions, policymakers must be mindful of the checkered history of aid and the numerous possible pitfalls, including real exchange rate overvaluations that can undercut exports and productivity growth ("Dutch disease"), crowding out of the private sector, limited government capacity to spend money well, ramifications for governance and domestic revenue generation, and unpredictable and volatile flows, especially when aid gives rise to ongoing spending needs.

Lessons of experience

Following apparently successful efforts to subject monetary policy to more formal frameworks, such as inflation targeting, many countries in recent years have moved to constrain fiscal policy through fiscal rules and fiscal responsibility legislation. Should countries adopt limits on their deficits and debt, as the European Union did with its Maastricht Treaty?

Daniel, reflecting the view of the new IMF pamphlet, suggests that "the jury's still out." The Fund counsels countries to be pragmatic and see what works in their own circumstances. Still, there are some tentative lessons to be learned from the experience so far, he says. Chief among them is that fiscal responsibility requires a broad political consensus to be successful. Rules and laws are no substitute for political commitment.

Finally, the Asian and other emerging market crises of the 1990s taught the importance of balance sheet variables. It is critical not only to look at flow indicators, like the well-known fiscal deficit measure, but also to keep an eye on stock variables, such as government debt, and on details such as who holds the debt and what currency it is in. Tied in with this idea is the concept of fiscal risk. Country authorities would do well to be aware of contingent liabilities, like government guarantees, that may become costly when times are tough. ■

Copies, in English and French, of IMF Pamphlet No. 55, *Fiscal Adjustment for Stability and Growth*, by James Daniel, Jeffrey Davis, Manal Fouad, and Caroline Van Rijckeghem, are available free from IMF Publication Services. See this page for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

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