RISING ENERGY COSTS
High Oil Prices Pose Challenge for Policymakers

With oil prices in sight of $100 a barrel, the rise in energy costs is a new worry for consumers at a time of continued concerns in major economies about fallout from the credit crunch.

In November, the average petroleum spot price (APSP) reached a new high of over $94. The three main benchmark prices for oil all reached record highs, with West Texas Intermediate closing at almost $99, Brent at $96, and Dubai at over $90. Despite some softening at end-November, oil prices remained high and volatile.

But not everyone is feeling the same pinch from the oil price hike. Measured in euro and Special Drawing Right (SDR) terms, the surge has not been as dramatic, reflecting the depreciation of the dollar, the currency in which oil producers are paid (see Chart 1). The effects of the depreciating dollar on the price of oil

IMF to Deliver Debt Relief to Liberia

Managing Director Dominique Strauss-Kahn said November 12 that the IMF has secured sufficient financing pledges from member countries to allow it to provide debt relief to Liberia. When these pledges, totaling about $842 million, are formalized, a process will be followed of arrears clearance and new IMF financing that will enable the writing off of Liberian debt to the Fund. Hailing the “breakthrough” in financing, Strauss-Kahn said it represented “a critical step in moving Liberia onto a path toward comprehensive debt relief.” He said the IMF would continue to support postconflict recovery in the country, “building on Liberia’s many achievements over the past two years.”

Strauss-Kahn thanked IMF member countries for “generous support,” citing “efforts of many leaders around the world,” including low-income countries, in securing the financing. He also acknowledged the roles played by Liberian President Ellen Johnson-Sirleaf and her

Latin America Set for 5th Year of Healthy Growth

Latin America is poised for what could be its fifth consecutive year of strong economic growth in 2008.

But inflation, after falling to a historic low for the region in 2006, is edging up in several countries, the IMF said in its Regional Economic Outlook for the

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were discussed at the third summit of the Organization of Petroleum Exporting Countries (OPEC), held November 17–18.

At end-November, futures and options markets indicated that the APSP would average almost $88 a barrel in the fourth quarter of 2007 and almost $87 in 2008, with about a one in three chance that Brent crude prices could be above $100 by April 2008.

The recent oil price surge was sparked by geopolitical concerns about growing tensions in the Middle East and some weather-related production shutdowns, underscoring that in an environment of limited spare oil production capacity and declining inventories, prices have become highly sensitive to news that may indicate possible future supply shortages. The weakening dollar also played a role. But more fundamentally, spare capacity remains low and market conditions are expected to remain very tight.

Demand outstripping supply
Oil demand growth has remained robust, supported by strong growth in emerging markets, particularly China and the Middle East (see Chart 2). Although the International Energy Agency recently revised oil demand downward in the fourth quarter of 2007 because of the slowing U.S. economy, global demand is expected to remain strong in 2008.

In contrast, supply has lagged behind and inventories are falling. During the first nine months of 2007, world oil supply declined moderately by 0.1 million barrels a day (year on year), reflecting a decline in OPEC’s output and limited output growth in oil-producing countries that are not members of OPEC. As a result, commercial inventories in industrial countries fell in the third quarter and in October, a period normally marked by inventory accumulation.

Supply is lagging demand growth because of the increasing technological and economic challenges for oil production. As a result, tight market conditions are expected to persist and possibly intensify, assuming strong GDP growth continues in emerging markets such as China and India.

Analysis by the IMF shows that, over time, a prolonged price surge will certainly have the effect of curtailing demand—especially in the United States—by

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economic team, and World Bank President Robert Zoellick.

Track record
Johnson-Sirleaf took office in January 2006, leading a country that was emerging from a 14-year civil war that had ended 3 years earlier. The latest IMF staff report on the country’s economy says economic activity remains buoyant, with GDP growth projected at around 8 percent in 2007.

Strauss-Kahn noted that, despite difficult postconflict circumstances, the Liberian government had established an encouraging track record of macroeconomic management and reforms that the IMF has supported through technical assistance and policy advice.

“IMF staff are currently finalizing discussions with the Liberian authorities on a three-year IMF-supported program, so that Liberia can build upon the initial economic recovery, maintain the strong growth needed to reduce poverty, and restore debt sustainability,” Strauss-Kahn added.

The agreement follows talks between the IMF and the Liberian government during the IMF–World Bank Annual Meetings in October. Former IMF Managing Director Rodrigo de Rato said in an October 18 statement that it was “urgent that the international community make progress in moving Liberia onto the path toward debt relief.” de Rato said the effort hinged on securing the resources needed to provide debt relief to the country.
The limited impact reflects the likely macroeconomic impact. High oil prices have not so far had much of an impact on global activity and inflation. The limited impact reflects the demand-driven nature of the run-up in oil prices since 2002, as well as lower energy intensity, more competitive labor markets, and the improved credibility of monetary policy frameworks. For developing countries in particular, strong global growth and the rise in nonfuel commodity prices have mitigated the impact of higher oil prices on many countries’ trade balances.

That said, the recent oil price surge will likely boost headline inflation in the months ahead (headline, or total, inflation includes food and energy price components, whereas core inflation typically excludes these volatile items). The direct effect of the recent oil price rise on headline inflation in the United States is estimated to be about ½ of 1 percentage point by the end of the year.

The impact in other advanced economies will likely be smaller because reliance on private transportation is lower and because prices have risen less in other currencies. However, central banks may find that they have less room for maneuver in responding to weakening demand caused by the recent financial turbulence, given that higher fuel costs could have second-round effects on other prices and on wages.

Overheating pressures

The situation is particularly challenging in some emerging market and developing countries, where overheating pressures are of greater concern and rising fuel and food costs may put pressure on household budgets and external balances. In particular, for many low-income oil-importing countries, the recent oil price increase will raise their import bill and could strain fiscal positions.

Looking ahead, with market conditions so tight, any significant supply disruption could push prices higher still. In particular, spare production capacity remains below its historic comfort zone, and the majority of it is sour crude from Saudi Arabia, which is difficult to refine into the low-sulfur distillates demanded by OECD countries.

According to most oil market forecasters, this situation is not likely to improve anytime soon, because limited new exploration opportunities will constrain supply. Assuming that strong GDP growth continues in the emerging market countries, high and volatile oil prices could accordingly become the norm for some time.

Kevin C. Cheng and Valerie Mercer-Blackman
IMF Research Department
Most scientists agree that the global temperature is rising as a result of man-made emissions of greenhouse gases and that the Earth’s climate is changing. This can lead to, among other things, a rise in sea levels; increased frequency or intensity of heat waves, droughts, hurricanes, and floods; and a loss of biodiversity. The physical and biological consequences of climate change and, hence, their economic costs, are uncertain, but are likely to vary across regions.

Although the direct impact of climate change is expected to be felt slowly, the steps that governments, businesses, and individuals take to mitigate, or adapt to, climate change can have immediate economic and financial consequences. The analytical and policy challenges posed by climate change were discussed at a workshop organized by the IMF’s Research Department on September 20.

**Economic costs**

All participants in the workshop underscored the high degree of uncertainty surrounding estimates of the economic costs of climate change. John Reilly (Massachusetts Institute of Technology) noted that although most available models suggest that the aggregate economic costs of climate change are likely to be small, these estimates represent a central tendency that summarizes the gamut of scenarios ranging from relatively favorable to catastrophic effects of climate change (see chart); policymakers may be particularly concerned about the tails of the distribution.

Low-impact estimates also disguise significant differences across countries: small, poor, resource-dependent economies are likely to be most affected by climate change. Robert Shackleton (Congressional Budget Office) and Francisco de la Chesnaye (Environmental Protection Agency) echoed these views, pointing out that the effects of climate change on economic growth, trade, financial flows, and migration depend on how physical and biological systems respond to rising temperatures and on how well countries adapt to climate change and cope with the institutional and social stresses climate change is likely to pose.

**Mitigating climate change**

In discussing the challenge of designing policies that would provide incentives for countries to participate in an international agreement on mitigating climate change, Warwick McKibbin (Australian National University) argued that these policies must be robust to uncertainty.

If an economy grows faster than originally anticipated, for example, its abatement costs will rise, making the original targets under a quantity-based scheme (cap and trade) hard to achieve and weakening the country’s incentives to participate in an international cap-and-trade agreement.

The increase in costs would be considerably smaller under a price-based scheme (a carbon tax) or a hybrid scheme that converts a quantity-based scheme into a price-based plan using a safety valve if abatement costs rise above a certain threshold.

William Pizer (Resources for the Future) underscored, among other things, the importance of international competitiveness in the context of designing sustainable international agreements. He pointed out that, for the business sector in countries considering joining an international agreement, the critical issue is whether it
would remain competitive with producers from nonparticipating countries.

Nicholas Stern (London School of Economics) stressed that although advanced economies need to take the lead in mitigation, the participation of developing economies is crucial. He advocated working toward an international agreement that would combine strong individual emissions targets for developed countries with trading schemes open to developing countries. These issues are likely to remain high on the international policy agenda in the coming years, as countries debate the future of the Kyoto agreement, which is set to expire in 2012.

**IMF’s role**

The IMF is not a center of expertise on the scientific aspects of climate change, but it is building its capacity to assess the macroeconomic implications of climate change and policies to abate it. This is part of the IMF’s strategic effort to understand the long-term challenges to the global economy, which could help form a basis for its policy advice to member countries and for contributing to the international efforts to deal with these challenges.

A considerable amount of work on climate change issues is already under way at the IMF in coordination with its sister organization, the World Bank. This work comprises, among other things, an appendix in the October 2007 World Economic Outlook that summarizes the state of knowledge and policy debate on the key economic aspects of climate change.

Natalia Tamirisa
IMF Research Department

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**Calculating the costs**

The results of different studies assessing the macroeconomic effects of climate change span a wide range of possible costs.

(average per capita GDP losses; percent of world GDP)

![Graph showing the results of different studies assessing the macroeconomic effects of climate change](image)

Each line represents a different study. For more information about the studies, see October 2007 World Economic Outlook.

Source: IMF, World Economic Outlook October 2007, Appendix 1.2.

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**The Climate Change Challenge**

The average global temperature increased by about 0.7°C between 1906 and 2005, and existing greenhouse gases are expected to cause a further substantive temperature increase in the coming decades. The Nobel Peace Prize-winning Intergovernmental Panel on Climate Change projects that—without any policy response—emissions will lead to average global temperature increases of between 1.1°C and 6.4°C by 2100. The greatest increases in temperature are projected for the northern parts of North America, Europe, and Asia, with smaller—but still sizable—increases in tropical areas.

A number of other climatic effects are expected. The global pattern of rainfall, for example, is likely to change, with many already dry areas expected to become even drier. And there are further possible effects on rainfall in many tropical zones as well as on seasonal patterns, potentially affecting the sustainability of large human populations and critical natural resources. Flood risk is projected to increase through more intense rainfall and sea-level rise. In addition, the frequency and/or severity of extreme weather events, including hurricanes, floods, heat waves, and droughts, are expected to increase, most seriously in Africa, Asia, and the Caribbean.

Beyond these effects, there may be “tipping points” that, if passed, would result in more dramatic and irreversible climate effects. These include the potential for rapid glacial melting, reversal of the Gulf Stream, and large-scale tundra thawing in Canada, China, and Russia.

**Policy responses**

Although views differ on the appropriate extent and urgency, there is broad consensus on the need for some action to reduce the high economic risks posed by expected levels of warming in “business as usual” projections. The question of quite how much policy intervention would be desirable has generated a lively debate, reflecting the different assessments of the relative costs and benefits of action and inaction.

A core challenge is to reach agreement among major emitting countries on the implementation of policies to limit future greenhouse gas emissions. Initial steps toward international cooperation—most notably, the Kyoto Protocol—have had only limited success. The United States was assigned an emissions reduction under the Protocol but did not ratify the Protocol and is therefore not committed to it. And several ratifying countries are currently some way from achieving their commitments.

Some efforts to limit emissions currently undertaken by parties not bound by the Kyoto Protocol, notably Australia and the United States, have supported the development and diffusion of new technologies designed to promote energy efficiency. In addition, some countries have made efforts to reform energy pricing and reduce deforestation to increase energy security and reduce local air pollution. In each case, there have been important co-benefits in constraining the growth of greenhouse gas emissions.

These efforts, along with a range of wider international frameworks and processes that are being developed, should help reduce greenhouse gas emissions. But they will need to be extended significantly in breadth, depth, and efficiency, while paying due regard to the need for equitable sharing of the burden, to meet this challenge.
European Outlook

Europe: Riding Out the Market Turbulence

Strong fundamentals should allow Europe’s economies to weather the current financial turmoil, which was sparked by subprime mortgage lending in the United States, relatively well. In the advanced economies, average growth is expected to slow to 2.2 percent of GDP in 2008, down from 2.7 percent in 2007. In the emerging economies, growth should remain robust at 5.7 percent in 2008, down from 6.3 percent in 2007 (see table). However, continued problems in the credit markets constitute a key downside risk to this outlook.

Subprime fallout

A still resilient global economy, combined with generally sound macroeconomic policies and increasing trade and financial integration in Europe, has yielded a vibrant regional economy. After years of sluggish growth, the advanced economies in Europe are expected to outpace the United States this year and next, and the top-performing European emerging economies are posting growth rates second only to developing Asia’s.

But continued problems in the credit markets constitute a key downside risk to the outlook for Europe, especially for its advanced economies. While the broader financial system has continued to function well, money and credit markets remain tight. There is little doubt that protracted financial turbulence would affect the real economy, especially in the context of higher-than-expected oil price increases and euro appreciation.

Despite relatively high external vulnerabilities, the financial turbulence has so far had little effect on Europe’s emerging markets because of limited reliance on interbank markets and complex financial products. But risks have also risen for this part of the region, especially for those countries that have been funding large current account imbalances with foreign bank borrowing. In this regard, the financial turbulence may herald a healthy correction to past exuberance, bringing risk spreads closer to fundamentals, improving credit discipline, and helping reduce external imbalances.

Navigating uncharted waters

The problems in the credit markets have complicated policymakers’ task of maintaining growth without overheating, especially in advanced economies. Although their response has been broadly effective so far, central banks will have to continue to stand ready to provide liquidity.

In the euro area and several other advanced economies, monetary policy has been appropriately kept on hold in view of the downside risks. Looking further ahead, the baseline forecast assumes that these risks will gradually dissipate, in which case a further tightening may be required. Tighter interest rates would, of course, need to be reconsidered if the slowdown became protracted.

In the emerging economies, inflationary pressures and external vulnerabilities could warrant further interest rate increases. In countries where monetary policy tools are either ineffective or unavailable, the tightening will need to be achieved through fiscal restraint. Strong banking supervision will be critical throughout emerging Europe.

Closing supervisory gaps

The subprime lending crisis has underscored the need for financial sector reform. The losses sustained by a number of European financial institutions revealed that prudential frameworks have not kept up with developments in financial innovation. Europe’s financial supervisors will need to do a better job going forward, not least in ensuring that new financial products do not exploit gaps in prudential frameworks.

That said, financial innovation is important to Europe’s overall competitiveness. The challenge will thus be to make prudential arrangements, financial safety nets, and crisis resolution mechanisms more effective without stifling innovation.

Keeping an eye on fiscal policy

Looking beyond the current turmoil, Europe faces major challenges if it wants to sustain reasonably robust growth. More structural reforms will be needed to foster growth, and fiscal consolidation must be stepped up to address expenditure pressures from population aging. Reduced public spending will help Europe’s advanced economies prepare for economic downturns. In the emerging economies, it will help mitigate demand pressures arising from rapid catch-up growth and provide a counterweight to the rapidly rising indebtedness of the private sector.

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IMF European Department
Western Hemisphere, which it unveiled in São Paulo, Brazil, on November 9. So far, Latin America and the Caribbean seem to have weathered the fallout from the global financial turbulence that has its roots in the decline in the U.S. housing markets. But the problems in financial markets, which began last summer, have “significantly increased downward risks” for the region, the IMF said in its semi-annual report. The main sources of that risk include weaker external growth, with its attendant impact on commodity prices, and possible further tightening in U.S. and world credit markets.

Beyond the external conditions, the IMF said, the “sustainability” of the Latin American expansion will also depend on preserving “the strength of underlying fiscal positions” in the countries and “the resilience of domestic financial sectors.” The report noted that strong fiscal and external current account surpluses are beginning to shrink as public spending accelerates and imports rise.

Solid policies
Still, the overall message is “positive,” said Anoop Singh, Director of the IMF’s Western Hemisphere Department. “This is a recovery and a growth phase that is different from its predecessors” and is “not going to be terminated, we think, as prematurely as earlier ones” because of solid fiscal and monetary policies that make the region more resilient than it was in the past to changes in the external environment, Singh said at a briefing in Washington.

Overall, the IMF predicts that growth in the region will be about 5 percent in 2007, moderating to about 4¼ percent in 2008. The decrease next year reflects a less favorable external environment and capacity constraints in some countries. Still, if developments turn out as expected, 2008 would be the fifth year in a row that growth has exceeded 4 percent, Latin America’s best performance in decades (see table).

While Latin America is resilient enough to deal with the current global financial turbulence and some slowdown in U.S. growth, it would be more seriously affected if there were a pronounced slowdown in the industrial countries, especially the United States, and a credit crunch in financial markets. If that downside scenario were to unfold in the coming months, with a further weakening of commodity prices, growth would slow significantly in Latin America’s economies, perhaps to as low as 2½ percent overall in 2008, nearly 2 percentage points below the baseline projection.

Energy shortages
In a few countries, “energy shortages could also create risks to the growth outlook,” and many nations are facing food price shocks that heighten inflation risks. Overall, inflation in Latin America and the Caribbean is expected to rise from 5 percent last year to 5.4 percent this year and 5.7 percent next year.

The rising inflation reflects both the worldwide increase in food prices and growing aggregate demand as a result of the economic expansion. Because imports are growing faster than exports and commodity prices have stabilized, export earnings are no longer rising so rapidly. As a result, current account surpluses are weakening in most countries, the IMF said.

Meanwhile fiscal surpluses, which peaked in 2006, should decline to about 2 percent of GDP this year and 1¼ percent next, as revenues slow and government expenditures grow. “Unless the pace of spending growth is curbed, many countries in the region are likely to return to structural deficits in 2008,” the report warned.

Better targeting
The ongoing expansion has brought with it significant declines in both poverty and inequality, among the two most pressing long-term problems facing Latin America. Continuing reductions in both are linked to sustaining a rising trend in growth and productive investment—two areas in which, despite improvement, the region lags behind other emerging market economies. The regional outlook said that “to tackle persistent inequality and high poverty,” better targeting of social spending is essential, and the region is developing effective models for this purpose in its growing experience with conditional cash transfer programs.

Good times
Real GDP is expected to grow smartly in 2008 in Latin America and the Caribbean. (real GDP growth, year-end to year-end, percent)

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Sources: IMF, World Economic Outlook, and staff estimates.
1 Weighted by purchasing power parity.
The Middle East and Central Asian region is growing at 6½ percent in 2007; growth is expected to be about the same in 2008. The overall outlook is favorable, but the downside risks from the global economy have increased, and the region must tackle important policy challenges to sustain strong growth and further reduce poverty and unemployment.

Growth in the region, which is divided into oil exporters, low-income countries, and emerging markets, will outstrip global growth in 2007 for the eighth year in a row and is outpacing population growth.

In the oil exporters, growth is expected to be about 6½ percent this year and next, underpinned by non-oil activity. The low-income countries are growing the fastest at 9 percent, although growth should dip next year. The emerging market countries are estimated to grow by slightly less than 6 percent in 2007 but should reach 6½–7 percent next year.

Inflation has picked up to about 8½ percent and will likely ease only slightly in 2008. In the oil exporters, inflation will jump to 10 percent from 7 percent last year. Inflation has been low in Bahrain, Kuwait, and Saudi Arabia, which have open trade systems, flexible labor markets, less binding capacity constraints, and limited domestic pass-through of higher fuel costs. Inflation will likely be highest in Azerbaijan, Iran, Libya, and Qatar because of pressures from increased domestic demand, including from hikes in public sector wages, and supply constraints. In most countries, the recent increases in food prices are beginning to exert additional inflationary pressures.

Regional changes
The region has seen increases in per capita incomes, enhanced economic integration, and changes in countries’ economic systems. It is becoming more diversified, and, in the Gulf Cooperation Council countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates), the non-oil sector is growing in importance. Moreover, the role of market forces and the private sector in the region is expanding.

Development indicators are improving. Extreme poverty (those living on less than $1 a day) has fallen, life expectancy has increased, and fertility has declined. The region’s population, swelled by immigrants, now numbers 650 million. The populations of Qatar and the United Arab Emirates have increased fourfold, fueling these countries’ strong growth but straining infrastructure. Despite the region’s recent strong growth record, unemployment has declined only slightly and exceeds 10 percent in many countries.

Spending versus saving
Higher spending by oil exporters has lowered the region’s savings this year. With oil and gas export receipts rising, spending on infrastructure and social investment projects has accelerated. The oil exporters can expect external current account surpluses to drop to about 17 percent of GDP ($275 billion) this year from 21 percent ($275 billion) last year, contributing to a narrowing of global current account imbalances. The low-income countries have also spent more in 2007; in contrast, the emerging market countries’ spending as a percentage of GDP has declined on average.

Most emerging market and low-income countries have generally recorded current account deficits. In the former group, the deficit has widened to 2½ percent and will remain at that level in 2008. In the latter group, the deficit is projected to widen to about 3½ percent of GDP, largely because of strong import growth driven by domestic demand. In some oil importers, however, the effect of higher oil prices on the current account has been partly offset by remittance inflows and higher export prices.

Flows of foreign direct investment to the region have quadrupled since 2002 and should top $80 billion this year. These flows, combined with the large current account surpluses, have substantially increased the region’s official international reserves, which are set to reach almost $790 billion by the end of this year. Oil exporters have the largest reserves, which should reach $675 billion by the end of the year.

Policy issues
The outlook for the Middle East and Central Asia is positive but could be marred by, for example, conflicts and worsening security. If global growth slowed significantly, the region could also suffer, particularly in light of its increasing integration with the global economy and dependence on commodity exports. Another potential risk is that of worsening international financial market conditions, which could reduce capital flows to the region.

Key challenges will be to manage exceptionally strong foreign exchange inflows, which have provided opportunities for long-term growth in some countries but sparked inflationary pressures in others; ensure fiscal and external sustainability in some countries; continue to develop the financial sector; maintain progress toward diversification; and promote private sector-led economic expansion.
**IMF to Step Up Work with Donors to Boost Effectiveness of Assistance**

Providing technical advice and know-how to member countries is a vital role of the IMF in a globalized economy. The Fund is seeking to enhance its partnership with donors in its technical assistance program. The aim is to improve the effectiveness of IMF technical assistance and training by leveraging on the development assistance strategies of donors.

A key benefit of IMF membership, technical assistance—over 80 percent of which goes to low- and lower-middle-income countries—is aimed at building the institutions and skills countries need to design and implement macroeconomic policies that promote growth. To ensure strong country ownership, IMF technical assistance is designed and delivered within the context of each recipient country’s economic reform strategy and priorities.

**Partnering with external donors**

Although the largest portion of IMF technical assistance is funded with its own resources, contributions from bilateral and multilateral donors have played an increasingly significant role in enabling the IMF to meet country needs in this area.

“The participation of donors in our technical assistance program flows naturally from our mandate to promote international economic cooperation,” says IMF Deputy Managing Director Murilo Portugal. “We believe that strong partnerships between recipient countries and donors enable IMF technical assistance to be developed on the basis of a more inclusive dialogue and within the context of a coherent development framework. The benefits of donor contributions therefore go beyond the financial aspect.”

Since the early 1990s, IMF cooperation with donors on technical assistance projects has grown steadily. External support—provided in the form of donor grants to the IMF—now finances about one-fifth of the IMF’s total technical assistance. Of the more than 25 donors that support this work, the government of Japan remains the single largest contributor.

Total Japanese support for the IMF’s technical assistance program has exceeded $230 million since 1990, and has covered projects in more than 120 countries in all areas of the IMF’s expertise. Apart from Japan, the United Kingdom’s Department for International Development and Switzerland’s State Secretariat for Economic Affairs represent two other key contributors to the program, each financing over $20 million worth of technical assistance over the past decade.

As the IMF’s technical assistance program continues to develop, donor partnerships have similarly expanded to include grants from Australia, Austria, Brazil, Canada, China, Denmark, Finland, France, Germany, India, Ireland, Italy, the Republic of Korea, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Russia, Singapore, Slovenia, Spain, Sweden, the African Development Bank, the Asian Development Bank, the European Commission, the European Investment Bank, the Inter-American Development Bank, the United Nations Development Program, and the World Bank.

**Unique tripartite arrangement**

In working with donors to finance technical assistance, the IMF is fostering a unique tripartite arrangement. According to Alfred Kammer, Director of the IMF Office of Technical Assistance Management, “We see in the IMF’s technical assistance program very powerful opportunities in which donors, recipient countries, and the IMF can join hands to strengthen economies around the world: First, IMF technical assistance is integrated with its surveillance and lending activities, and the resulting synergies enable our technical assistance to be designed and delivered as part of the institution’s regular ongoing dialogue with countries. Our recipient countries appreciate the fact that, when the IMF makes certain recommendations in surveillance or lending programs,
it can support the implementation of those recommendations with technical assistance. Donors in turn appreciate that, when they finance a technical assistance project, they can be assured that the assistance will be delivered in close consultation with the recipient country.

“Second, IMF technical assistance is concentrated in macrocritical areas where the Fund has the greatest comparative advantage. And, with its near-universal membership, IMF assistance is informed by experience and knowledge gained across diverse regions and countries at different levels of development. Recipient countries and donors alike seek to work with us because they see that we deliver a high-quality product.

“Third, by working closely with each other, both the IMF and donors are able to better coordinate their respective assistance to countries. This avoids wasteful duplication of efforts and reflects the aspiration to countries. This avoids wasteful duplication of efforts and reflects the aspiration to countries. This avoids wasteful duplication of efforts and reflects the aspiration to countries. This avoids wasteful duplication of efforts and reflects the aspiration to countries.

Experience with these centers has been very encouraging, with many singling out the RTACs’ governance structure for special praise. Under this framework, strategic guidance for each center’s work program is provided by a steering committee comprising representatives from beneficiary countries, donors, and the IMF. This arrangement has served to ensure strong ownership of each center’s activities by all stakeholders.

Strengthening donor partnerships
Looking ahead, building closer relationships with donors, recipient countries, and other development partners is a key objective of the IMF. “We have established donors who are ardent supporters of our technical assistance, and these relationships must be reinforced,” says Kammer. He adds, “To do that, the IMF will continue to improve efficiency in its technical assistance delivery, including by enhancing transparency and demonstrating concrete results.”

The IMF is also looking to better engage donors by adopting a medium-term approach to planning its technical assistance. This would afford the institution greater ability to match countries’ technical assistance needs with donors’ financing strategies, resulting in a unique “win-win-win situation” all around.

Seng Chee Ho
IMF Office of Technical Assistance Management

IMF Backs UAE in Statistics Overhaul

The United Arab Emirates (UAE), determined to improve its statistical system, is constructing a monthly consumer price index—set for introduction in almost two years’ time—with the support of IMF technical assistance.

In 2005, the UAE, faced with growing oil revenues and concerned that shortcomings in the country’s federal statistical system imposed serious constraints on analysis and policy formulation, approached the IMF to discuss collaboration for the development of key statistical indicators, particularly a monthly consumer price index (CPI).

Since then, with the help of the IMF, progress has been made in constructing this closely watched economic statistic, which is now set for introduction in May 2009. The UAE authorities have also expressed interest in additional technical assistance for implementing a wider strategy aimed at improving coordination among the seven emirates’ main data-producing agencies.

Need for good data
Good economic data are a precondition of effective macroeconomic management. With the complexity of modern economies and the lags inherent in macroeconomic policy instruments, a country must have the capacity to promptly identify any adverse trends in its economy and to apply the appropriate corrective measure.

The CPI, whose percent change is a measure of inflation, is among a country’s most closely watched national economic statistics. In the UAE, the Ministry of Economy compiles an annual CPI. This index covers the whole country, but it suffers from methodological shortcomings and is disseminated with a lag of three months—not quickly enough to meet users’ needs.

Continued dialogue between UAE authorities and IMF staff, which resulted in a solid understanding of the country’s statistical needs and constraints, prepared the ground for rapid development of the monthly CPI, starting in early 2007. An IMF team visited Abu Dhabi, provided technical advice based on cross-country experience, and agreed with the authorities on a work plan for the development of the index.

At first, an interim price index would be released, in advance of the more robust CPI, to satisfy the need for more timely information. And a monthly CPI, compiled in accordance with international standards, is set to be released in May 2009.

Claudia Dziobek and Florina Tanase
IMF Statistics Department
Since the end of its devastating civil war in 1992, Mozambique has undertaken wide-ranging structural reforms that contributed to an average annual growth rate of 8 percent between 1996 and 2006. Indeed, its remarkable record of economic growth and structural reforms remains a model of successful postconflict reconstruction. A cornerstone of the country’s reform efforts has been the implementation of a far-reaching, donor-funded public financial management reform program.

Despite some setbacks, this program has progressed well, reflecting a virtuous circle of strong ownership on the part of the Mozambican authorities, sustained donor support, and an intense IMF technical assistance program, conducted in conjunction with continued support under the Poverty Reduction and Growth Facility and, more recently, under the IMF’s Policy Support Instrument.

Stepping stones
The origin of Mozambique’s current public financial management reforms can be traced back to a 1996 Consultative Group meeting in which the authorities presented their own public financial management reform program to the country’s main donors and funding agencies.

Under isolated and not always well-coordinated donor-supported projects, Mozambique introduced several public financial management reforms, including the elaboration of a Medium-Term Fiscal Framework in 1998; the strengthening of the planning capacity for the elaboration of the first Poverty Reduction Strategy Paper in 2001; and the promulgation, in 2002, of a well-designed government-wide organic budget law (Lei do Sistema de Administração Financeira do Estado, or SISTAFE law) aimed at ensuring an efficient, transparent use of public funds.

In 2002, following the authorities’ request for greater donor coordination, a group of donors— the governments of Belgium, Denmark, Norway, Sweden, and the United Kingdom, as well as the European Union—agreed to pool their resources in a common fund to support Mozambique’s reforms of public financial management.

In addition, the government created a management unit—the UTRAFE—at the Ministry of Finance, charged with implementing the reforms. It also introduced several monitoring mechanisms, such as a steering committee that included all high-level senior officials of the Ministry of Finance, and a quality assurance group made up of international experts on public financial management.

Essential technology
Since its enactment, the SISTAFE law has been the pivotal element of Mozambique’s public financial management reform program—in particular, the law’s mandate of developing a computerized integrated financial management information system. In line with this mandate, the government, with donor support, launched the e-SISTAFE project in 2002 and invited the IMF to take the lead in assisting UTRAFE in implementing it.

To that end, during 2002–06, the IMF, as executing agency of donors’ funds, was responsible for the design of the work program and the recruitment of two long-term resident experts on public financial management. This was undertaken through the IMF’s Fiscal Affairs Department, whose responsibilities also included the continuous provision of technical support and feedback to the two experts, sometimes by conducting diagnostic and inspection missions, in close coordination with the IMF’s African Department.

The IMF’s involvement has been critical in designing some of the e-SISTAFE’s core technical aspects. Overall, the e-SISTAFE project has progressed well, despite some setbacks arising from the UTRAFE’s limited capacity, the lengthy approval of the SISTAFE law’s regulations, and the difficulties in establishing the treasury single account and uploading past budget records into the system.

These hurdles have been overcome, thanks to the authorities’ strong commitment to the project, which the donors have rewarded with substantial and sustained support, and to the high-quality assistance of the long-term resident experts provided by the IMF.

Remaining challenges
The e-SISTAFE project is still far from finished. Critical extensions are scheduled to be implemented during 2007–09. Nevertheless, after several years of IMF involvement, the Mozambican authorities have developed sufficient capacity to continue making good progress with the e-SISTAFE project—with donor support—and for the IMF’s role to switch to providing only periodic advice.

However, major challenges lie ahead to ensure the sustainability of the reform effort—including the need to secure continued support from the international community and the gradual replacement of external consultants by local civil servants.

Teresa Dabán and Mario Pessoa
IMF Fiscal Affairs Department
The IMF put the spotlight on exchange rates at its annual research conference, held in mid-November at a time of continued concern about currency market fluctuations and exchange rate misalignments. A group of leading economists met for the IMF’s eighth Jacques Polak Annual Research Conference in Washington, D.C., to present papers on and discuss a wide range of exchange rate–related issues. Topics covered at the conference, which was opened by new IMF Managing Director Dominique Strauss-Kahn, included the international role of the dollar, unbalanced trade, exchange rate models, and when to abandon a fixed exchange rate.

The keynote Mundell-Fleming Lecture, “Exchange Rate Systems, Surveillance, and Advice,” was delivered by Stanley Fischer, Governor of the Bank of Israel and former IMF First Deputy Managing Director. Peter Garber from Deutsche Bank, Michael Mussa from the Peterson Institute of International Economics, and David Wessel from the Wall Street Journal participated in the Economic Forum “The Exchange Rate and Economic Performance,” which was moderated by Simon Johnson, the IMF’s Economic Counsellor and Director of the Research Department.

The conference marks the 70th year of Jacques Polak’s career as an international economist. At the conference, both Strauss-Kahn and First Deputy Managing Director John Lipsky paid warm tributes to Polak, acknowledging his important role in shaping the work of the IMF.

Increasing interdependence
In his opening remarks, Strauss-Kahn singled out three exchange rate–related themes—increasing macroeconomic interdependence stemming from globalization, exchange rate determination, and political economy perspectives on exchange rates—that were highlighted at the conference. On the first theme, he cited the paper, “Macroeconomic Interdependence and the International Role of the Dollar,” by Linda Goldberg and Cedric Tille, who argue that U.S. or European Central Bank monetary policy can have far-reaching effects on countries that denominate trade in dollars, even if direct trade with the United States or the euro area is negligible. “This is especially important for the dollar and the euro,” Strauss-Kahn said.

The interaction between exchange rates and goods trade between countries is central in analyzing cross-country interdependence and policy spillovers. In their paper on fiscal policy and the trade balance, Tommaso Monacelli and Roberto Perotti of Italy’s Università Bocconi underscored the importance of fiscal policy for the real exchange rate and the trade balance. They found that, in all OECD countries that were part of their sample, a rise in government spending induces a real exchange rate depreciation and a trade balance deficit. In the United States, however, the trade balance effect is small.

On the degree of real exchange rate adjustment necessary to improve the U.S. current account balance—a topic of continuing debate—Robert Dekle, Jonathan Eaton, and Samuel Kortum calibrated a novel trade model and found that balancing current accounts may require modest changes in relative wages and real wages. For example, wages in the United States (the country with the largest deficit) need to fall by about 10 percent relative to those in Japan (the country with the largest surplus) to balance current accounts.
Exchange rate determination
The issue of how exchange rates are determined over time, Strauss-Kahn said, was of the "highest importance" for the Fund. Referring to the IMF's 2007 Decision on Bilateral Surveillance—which provides a comprehensive framework for monitoring country economies anchored on the concept of external stability—Strauss-Kahn stressed that effective surveillance would require not only an appreciation of a member's individual circumstances, but also solid analytical tools for assessing the consistency of exchange rates with medium-run fundamentals. Such tools take into account the constraint that overvaluations in some parts of the world need to be balanced out by undervaluations elsewhere—or multilateral consistency.

In this context, Strauss-Kahn underscored the work of the Fund's Consultative Group on Exchange Rates (CGER), which had been expanded to include the key emerging market countries as well as the main currencies in the industrial world.

Lipsky described the CGER as a cutting-edge analytical tool for conducting bilateral and multilateral surveillance in an evenhanded fashion. He said the scope of the Fund's analytical work on exchange rates would expand further to include producers of exhaustible natural resources and some low-income countries that have become important players in the global economy. Progress is also being made on integrating portfolio investment decisions into the CGER framework.

In the first paper presented in the exchange rate determination session, "Financial Exchange Rates and International Currency Exposures," Philip Lane and Jay C. Shambaugh highlighted how the foreign currency denomination of a country's external position can play a pivotal role in external adjustments. Several papers also considered the impact of economic fundamentals and policy on the exchange rate. Columbia University's Richard Clarida and Daniel Waldman examined the impact of monetary policy on the exchange rate, arguing that news of higher-than-expected inflation can lead to an appreciation of the nominal exchange rate if the central bank has an inflation target implemented with a "Taylor Rule." Charles Engel, Nelson C. Mark, and Kenneth D. West found in their paper, "Exchange Rate Models Are Not as Bad as You Think," that when flexible exchange rates incorporate news about future macroeconomic fundamentals, as implied in standard models, these models should be expected to have low forecasting power and thus should not be subject to the standard critiques of the literature. The authors proposed a number of ways to evaluate models and showed that these models might be able to account for observed exchange rate volatility.

Political economy
The political constraints faced by country authorities in making economic policy decisions are well known. Two conference papers focused on how the preferences of different interest groups over exchange rate movements may play out in practice.

In their paper on exchange rate policy attitudes, Lawrence Broz, Jeffrey Frieden, and Stephen Weymouth used survey data to show that decisions made by different players in the private sector can hinge on exchange rate movements. Citing this paper as one that highlights the theme of political economy, Strauss-Kahn said this research could be applied to explain why it is that countries often resist pressures toward both currency depreciation and appreciation.

Irineu de Carvalho Filho and Marcos Chamon of the IMF explored the "distributional impact of exchange rate movements" in their paper on the political economy of exchange rate populism. Their research showed that, in Brazil and Mexico, effects of currency appreciations on consumer goods prices tend to benefit poor households more than richer ones. However, the income of the rural poor is more adversely affected when a currency appreciates.

Policy issues
Two conference papers focused on policy responses when the economy is hit by shocks, paying particular attention to the reaction of the exchange rate. MIT's Ricardo J. Caballero and Guido Lorenzenzi explained foreign exchange interventions in countries experiencing capital inflows and persistent real exchange rate appreciations. According to them, intervention in the foreign exchange market has a role to play when there are risks of overshooting and when the export sector is financially constrained. Sergio Rebelo and Carlos Végh, who studied optimal exit strategies from pegged exchange rate regimes following an unexpected increase in government spending, showed that, when fiscal shocks are large, countries should abandon a peg as soon as possible, even if international reserves are plentiful.

On the issue of the exchange rate regime, Adolfo Barajas, Lennart Erickson, and Roberto Steiner examined why emerging markets fear declaring their exchange rate regime choice. In their paper, "Fear of Declaring: Do Markets Care What Countries Say about Their Exchange Rate Policies?" the authors suggested that international capital markets tend to reward countries with exchange rate regimes classified as flexible. And in their paper on estimating de facto exchange rate regimes, Jeffrey Frankel and Shang-Jin Wei developed a new technique for estimating the de facto degree of exchange rate flexibility of a currency.
Exchange Rate Regime Bipolarity Continues, Slowly

The economic crises of the 1990s forced many countries to reexamine their choice of exchange rate regimes and to move away from more crisis-prone arrangements. This resulted in a shift from soft pegs—the use of pegged but adjustable rates—toward either a hard peg or a free-floating regime.

In his popular 2001 essay, “Exchange Rate Regimes: Is the Bipolar View Correct?” Stanley Fischer, then First Deputy Managing Director of the IMF and now Governor of the Bank of Israel, predicted that the move toward bipolarity by many advanced and emerging market countries, which was strikingly visible in the 1990s, was likely to continue. Soft pegs had proved to be unviable over time, Fischer said in 2001, for countries with open capital accounts. Various currency crises dating as far back as the 1970s had shown that countries could not simultaneously maintain fixed exchange rates, capital mobility, and domestically oriented monetary policies—the so-called impossible trinity.

Delivering this year’s Mundell-Fleming Lecture— “Exchange Rate Systems, Surveillance, and Advice”—at the IMF’s eighth Jacques Polak Annual Research Conference on November 15, Fischer revisited the topic of bipolarity and updated it in the light of the experience of the past decade. The shift by developed and emerging market countries from the more crisis-prone soft pegs, in which the government commits itself to defending a particular exchange rate value or narrow range of values, toward hard pegs or floating regimes, Fischer found, had continued over time, though at a reduced pace (see chart). However, this trend had reversed among other (mostly developing) countries, which had seen a move away from the floating rate to the intermediate regimes.

But why has the pace of the bipolar shift slowed in advanced and emerging market countries? The introduction of the euro and the 1990s’ emerging market financial crises were largely responsible for the faster pace of the shift, he said. The current decade has not seen any events on a similar scale, though the slowly growing number of Europe’s Economic and Monetary Union countries means the shift to bipolarity for the advanced and emerging market country grouping is likely to continue, he explained.

Two qualifications

Although the recent exchange rate regime developments in developed and emerging market countries had been broadly consistent with the bipolar view, Fischer emphasized two important qualifications to the hypothesis. First, the shift to bipolarity applies to countries with open capital accounts, he said, though some countries in the emerging market grouping (in the chart) had significant capital controls.

This qualification was noted in Fischer’s 2001 bipolar hypothesis: “for countries open to international capital flows: (i) soft exchange rate pegs are not sustainable; but (ii) a wide variety of flexible exchange rate regimes remain possible; and (iii) it is to be expected that policy in most countries will not be indifferent to exchange rate movements. . . . For countries not yet open to international capital flows, [possible exchange rate regimes] include the full gamut of exchange rate arrangements.” But perhaps the original qualification “was not adequately stressed,” Fischer said.

Second, the floating group consists of not only free floaters but also managed floats. In fact, for the emerging market and the “other” categories in Fischer’s sample, there are more managed than independent floaters. Even among independent emerging market floaters, there are many countries that intervene significantly and often, a fact that shows that “very few countries, if any, are indifferent to the behavior of the exchange rate,” he remarked.

Surveillance worries

In his comments on IMF surveillance and advice, Fischer noted that the IMF’s 2007 Bilateral Surveillance Decision “puts exchange rate policies at the center of the surveillance process.” But he voiced concern that the new decision’s focus on exchange rate policies—rather than on domestic and exchange rate policies or “overall policies”—was a drawback, because the focus on exchange rates alone was “too narrow.” He hoped that the new decision would not reduce the scope of small economies’ Article IV staff reports, which he characterized as “the most thorough and professional evaluation of a country’s economy and economic policies.”

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Fiscal Policy

Major Reforms for German Budget System

Germany is expected to introduce performance budgeting and accrual accounting into its budget system as part of a package of reforms recently recommended by a Finance Ministry task force. The reforms were proposed by the ministry’s Budget and Accounting Reform Task Force after more than a year’s work, in which it was assisted by staff of the IMF’s Fiscal Affairs Department. The aims of the proposed reforms are to improve expenditure efficiency and strengthen fiscal policy.

At present, Germany has a traditional “line-item” budget, in which ministries receive budget allocations based on the anticipated costs of their inputs, such as staff costs and supplies. This method of funding has little to do with the types of services (“outputs”) to be delivered, or with the intended outcomes of those services. As an increasing number of countries have recognized, it is not a budget structure that facilitates good decision making about expenditure priorities.

To remedy this situation, the task force envisages the introduction of “product budgets”—often known elsewhere as “programs”—based on outputs and outcomes. The intention is to focus greater attention in the budget formulation stage on choices about how much money to allocate to, say, preventative health versus health treatment, or to primary versus tertiary education.

Product budgets

Under the task force’s proposals, the product budgets would not in the first instance be used for parliamentary budget appropriations. The idea is that they would initially be used internally within the government in the process of formulating the budget. The logical next step would, however, be to also shift the annual budget law to a programmatic basis.

The proposed move to accrual accounting is inspired by both fiscal policy and expenditure efficiency considerations. Germany recognizes that, as the IMF has argued since the promulgation of the accruals-based Government Finance Statistics Manual in 2001, accrual accounting gives fuller information about fiscal sustainability than does traditional cash accounting.

This is because accrual accounting systematically recognizes, in the government’s balance sheet, financial assets and liabilities that are not conventional debt—such as money owed to suppliers or liabilities to pay pensions to civil servants—but that are just as relevant to fiscal sustainability. There is also a growing recognition that accrual accounting helps improve asset management and service delivery by providing better measures of the costs of production.

Golden rule

In Germany’s case, there is an important additional fiscal policy consideration for the adoption of accruals. This relates to the “golden rule” enshrined in the country’s constitution that requires, roughly speaking, that borrowing be used for fund only investment and not consumption.

The interpretation placed to date on the golden rule in Germany is that it permits the financing of all capital expenditure—in other words, gross investment—through debt. However, as the German Council of Economic Experts pointed out in a March 2007 report, using debt to finance gross investment means that debt is financing not only new public capital formation but also the consumption of existing assets. This allows the costs of citizens’ use of public infrastructure today to be transferred to future taxpayers.

To address this problem, the Council of Economic Experts recommended that the interpretation of the golden rule be tightened to restrict borrowing to net investment—in other words, to capital expenditure minus depreciation. This calls for a measure of depreciation, for which accrual accounting is required.

However, no decision has yet been made on the status of the golden rule or on a broader reform of the fiscal framework.

Funding based on payments

The task force has recommended that the adoption of accrual accounting not be accompanied, at least at this stage, by accrual budgeting. Thus, the German budget will continue to give ministries funding based primarily on the payments they are permitted to make, rather than on the costs that they will incur.

There is much to be said for this approach. The handful of countries that have adopted accrual budgeting (notably Australia, New Zealand, the United Kingdom, and Denmark) all did so some years after having moved to accrual accounting—and nevertheless even then found accrual budgeting a demanding and complex reform.

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Poverty Reduction Loan Installments for Nepal, Mali

The IMF Executive Board approved disbursements totaling $79.1 million to Nepal and Mali following the fifth and final review of their Poverty Reduction and Growth Facility (PRGF) arrangements.

Nepal received a total of $79.1 million over the five-year period (2003-07). The disbursement of $21 million to Nepal and $19 million to Mali was approved in June 2004. The concessional PRGF loans, which carry an interest rate of 0.5 percent and are repayable over 10 years with a 5½-year grace period, support poverty reduction strategies devised by poor countries.

IMF Endorses Senegal’s Program

The IMF Executive Board approved a three-year Policy Support Instrument (PSI) for Senegal to back the country’s efforts at consolidating macroeconomic stability, increasing its growth potential, and reducing poverty. The program focuses on keeping a sound fiscal policy and enhancing fiscal governance.

PSIs are designed for low-income countries that may not need, or want, IMF financial assistance, but still want IMF advice, monitoring, and endorsement of their policies. The instruments are voluntary and requested by the country. IMF Managing Director Dominique Strauss-Kahn said that despite “temporary setbacks suffered in the last two years, Senegal has achieved a high degree of macroeconomic stability and robust growth over the last decade. The Policy Support Instrument is viewed as the appropriate next step in the Fund’s relations with Senegal.”

Flexible Exchange Rate Helps Colombia

Colombia’s flexible exchange rate had helped it weather well the recent turbulence in global financial markets, the IMF noted on November 9 after its annual health check of the economy. The Fund said growth will remain strong in 2007 and slow to 5 percent in 2008, while inflation will decline. Colombia’s economic performance has been impressive, with economic growth last year equaling its fastest pace since the late 1970s and topping the Latin American average, the IMF noted.

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Booknote

Postconflict Case Studies—How the IMF Is Helping

Restoring monetary and financial systems in postconflict countries features in a new IMF book. Case studies include tales of the personal courage of people in countries emerging from conflict. The study on Rwanda notes that the National Bank of Rwanda “was faced with quite a different situation from the one prevailing before the genocide: a large number of senior positions were now held by new staff” because the previous staff had lost their lives or had to flee the country.