

Long-term fiscal outlook is key U.S. challenge

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Despite tighter monetary policy, sharply higher energy prices, and a devastating hurricane season, the U.S. economy remained a key engine of global growth in 2005 and now appears to be on course for a soft landing. The country's main challenge lies ahead: if it is to ensure a sound long-term fiscal outlook, the United States must find a way to put Social Security and, especially, its Medicare and Medicaid programs on a durable footing.



Greg Lovett/Palm Beach Post

Egypt moves forward with economic reforms

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With incomes stagnating at the beginning of this decade, Egypt in 2004 began to pursue ambitious reforms designed to help a more market-oriented economy take root. Aided by a supportive global economic and financial environment, real GDP has accelerated and investor interest has surged. But growth will have to speed up further to help employ a burgeoning, youthful workforce, and public debt must be lowered.



Chris Beaman/AP

Canadian reforms enable more women to work

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In the past decade, Canada has seen an impressive increase in the number of women in the workforce. Much of the credit appears to go to mid-1990s reforms: family-friendly policies (improved access to quality early childhood education and care, and expanded maternity and paternity leave benefits) and lower taxes (a decrease in the secondary earner's tax wedge). To boost female participation and meet the challenges of population aging, other countries can follow Canada's example.



Ted Andrlker/Picture Desk

The high cost of suspending the Doha trade talks

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The suspension of the Doha Round trade talks on July 24 caused barely a ripple in financial markets, but a lengthy breakdown would represent a "missed opportunity," cautions IMF trade expert Hans Peter Lankes. The world economy risks seeing an even more pronounced shift toward bilateral deals, with reduced transparency, more discrimination, and added red tape. The talks need to be rescued right away, Lankes says, or there may be years of drift.



Dong Ng/Eye Press

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AUGUST

24–26 2006 Economic Policy Symposium, Jackson Hole, Wyoming, United States

27–September 1 International Disaster Reduction Conference, Davos, Switzerland

SEPTEMBER

6 IMF's September 2006 *World Economic Outlook* (analytical chapters) released

7–8 13th Asia Pacific Economic Cooperation Finance Ministers' Meeting, Hanoi, Vietnam

10–11 IMF High-Level Seminar on Financial Taxation, Singapore

10–11 China Business Summit 2006, Beijing, China

12 Organization of the Petroleum Exporting Countries Conference, Vienna, Austria

12 IMF's September 2006 *Global Financial Stability Report* released

14 IMF's September 2006 *World Economic Outlook* (Chapters 1 and 2) released

14–15 High-Level Dialogue on International Migration and Development, United Nations General Assembly, New York, United States

14–15 Raffles Forum on Good Governance and the Wealth of Nations, Singapore

19–20 IMF–World Bank Annual Meetings, Singapore

19–20 United Nations General Assembly, High-Level Meeting on the Review of the Brussels

Program of Action for the Least Developed Countries, New York, United States

25–26 World Trade Organization Public Forum, "What WTO for the 21st Century?" Geneva, Switzerland

OCTOBER

23–27 IMF High-Level Seminar on Current Issues in Monetary and Financial Law, Washington, D.C., United States

NOVEMBER

6–7 IMF Symposium on Integrity Supervision of Financial Sector Firms, Washington, D.C., United States

9–10 Jacques Polak Seventh Annual Research Conference, IMF, Washington, D.C., United States

17–18 Rio 6: World Climate and Energy Event, Rio de Janeiro, Brazil

18–19 14th Asia Pacific Economic Cooperation Economic Leaders' Meeting, Hanoi, Vietnam

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

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

JANUARY 2007

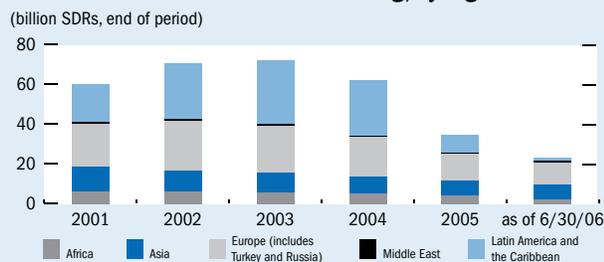
24–28 World Economic Forum Annual Meeting, Davos, Switzerland

IMF Executive Board

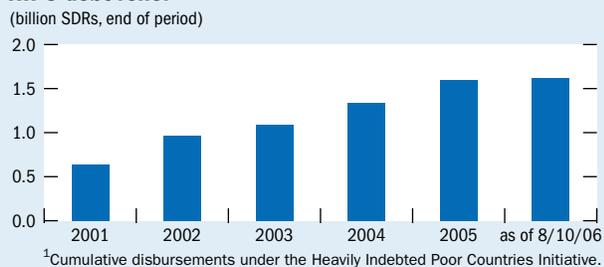
For an up-to-date listing of IMF Executive Board meetings, see www.imf.org/external/np/sec/bc/eng/index.asp.

IMF financial data

Total IMF credit and loans outstanding, by region



HIPC debt relief¹



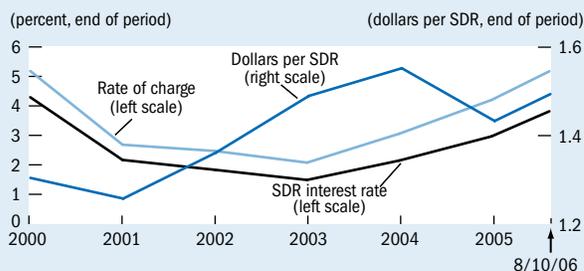
Note: Special Drawing Rights (SDRs) are an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also

Major currencies, rates per SDR

	August 15, 2006	Year ago (August 15, 2005)
Euro	1.174	1.202
Japanese yen	171.876	162.254
U.K. pound	0.802	0.831
U.S. dollar	1.466	1.444

Related rates

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



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.

U.S. economy appears headed for a soft landing, but long-term fiscal sustainability remains a challenge

Despite monetary policy tightening, higher energy prices, and significant hurricane damage in parts of the country, the U.S. economy continued to be a key engine of global growth in 2005. For the near term, a soft landing to growth at a more sustainable rate appears likely, but the country's long-term fiscal outlook remains unsustainable. The key challenge ahead, according to the IMF's annual Article IV consultation on the economy, will be to put Social Security and, in particular, Medicare and Medicaid, on a durable footing.

Real GDP in the United States grew by 3.2 percent in 2005, reflecting robust consumer spending and business investment. Personal consumption was supported by significant borrowing encouraged by low interest rates and by modest employment growth. Since 2001, sizable capital gains—reflecting, in part, double-digit house price inflation—have boosted personal wealth, allowing real consumption and residential investment spending to grow at an average ½ of 1 percentage point faster than GDP. As a result, the household saving ratio moved into negative territory in 2005.

Prospects for the U.S. economy in 2006 remain favorable (see table), with the IMF staff projecting real GDP growth to ease to a more sustainable pace of about 3 percent in 2007. This soft-landing scenario is based on expectations of solid productivity growth, robust business investment, and faster external growth. Concerns remain, however, about the downside risks from the housing market, which has weakened in 2006. A more abrupt slowdown in the housing market and higher energy prices could trigger a sharper adjustment in household consumption, undermining the expansion.

Emerging pressures

The sustained growth of recent years has reduced economic slack and, with significant hikes in commodity prices, caused inflationary pressures to emerge. In particular, the unemployment rate—at just over 4½ percent in June—is at the low end of most estimates of the NAIRU (the nonaccelerating inflation rate of unemployment), capacity utilization has reached its long-run average, and core consumer price inflation exceeded 2½ percent in the 12 months to June. On the other hand, increases in unit labor costs through the first quarter were moderate, reflecting solid productivity growth and modest wage gains.

After an unbroken series of 17 interest rate hikes, the U.S. Federal Reserve recently left the interest rate unchanged and

cautioned that the pace and timing of future rate adjustments would be less certain. The Federal Open Market Committee noted that “the extent and timing of any additional firming that may be needed . . . will depend on the evolution of the outlook for both inflation and economic growth. . . .” In this context, the committee also said that risks to inflation remain, reflecting high levels of resource utilization and the potential for greater pass-through of elevated commodity (especially energy) prices.

Indeed, the recent increase in core inflation and the decline in the unemployment rate underscore the upside risks to inflation. The IMF staff found the gradual withdrawal of monetary stimulus over the past year to be appropriate and observed that, in the year ahead, the Federal Reserve would need to steer a delicate course between competing risks.

The U.S. current account deficit reached a new high of 6.4 percent of GDP in 2005, reflecting both higher oil prices and solid import demand. Nonetheless, the dollar remained broadly stable, and the U.S. net foreign liability position barely deteriorated in 2005 owing to the relative strength of foreign equity markets.

At the same time, staff observed that the real exchange rate appeared overvalued given macroeconomic fundamentals. Concern remained about the risks of a “disorderly” correction to the current account imbalance. To help minimize these risks, staff urged the United States to raise national saving—including through more ambitious fiscal consolidation—in conjunction with steps toward greater exchange rate flexibility in emerging Asia and growth-enhancing reforms in Europe and Japan.

Economic expansion continues

U.S. growth has remained steady in the face of head winds, but inflationary pressures are emerging.

	2002	2003	2004	2005	Proj. 2006
	(percent change)				
Real GDP ¹	1.6	2.5	3.9	3.2	3.4
Consumer price index	1.6	2.3	2.7	3.4	3.6
	(percent of labor force)				
Unemployment rate	5.8	6.0	5.5	5.1	4.8
	(percent of GDP)				
Federal government balance (fiscal year)	-1.5	-3.5	-3.6	-2.6	-2.3
Current account balance	-4.5	-4.8	-5.7	-6.4	-6.4

¹This table reflects data available after the publication of the IMF staff report on the United States, including revisions to national accounts data showing lower growth for 2003-05.

Data: Haver Analytics and IMF staff projections.

Resilient financial sector

The U.S. economy has been able to sustain impressive growth and finance its current account deficit through access to foreign saving at relatively low rates. In this effort, the country's remarkably innovative and resilient financial sector has played a key role. In particular, financial market innovation—including securitization and credit risk transfer techniques—has contributed to low credit risk spreads and improved pricing and credit allocation, especially for asset classes with higher risk profiles. Banks also remain well capitalized and highly profitable despite challenging market conditions.

The financial sector appears well positioned as the credit cycle turns, but further reforms could enhance the system's resilience and efficiency. These reforms include tightening the supervision of government-sponsored enterprises like the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and limiting the size of their balance sheets; reforming rules for defined-benefit pension plans; and, possibly, consolidating the supervision and regulation of insurance companies.

Over the longer term

On the fiscal side, robust revenue growth and, to a lesser extent, expenditure discipline have improved prospects. Both personal and corporate tax receipts have recently exceeded projections by a wide margin, and all indications are that this year's federal deficit will fall below 2½ percent of GDP—down from over 3½ percent in 2004. However, the permanence of the revenue buoyancy remains to be seen, and significant pressures for higher spending persist despite moderate success in constraining nondefense discretionary expenditure in 2005.

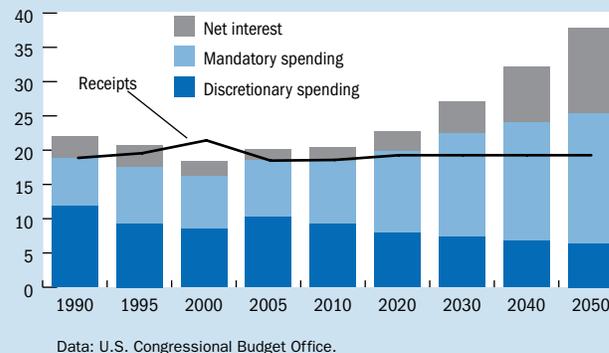
Despite the improved medium-term outlook, the long-term fiscal path remains unsustainable (see chart). The IMF staff and U.S. officials agree that far-reaching reform of entitlement programs (including Social Security and Medicare) is needed to restore fiscal sustainability. The FY2007 budget estimates that spending on entitlement programs will rise by about 1½ percent of GDP each decade through 2080, as population aging and rising health care costs place an increasing burden on public retirement and health care systems. U.S. health care spending is around 15 percent of GDP—well above the industrial country average—with the public sector responsible for half the total. Moreover, overall costs continue to rise more quickly than nominal GDP.

A key challenge for policymakers will be to form a bipartisan consensus on a package of reforms that can make these entitlement programs more sustainable. The administration has offered proposals to reform Social Security—including progressive price indexation, which maintains a larger share

Challenging fiscal outlook

Even with entitlement reforms, the deficit will be unsustainable without further fiscal adjustment.

(long-run federal projections, percent of GDP)



of the benefits of lower-income beneficiaries—but legislative efforts in Congress appear to have stalled. The administration's health care strategy combines high-deductible health savings plans with improved information on the quality and effectiveness of medical procedures and services. However, the financial shortfall of the Medicare and Medicaid programs dwarfs that of Social Security, and a broader, more fundamental reform of Medicare and Medicaid seems necessary.

With economic expansion having recently narrowed the deficit, the IMF staff views the present time as particularly appropriate for the administration to establish a more ambitious medium-term fiscal anchor to support long-run fiscal sustainability. In particular, staff research suggests that balancing the budget—excluding the Social Security surplus—within the next five years would set the federal debt ratio on a downward path. Given current budget projections, consolidation of about ¾ of 1 percentage point of GDP a year would be necessary. Together with entitlement reform, this would be an important step toward long-term fiscal solvency. This policy would have a manageable effect on U.S. and global demand, and, by boosting national saving, it would facilitate multilateral efforts to reduce global imbalances. ■

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Copies of *United States: 2006 Article IV Consultation*, IMF Country Report No. 06/279, are available for \$15.00 each from IMF Publication Services. See page 256 for ordering details. The full text is also available on the IMF's website (www.imf.org).

What drives U.S. inflation dynamics

As in several other industrial countries, inflation in the United States has been low since the mid-1990s despite generally robust economic growth and—especially in recent years—substantial increases in the prices of oil and other primary commodities. A new IMF Working Paper investigates this apparent puzzle by decomposing changes in U.S. inflation into their structural (or long-run) and cyclical components and focusing on the roles that improved monetary policy credibility and globalization have played.

Using quarterly data for 1960–2005 and applying the technique of frequency domain decomposition, the paper first documents two key stylized facts: a secular decline in the long-run component of inflation that began around 1980 and a decline in the size and volatility of the business-cycle component of inflation over the same period (see chart). It then seeks to identify the factors behind these developments using both traditional backward-looking Phillips curve models of inflation and new forward-looking Keynesian Phillips curve models of inflation.

Traditional Phillips curve models emphasize the role of lagged inflation and the output gap. The paper uses these models to separately explain the long-run and cyclical movements in inflation. It finds that even after taking into account external shocks to capture the effect of imported inflation—proxied by movements in the terms of trade—much of the trend decline is not explained. Traditional models do, however, produce relatively good forecasts for the business-cycle component of inflation. Overall, the results suggest that the decline in inflation since the 1980s is indeed a structural, as opposed to cyclical, phenomenon.

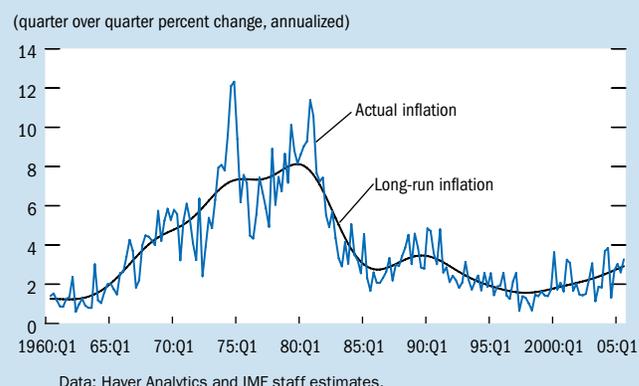
A number of factors might explain why traditional models leave most of the improved inflation performance unexplained. First, they do not allow for forward-looking inflation expectations and, therefore, the possibility that inflation expectations may have been changed by enhanced U.S. monetary policy credibility. Second, measures of the output gap are subject to significant measurement error, especially in view of the apparent structural increase in U.S. productivity growth during the second half of the 1990s.

The new Keynesian Phillips curve models were developed to address some of the shortcomings inherent in traditional models, in particular by allowing for forward-looking inflation expectations and focusing on measures of marginal costs as opposed to the output gap. Although the new models explain the structural decline in inflation somewhat better than traditional models, they, too, fall short of a satisfactory explanation.

The results also suggest that the link between production costs and inflation over the business cycle has weakened in

A change in course

After trending downward since 1980, long-run inflation began to increase gradually in 1998.



recent years. In particular, using labor's share of GDP as a proxy for marginal production costs, the study finds that the relationship between inflation and marginal costs breaks down in the late 1990s—around the same time traditional Phillips curve models start to overpredict inflation.

The study finds that allowing for globalization pressures improves the fit of the new models. Indeed, extending the models to allow for imported intermediate goods and equilibrium price markups that vary with the business cycle and the degree of competition improves overall performance. The impact and significance of external variables are evident mostly in the cyclical component, however.

Some answers

What has caused the secular decline in inflation, and what is implied for the future direction of monetary policy? Despite the absence of satisfactory proxies for monetary policy credibility, the long-run decline in inflation appears to be largely structural and, as such, could reflect improved monetary policy credibility in the United States. The results also suggest that globalization factors influence inflation primarily over the business cycle and are therefore likely to be transitory. ■

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This article is based on IMF Working Paper No. 06/159, "U.S. Inflation Dynamics: What Drives Them over Different Frequencies?" by Ravi Balakrishnan and Sam Ouliaris. Copies are available for \$15.00 each from IMF Publication Services. See page 256 for ordering details. The full text is also available on the IMF's website (www.imf.org).

More balanced growth is key to Ireland's continued economic success

Thanks largely to sound policies—including prudent fiscal policy, low taxes on labor and business income, and labor market flexibility—Ireland's economy is performing well, the IMF said in its recent economic review. Growth is strong, unemployment is low and labor participation is rising, and government debt has been reduced dramatically over the past two decades. Inflation is close to the euro area average, and participation in European and Economic Monetary Union has lowered interest rates in Ireland.

Executive Directors commended Ireland's continued impressive economic performance but observed that growth has become increasingly unbalanced in recent years, with heavy reliance on building investment, sharp increases in house prices, and rapid

credit growth. At the same time, competitiveness has eroded, reflecting the combination of faster wage growth in Ireland than in its trading partners, declining productivity growth, and the appreciation of the euro against the U.S. dollar. Ireland's small, highly open economy is also vulnerable to external shocks.

Directors expected economic growth in 2006–07 to remain strong, driven by domestic demand and accompanied by a widening current account deficit and continued rapid credit growth. While a contraction of the construction sector to a more sustainable size over the medium term is likely to be smooth, Directors noted that an abrupt correction cannot be ruled out.

Directors welcomed the Financial System Stability Assessment Update, showing generally strong financial sector soundness indicators and major lenders with adequate buffers to cover a range of shocks. Directors called for a further strengthening of the regulatory and supervisory framework, especially for insurance.

Most Directors considered that modest fiscal tightening would be desirable in 2007, given the strength of domestic demand, potential risks of a hard landing, and the need to prepare for population aging. A number of Directors, however, emphasized the need for further spending increases to achieve social goals. Directors agreed that improvements in public services remain a key priority and welcomed the authorities' plans to deepen the public debate on fiscal priorities. ■

Ireland	2003	2004	2005	2006 ¹
		(percent change)		
Real GNP	5.5	3.9	5.4	6.2
Harmonized index of consumer prices	4.0	2.3	2.2	2.8
		(percent of labor force)		
Unemployment rate	4.7	4.5	4.3	4.3
		(percent of GDP)		
General government debt	31.1	29.6	27.4	25.9
Current account	0.0	-0.6	-2.6	-3.0

¹IMF staff projections.
Data: Ireland, Central Statistics Office and Department of Finance; Datastream; and IMF, *International Financial Statistics*.

Accelerated reforms will carry forward Macedonia's hard-won economic achievements

After a decade of sluggish growth, in part the result of external shocks, the former Yugoslav Republic of Macedonia's economic growth reached 4 percent for two years in a row in 2004–05 and is expected to stay at that rate in 2006. Inflation has also remained under control, the current account deficit has narrowed, international reserves have increased, and the fiscal position is sound, the IMF said in its recent economic review.

Despite recent progress, structural weaknesses constrain the economy's ability to increase employment and achieve more rapid growth. Recorded unemployment is one of the highest in the region, and financial intermediation and foreign direct investment remain low. In addition, Macedonia ranked low in international comparisons of the business environment because of the high costs of opening and closing businesses, hiring and laying off workers, and enforcing contracts. Property rights are

also poorly defined; the tax wedge on labor is high; and telecommunications services are expensive.

IMF Executive Directors commended the Macedonian authorities for their sound macroeconomic policies, which have now started to deliver economic recovery. Considerable challenges lie ahead, however, including raising living standards closer to European levels, reducing unemployment, and keeping the current account deficit under control. The best way to meet these challenges, Directors said, would be by maintaining the country's hard-won macroeconomic stability and accelerating structural reforms. Judicial reform and improving public governance will be essential to developing a functioning market economy. Unemployment can be reduced through active labor market policies, reduction of the tax wedge, and elimination of barriers to part-time employment. Financial market development is also needed—notably to lower intermediation costs, improve the credit culture, and enhance banking supervision.

Directors cautioned that loosening the fiscal stance would be premature in view of uncertainties about the true size of the current account balance, medium-term fiscal challenges, and the limited institutional capacity to spend additional funds efficiently. Rationalization of the public sector should be undertaken before spending increases are envisaged. Directors also encouraged efforts to strengthen the fiscal revenue base and reduce nondiscretionary spending. ■

FYR Macedonia	2004	Prel. 2005	Proj. 2006	Proj. 2007
Real GDP (percent change)	4.1	4.0	4.0	4.0
Consumer prices (percent change, period average)	-0.3	0.5	2.9	2.0
Unemployment rate (percent of labor force, average)	37.2	37.3
Central government balance (percent of GDP) ¹	0.4	0.3	-0.6	-0.6
Official gross reserves (million euros)	717	1,123	1,602	1,699

¹In 2005, the central government spent an additional 0.4 percent of GDP on its recapitalization.
Data: Macedonian authorities and IMF staff projections.

El Salvador reaps rewards of outward-oriented strategy

Since taking office in 2004, the government of El Salvador has pursued an outward-oriented strategy to boost growth and improve social conditions through greater integration with the global and regional economies, investment and social reforms, and stabilization of the public debt. Its early achievements include an increase in tax revenue, improved debt management, and the signing of the Central America-Dominican Republic-United States Free Trade Agreement. Economic growth—spurred by investment and exports—has picked up; inflation has fallen to the lowest in the region, despite the full pass-through of higher oil prices; and the external current account deficit has widened only slightly, the IMF said in its most recent economic review.

Looking ahead, the authorities plan to bolster the fiscal position in 2006 by limiting income tax exemptions and subsidies and to secure passage of banking reforms to underpin financial stability and deepen intermediation. Over the medium term, the strategy is to keep the public debt–GDP ratio stable through 2008 and reduce it gradually thereafter. This would be achieved by further reducing tax evasion and controlling pension costs while creating space for priority infrastructure and social spending.

Executive Directors commended El Salvador's continued progress and observed that the authorities' main policy challenge is to place the economy on a path of sustained rapid growth and

El Salvador	2003	2004	Est. 2005	Proj. 2006
Real GDP (percent change)	2.3	1.8	2.8	3.5
Consumer prices (12-month percent change to end-year)	2.5	5.4	4.3	4.0
Consolidated public sector deficit (percent of GDP)	-3.7	-2.9	-3.0	-2.8
Public sector debt (percent of GDP, end of period)	42.1	43.5	42.3	42.6
Data: Salvadoran Central Reserve Bank and Ministry of Finance, and IMF staff estimates and projections.				

social progress that will help the country achieve the Millennium Development Goals. This will involve continued progress on its fiscal sector, financial system, and structural reform agendas.

To limit fiscal pressures and further improve the investment climate, Directors encouraged the authorities to facilitate further private sector participation in infrastructure projects and improve procedures for corporate insolvency, business dispute resolution, and creditors' rights. Although the banking system appears well positioned to withstand temporary liquidity shocks, Directors recommended restructuring the balance sheet of the central bank and strengthening its lender-of-last-resort function to provide an additional cushion against systemwide financial shocks and to minimize contagion risks. ■

Uruguay in solid recovery, but work to reduce vulnerabilities should continue

Since its 2002 crisis, Uruguay's economy has recovered, thanks to a supportive external environment, strong macroeconomic policies, and ambitious structural reforms, the IMF said in its most recent economic review. Real GDP is now above the prerecession level, inflation has declined rapidly, and financial soundness indicators have improved markedly. Moreover, strong export growth and good capital market access have contributed to an improvement in Uruguay's external position. In August, Uruguay advanced payment of its obligations to the IMF falling due in 2007, as part of a cash management operation, halving its outstanding obligations. This is a reflection of a strengthened external position and another measure of the success of the authorities' program, Managing Director Rodrigo de Rato said.

Executive Directors stressed that strong primary fiscal surpluses have been central to the authorities' success in helping reduce the ratio of public debt to GDP and boost market confi-

Uruguay	2002	2003	2004	Prel. 2005	Proj. 2006
Real GDP growth (percent)	-11.0	2.2	11.8	6.6	5.0
Consumer price index (period average)	14.0	19.4	9.2	4.7	6.3
Public sector primary balance (percent of GDP)	0.0	2.7	3.8	3.9	3.7
Gross official reserves (million dollars)	772	2,087	2,512	3,438	3,234
Data: Central Bank of Uruguay, Ministry of Finance, and IMF staff estimates.					

dence. Notwithstanding the strong performance, medium-term vulnerabilities remain, including the still-high and dollarized public debt and large gross financing needs. Also, the banking system remains highly dollarized, banking intermediation is still well below precrisis levels, and deposits are mostly at short maturities.

Directors also cautioned that inflation risks have increased in 2006; they recommended that the authorities adjust monetary policy as needed to meet inflation objectives. They also highlighted the significant progress made in addressing weaknesses of the financial sector. Many Directors welcomed the proposed new law aimed at increasing central bank autonomy as a significant step to underpin the commitment to low inflation.

Directors stressed that sustained high growth will be critical to improving social conditions, ensuring fiscal and debt sustainability, and supporting a healthy financial system. They welcomed the authorities' pro-growth agenda, encouraged them to continue improving the investment climate, and supported policies aimed at furthering trade expansion and diversification. Directors stressed the importance of the impending tax reform, which will improve the fairness and efficiency of the tax system. They also encouraged the authorities to implement reforms to improve the effectiveness of public spending and public enterprises. ■

For more information, please refer to IMF Public Information Notices Nos. 06/88 (Ireland), 06/98 (Macedonia), 06/84 (El Salvador), and 06/85 (Uruguay) on the IMF's website (www.imf.org).

Egypt on the move

Wide-ranging reforms, supportive macroeconomic policies, and a favorable external environment have contributed to faster growth in Egypt in recent years. The government now has a full agenda of economic and structural reforms in the pipeline to tackle much-needed fiscal adjustment while pursuing ambitious growth and employment objectives.

Recent economic reforms have placed Egypt on a path toward a full market economy—welcome news after almost a generation of economic performance below expectations. During the 1980s and 1990s, occasional growth spurts and sporadic bursts of reform were followed by policy reversals and widening economic and financial imbalances. From 2000 to 2003, real incomes in Egypt stagnated, unemployment was high and rising, and the economy was in the doldrums.

With the appointment in 2004 of a pro-reform cabinet led by Prime Minister Ahmed Nazif (reappointed in December 2005), Egypt saw a sea change in the direction of economic policies, with reforms aimed at boosting private sector activity and modernizing the government. The new cabinet established its credentials swiftly by adopting a number of bold policies, including drastic cuts in import tariffs and income tax rates, and by announcing plans to restructure the financial sector and privatize most state enterprises.

Bolstered by a supportive global environment, economic performance since 2004 has been impressive. Real GDP growth has accelerated (to 5.7 percent in the second half of 2005), inflation has fallen sharply, real interest rates have turned positive, and investor confidence has surged. Egypt's stock market was the top

global performer in 2005, and, after suffering sizable losses in the first half of 2006, it rebounded by 20 percent in July.

Most of Egypt's foreign-exchange-earning sectors—energy, tourism, Suez Canal traffic, and worker remittances—have performed strongly. The non-oil trade deficit began to widen in late 2005, but the balance of payments has been buttressed by large capital inflows, mostly non-debt-creating. International reserves have risen to \$23 billion (7.5 months of imports), and external debt and external vulnerabilities are low.

Boosting growth, creating jobs

Despite Egypt's strong performance, boosting growth and raising employment remain pressing economic issues. The country will need sustained output growth of at least 6–7 percent a year to absorb its rapidly expanding labor force (see chart). Considering Egypt's endowments—among them, energy resources, a favorable geographic location and related infrastructure assets, enduring tourist attractions, and a youthful population—such rates should be attainable.

The Nazif cabinet recognized early on, however, that if the country's potential is to be unleashed, the apparatus of government and the foundations of a market economy would need comprehensive rebuilding. And reforms would have to address the key impediments to faster growth: namely, a large fiscal deficit (9 percent of GDP) and high public debt (69.8 percent of GDP, net basis), deficiencies in financial intermediation, price distortions caused by subsidies, and bureaucratic red tape.

The government embarked on a well-sequenced reform program, ambitious in scope but balanced by a shrewd measure of political realism. To kick-start the reform momentum and boost confidence, the program featured a number of high-profile measures. At the same time, the authorities began working in earnest to strengthen capacities and build institutions.

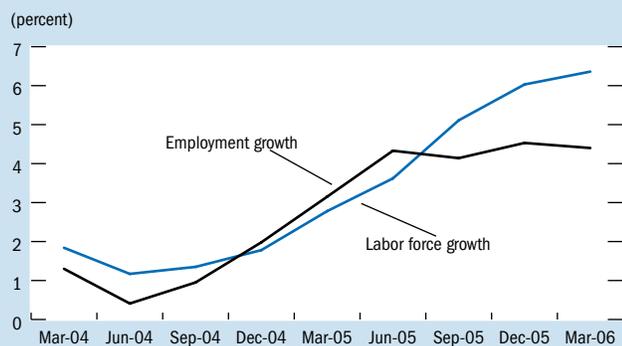
Promoting private sector activity

Improving the business climate was a key priority. The authorities immediately reduced and streamlined customs tariffs, cut income tax rates in half, and simplified tax filing procedures. The government then launched a privatization program that, in two years, has involved the sale of 87 state assets worth \$3.6 billion. In addition, the authorities recently signed a deal for \$2.9 billion to sell a third mobile phone operator license.

The government has also taken steps to strengthen regulatory and supervisory standards in the insurance industry, capital markets, and banking sector; has established a ministerial committee to expedite the settlement of commercial disputes with the government; and is preparing legislation for special

Job creation is top priority

Egypt will need to achieve sustained growth of at least 6–7 percent to absorb its rapidly expanding labor force.



Data: Egyptian authorities.

economic courts to improve the judicial framework underlying financial contracts. Having recognized the private sector's role as the engine of employment growth and wealth creation, the government is steadily removing the state from the productive sectors of the economy.

Restructuring the financial sector

To strengthen the financial sector, the government has made restructuring a critical pillar of the reform agenda. Before 2004, financial sector indicators were deteriorating and credit to the private sector was declining. The authorities believed that sustainable private sector growth would not take hold without a healthy, efficient banking system.

Over 24 months, they sold off 10 joint-venture banks and 2 investment houses, restructured and offered for sale a large state bank (Bank of Alexandria), and restructured half of all private sector nonperforming loans using a central bank–led arbitration approach. Now, work is under way to restructure and recapitalize the remaining two state banks on a parallel track over the next two to three years.

Revamping macroeconomic policy

Since taking office, the Nazif cabinet has worked to strengthen its macroeconomic policy tools. During the second half of 2004, the Central Bank of Egypt made the transition to a unified, flexible exchange rate regime, abolished the surrender requirement, and launched an interbank foreign exchange market. Since a sharp appreciation in early 2005, the exchange rate of the Egyptian pound vis-à-vis the U.S. dollar has remained stable.

With IMF technical assistance, the central bank has since focused on modernizing monetary policy formulation, operations, and communications. It has expanded its tool kit, including establishing an interest rate corridor, and significantly enhanced communications with the public. Annual average consumer price inflation dropped from 16 percent in early 2005 to 4 percent in the first half of 2006. Consumer price inflation has edged up since May, but the central bank attributes this to transitory supply factors that pushed up certain food prices and to adjustments in some administered prices. The central bank now plans to adopt a full-fledged inflation targeting framework in the medium term. With this objective in mind, it is strengthening its analysis and policy formulation, and its autonomy is being increased.

Cognizant also of the need to tackle the country's large fiscal deficit and rising public debt, the authorities began preparing the groundwork in 2004. With IMF technical support, the Ministry of Finance launched a broad range of fiscal reforms, including overhauling the tariff regime, rewriting the income tax law, improving revenue administration, and strengthening public finance management, particularly cash management.

Egypt also adopted a new budget classification in line with the latest IMF standard (*Government Finance Statistics Manual*, 2001). The reclassification of the fiscal accounts and some data revisions revealed a larger fiscal deficit in recent years (9 percent of GDP) than had been depicted earlier. Nevertheless, the integrity and transparency of the fiscal accounts have been significantly improved in line with the government's policy of greater openness. Indeed, Egypt subscribed to the IMF's Special Data Dissemination Standard and began publishing its annual Article IV staff reports on the country's economy in 2005.

Tackling public debt

With net public debt close to 70 percent of GDP, fiscal consolidation must be at the top of Egypt's macroeconomic policy agenda. Lowering debt will be essential to ensure macroeconomic stability, reduce uncertainty for investors, avoid debt overhang effects, and increase the authorities' ability to cope with external shocks. It would also contribute to a better allocation of resources in the economy, since a large share of government spending has been unproductive, with fuel subsidies of 7 percent of GDP being the most egregious example.

To this end, and armed with a more comprehensive understanding of the country's true fiscal position, the government recently mapped out a multiyear consolidation plan designed to reduce the deficit by more than 1 percent of GDP annually over the next four years, to 3–4 percent of GDP. It took its first major step in July by introducing an energy subsidy reduction package and also publicly signaled its intention to pursue deep reforms in sales and property taxes, government procurement, treasury management, and administrative modernization. The authorities are taking measures to target social assistance more directly at low-income households and are formulating a sweeping reform of the pension system.

Challenges ahead

Implementing the next phase of reforms will pose greater challenges in terms of policy trade-offs. The government will need to build a strong political and social consensus to achieve its objectives, especially with conflict in the region complicating matters. On the other hand, still-favorable global economic conditions, strong reform momentum, and bullish investor confidence may mean that the timing is ripe for tackling the toughest issues. ■

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Copies of *Arab Republic of Egypt: 2006 Article IV Consultation*, IMF Country Report No. 06/253, are available for \$15.00 each from IMF Publication Services. See page 256 for ordering details. The full text is also available on the IMF's website (www.imf.org).

Why women in Canada are working so much more

Canadian female labor participation has risen impressively during the past decade. With policymakers in many industrial countries seeking to encourage female participation in the labor market as a way to boost growth and mitigate the effects of population aging, the Canadian example is an interesting case. A recent IMF Working Paper analyzes this experience and finds that tax and benefit system reforms in the mid-1990s account for at least one-third of the observed increase during 1995–2001. It also concludes that policies similar to Canada’s family-friendly initiatives could help policymakers elsewhere meet the challenges of population aging.

After a long period of stability, the Canadian female labor participation rate has risen rapidly over the past decade. Currently at 73½ percent, it is now among the highest in the industrial world, just behind that in the Nordic countries (see table). This remarkable increase has helped spur Canada’s growth performance since 1995 and appears to hold lessons for other countries.

To compare the Canadian experience with those of other countries, the paper examined data from the Organization for Economic Cooperation and Development (OECD) on taxes and benefits of secondary earners for 10 large industrial countries. It also considered other determinants of secondary worker participation, such as preferences for education and childbearing, labor market conditions, and institutional labor market characteristics (wage compression, employment protection, and union density). Cultural factors and social norms were also taken into account using data for the proportion of parliamentary seats held by women or country-specific time trends to capture underlying differences across countries.

A panel approach using the OECD data offered a number of advantages. First, the selected countries exhibited a wide range of policies and experiences regarding female labor participation, and thus provided a valuable source of information and a benchmark for the relative effectiveness of Canadian policy initiatives. Second, a Canada-only analysis was constrained by data limitations—namely, the lack of extensive provincial child-care statistics (for example, child-care expenses in each Canadian province for long periods of time). Third, a panel analysis is often more informative because of difficulties in comparing the results of country-specific studies, stemming particularly from varying data and methodologies. Thus, using data obtained from the same source typically provides more reliable conclusions. In this case, the OECD data used the same methodology to calculate the tax wedge and child-care expenses for each country.

The beauty of reform

Can reforming the tax and benefit system encourage more individuals, particularly women, to enter the labor market? Tax wedges on labor—the difference between what employers pay out in wages and social security charges and what employees take home after tax and social security deductions plus any cash benefits for which they may be eligible—in theory raise the opportunity cost of work. They thus discourage entry into the labor force, particularly for secondary workers, who are generally women. Benefits, such as affordable and available child care, have the opposite effect. The Canadian tax and benefit system, both at the federal and the provincial level, underwent important reforms in the past decade.

Canadian tax wedges for secondary earners have fallen steadily (see chart, next page). The Canada Child Care Tax Benefit was introduced in 1997, a 3 percent general surtax on individual incomes was gradually eliminated starting in 1998, and further income tax cuts began in 2000 as part of a five-year tax reduction plan. Similar cuts in provincial income tax rates were initiated during this period.

Family-friendly benefits have increased since the mid-1990s. In 1996, federal and provincial/territorial education ministers began to assign high priority to improving the quality of, and access to, early childhood education and care. The 1997 National Children’s Agenda was established to support and enhance the health, safety, and development of all young children. Under its auspices, the federal government introduced the National Child Benefit, which increased the incentives for single parents to enter the labor market and freed up provincial funds to be invested in family support projects; the Early Childhood Development Agreement, which provided federal funds to provinces/territories to improve and expand child care and other services for children younger than 6 years old; and the Multilateral Framework on

Impressive participation

Female labor force participation has risen rapidly in Canada.

	Total		Female	
	1995	2004	1995	2004
Canada	74.6	78.2	67.7	73.5
Nordics	77.2	78.0	73.1	75.1
EU15 ¹	67.6	70.5	57.0	62.6
G10 ²	72.8	74.1	63.4	66.6
OECD	69.5	70.0	58.0	59.9
United States	76.9	75.4	69.7	69.2

¹EU15: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom.

²G10: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, United States.

Data: Organization for Economic Cooperation and Development (OECD), Labor Force Statistics Database, 2005.

Early Learning and Child Care, which allocated federal funds to be specifically used to “improve access to affordable, quality, provincially or territorially regulated early learning and child-care programs”; moreover, federal maternity and parental leave benefits were expanded to 50 weeks from 35. At the provincial level, since 1996–97, Quebec has implemented a comprehensive family support policy, including full-day universal child care for Can\$7 a day. As a result of these initiatives, almost one-third of working Canadian mothers now have access to government-sponsored child care (up from less than one-fifth a decade ago), and public spending for regulated child care (on a per child basis) has more than tripled.

Lower taxes and more child care

Results from panel regressions suggest that the decrease in the secondary earner’s tax wedge, coupled with the increase in child-care benefits, can explain at least one-third of the increase in Canadian female participation in the labor market between 1995 and 2001. As expected, the secondary earner’s tax wedge acts as a disincentive to labor participation, whereas child-care benefits encourage women to enter the labor market. More specifically, a cut of 1 percentage point in the tax wedge is found to raise the female participation rate by 0.17–0.19 percentage points, and the impact of an equivalent increase in child-care benefits is similar or larger, with estimates ranging from 0.14 to 0.99 percentage points.

Other considerations, such as preferences and institutional factors, also appear important in explaining the female participation rate and trends across countries:

Unemployment rate. Increases in the overall unemployment rate tend to dampen female participation, possibly because weaker labor market conditions discourage women from entering the labor market in the first place.

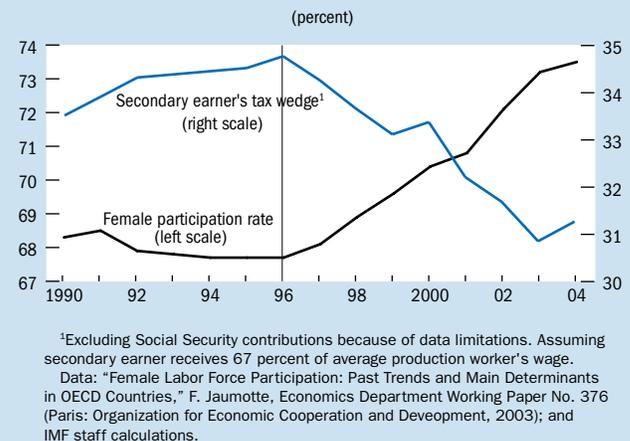
Degree of labor market regulation. Increases in union density and employment protection have a positive impact on female participation by raising job security. Higher wage compression—for example, a lower ratio of the median to the lowest tenth percentile of gross earnings for all employed—hinders participation because child-care fees are relatively higher in countries with compressed wage structures, as care givers typically fall at the lower end of the wage distribution.

Education and childbearing preferences. There is a close relationship between education, childbearing preferences, and female participation in the labor market. The decision to study—captured by years of education—and the decision to have children are disincentives to entering the labor market. The effect of parental leave on female participation was found to be ambiguous, with different signs across specifications.

Cultural characteristics. Social norms, captured by the role of women in politics and by specific country effects,

Female tax benefit

The increase in Canada’s female participation rate coincided with the decrease in the secondary earner’s tax wedge.



often linked to preferences and institutional and other characteristics not modeled explicitly, also help explain female participation in the labor market. In countries where women hold a higher proportion of parliamentary seats—a proxy for cultural attitudes toward women—female participation in the labor market is higher.

Lessons for Canada and beyond

What were the particular effects of reforms on female participation in Canada? According to the study, had a secondary earner’s tax and benefit wedges remained at the 1995 level, the Canadian female labor force participation rate would have risen by up to 2 percentage points between 1995 and 2001. Instead, the increase was 3¼ percentage points. The effects of tax and benefit reforms appear to have been of equal magnitude in boosting female participation.

To facilitate increases in female labor force participation rates, other countries could use similar policies to “reconcile work and family.” Policies that encourage young women to enter the workforce could have positive long-term implications, given their impact on lifetime participation. In view of the challenges that population aging poses for national welfare, pensions, and health care systems in industrial countries, further raising labor market participation (particularly for low-income earners and the elderly) would be desirable, even in Canada. ■

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This article is based on IMF Working Paper No. 06/92, “Why Are Women Working So Much More in Canada? An International Perspective,” by Evridiki Tsounta. Copies are available for \$15.00 each from IMF Publication Services. See page 256 for ordering details. The full text is also available on the IMF’s website (www.imf.org).

Stability and Growth Pact: boosting its enforceability

The seven-year-old fiscal framework of the European Union (EU)—the Stability and Growth Pact (SGP)—was intended to guide member countries toward fiscal prudence. But it has been difficult to enforce. Many countries, for example, have not been able to keep their fiscal deficits below the SGP's 3 percent of GDP benchmark, and problems also abound on the procedural side. A new IMF Working Paper asks why some countries have coped better than others and how the SGP can be made more enforceable.

The SGP, introduced in 1998 and revised in 2005, fleshes out the 1992 Maastricht Treaty, which provided the EU with a two-pronged fiscal framework. The framework's *preventive* arm focuses on multilateral surveillance and the avoidance of excessive deficits. The SGP complements the framework by requiring countries to strive for a medium-term objective that provides a sufficient cyclical safety margin to allow full operation of automatic stabilizers during downturns without breaching the 3 percent of GDP reference value. The framework's *dissuasive* arm is charged with ensuring that countries respect the Maastricht Treaty's limits on deficits (3 percent of GDP) and public sector debt (60 percent of GDP). If a country's deficit is deemed to be excessive, it is obliged to undertake corrective policies within a defined time frame.

Causes of the deficit bias

EU countries' fiscal records diverged widely before the signing of the Maastricht Treaty. While some countries, like France and Germany, held their public debt accumulation in check, others, particularly Belgium, Greece, Ireland, and Italy, ran persistent and unsustainable deficits. A range of factors—including divisions within governments, electorally motivated fiscal policy, and weak budgetary institutions—fueled this deficit bias, especially during the 1970s and 1980s.

A country's political architecture, explains the Working Paper, can distort fiscal policy decisions and have an inbuilt bias toward excessive deficits and debt. First, by the logic of the *common pool model*, politicians who represent different groups and vested interests have no incentive to constrain their spending demands, given that the costs are shared by the population as a whole. Second, politicians tend to be more myopic than the general public, favoring short-run electoral gain and ultimately failing to take account of longer-term policy implications.

Deficit biases may be even greater in a monetary union, where exchange rate risk and the associated interest rate risk premium are no longer operable. The ability to pass on at least some of the costs of profligate fiscal policy to other

members can also exacerbate the common pool problem within a monetary union.

Constraining discretion

To constrain policymakers' discretion, numerous governments have adopted formal fiscal rules. A number of countries have also reformed their budgetary processes by introducing *delegation*—granting a leading role in the budget process to the finance minister—or *commitment* techniques, whereby different parties negotiate a fiscal contract involving strict budget targets.

Throughout the 1980s and 1990s, more and more European countries undertook reforms along these lines—some prompted by the need to meet the Maastricht fiscal criteria. Large countries, like France, Germany, and the United Kingdom, with stable delegation arrangements over long periods, have been joined more recently by Austria, Greece, Italy, and Spain. Other, typically smaller, countries—such as Belgium, Finland, Ireland, and the Netherlands—developed an affinity for commitment. In some cases, the desire to meet the Maastricht criteria was a catalyst for these budgetary reforms, as countries strengthened institutions to bolster the effectiveness of fiscal rules.

Some countries have also constrained discretion by placing greater reliance on independent fiscal entities. Countries like Austria, Belgium, and the Netherlands have used independent bodies to provide independent projections, whereas others have allowed the analysis provided by these bodies to influence fiscal policy and keep political distortions in check.

Mixed results

How has the EU's fiscal framework fared? Ratification of the Maastricht Treaty spurred the EU countries into action as they scrambled to meet the deficit criterion. Most underwent substantial fiscal adjustment in the 1990s. By the onset of European Economic and Monetary Union (EMU) in 1999, almost all of the existing euro area members had succeeded in bringing their deficits below 3 percent of GDP.

Experience under the SGP has been more mixed, however. Data from the Organization for Economic Cooperation and Development indicate that the average cyclically adjusted primary balance did not budge between the Maastricht (1992–98) and SGP (1999–2004) periods. In only three countries did the adjustment in the SGP period go beyond that undertaken under Maastricht. This may be explained partly by adjustment fatigue and partly by the fact that the imminent threat of exclusion from EMU had passed.

But this is only part of the story. By the end of 2004, 5 of the euro area's 12 member countries—Belgium, Finland, Ireland, Netherlands, and Spain—had fiscal positions that could be deemed as “close to balance or in surplus,” the SGP standard. Others—including France, Germany, Greece, Italy, and Portugal—posted deficits in excess of 3 percent of GDP and became entangled with the excessive deficit procedure.

One clear pattern was the opening up of a gulf between large and small countries. Although the three largest countries were apparently reluctant to push for underlying balance, the SGP seems to have worked well for a core group of smaller countries, as well as Spain. Ironically, the traditional bastions of fiscal stability in Europe—France and Germany—slipped to the bottom of the pack (see chart).

An analysis of the data, as described in the Working Paper, indicates that some of the fiscal policy distortions that were mitigated by the Maastricht Treaty have staged a return under the SGP, because the threat of exclusion from EMU has passed. First, procyclical fiscal policy, largely eliminated with the advent of the Maastricht Treaty, came back during the SGP period, and electorally motivated fiscal profligacy rose in prominence under the SGP.

Finally, the study finds that commitment countries tend to take annual stability programs—the backbone of the SGP's preventive arm—more seriously, as evidenced by lower forecast errors in their budgetary projections. Also, countries using independent forecasts tended to have lower forecast errors under the SGP.

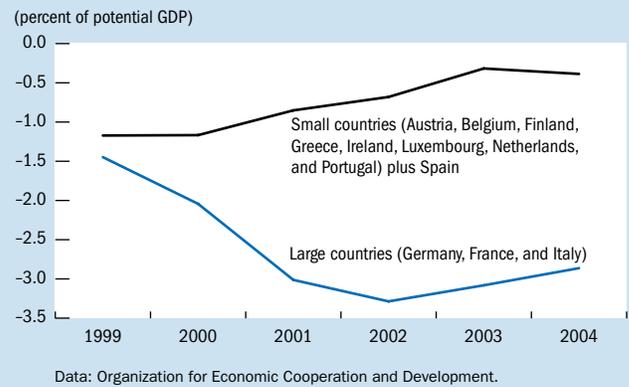
Explaining the differences

What explains countries' diverging performances under the SGP? An analysis of the determinants of fiscal policy before and after the SGP's introduction reveals three core results:

- Budgetary institutions underpinned by *commitment* (typically in the smaller states) contributed more to fiscal discipline in the post-SGP period. *Delegation* was effective in disciplining fiscal policy before the SGP but not after: with its emphasis on multiyear targets and a regular review procedure, the SGP fits snugly with the fiscal contract approach associated with the commitment states, but it is less compatible with delegation countries that rely on domestic governance institutions.
- Countries experiencing higher growth volatility tended to adopt a more disciplined fiscal policy under the SGP. In this regard, the SGP could act as an external anchor for countries prone to macroeconomic volatility, especially in the absence of exchange rate discipline.
- There is also some evidence that larger countries performed worse than smaller countries in meeting fiscal targets under the SGP. This could reflect either political consider-

Diverging deficits

The Stability and Growth Pact seems to have helped a core group of smaller countries bring down their fiscal deficits.



ations, whereby smaller countries are more accustomed to external influences over policy and suffer a greater loss in reputation from deviating from the rules, or economic ones, since the costs of fiscal consolidation tend to be higher in large countries. But this result holds only when the fiscal governance variables are excluded from the analysis.

Fortifying enforceability

Overall, the evidence shows that a rules-based fiscal framework can be an effective disciplining device but that the SGP works best in countries that are smaller, subject to greater volatility, and more inclined to adopt the commitment form of fiscal governance to strengthen budgetary institutions. Since most of the new members share these characteristics, the advantage of having a robust SGP should only increase over time.

At the same time, ways must be found to make the SGP more compatible with countries that are large and rely on domestic governance mechanisms, such as delegation to a strong finance minister. Here, a promising avenue might be reforms that bolster domestic institutions, such as independent entities that audit fiscal policy in a forward-looking manner and exert domestic reputational costs on the government. These have been shown to contribute to fiscal discipline, especially when they provide independent forecasts. ■

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This article is based on IMF Working Paper No. 06/116, “Enforcement and the Stability and Growth Pact: How Fiscal Policy Did and Did Not Change Under Europe's Fiscal Framework.” Copies are available for \$15.00 each from IMF Publication Services. See page 256 for ordering details. The full text is also available on the IMF's website (www.imf.org).

Doha doldrums carry a high price tag

On July 24, the World Trade Organization (WTO) agreed to the de facto suspension of the Doha Round of multilateral trade negotiations. What are the chances of getting these negotiations moving again, and what are the implications of a breakdown? The IMF's Natalie Hairfield discusses the issue with Hans Peter Lankes, Chief of the Fund's Trade Policy Division.

IMF SURVEY: Can the Doha talks be revived?

LANKES: In view of the lead time needed to conclude negotiations once the key parameters have been settled, the talks must be rescued right away—say, by September—or we are looking at months and perhaps years of drift. This is because there are elections in the United States and Brazil later this year and uncertainties over U.S. trade promotion authority, which expires in mid-2007.

Domestic political pressures for a deal have been weak everywhere, and only inspired statesmanship could produce results in the short term. The more likely scenario is a lengthy pause. This may provide some time for the pro-trade lobbies to organize themselves, and the IMF should join in making the intellectual case for the Round. But I fear the strongest force that could propel a deeper rethink over time will be the failure of the alternatives and perhaps a rise in protectionism once the global economy slows down.

IMF SURVEY: What are the implications of this breakdown?

LANKES: A lengthy breakdown would be a missed opportunity to strengthen the global economy over the medium term and provide a boost to developing countries. In some areas, negotiating positions were no longer far apart. We estimate, for instance, that [WTO Director-General Pascal] Lamy's middle-of-the-road proposal for tariff cuts in industrial products would have reduced applied tariffs by 45 percent, on average, in developed countries while eliminating peak tariffs, and by 13.5 percent in developing countries. This is more than the Uruguay Round achieved and would have opened vast new opportunities for trade.

Now what? The breakdown weakens multilateralism, at least temporarily. It will trigger an even more pronounced shift toward bilateral deals. The result, even with well-designed free trade agreements—and most aren't—is diminishing transparency, mounting trade discrimination, and increasing administrative red tape that will hamper cross-

border production chains. Another risk is that litigation will take the place of negotiation, especially in agricultural trade.

IMF SURVEY: What thwarted a deal on agricultural trade?

LANKES: On the face of it, the breakdown was a classic clash between EU [European Union] and U.S. agriculture. The United States wanted more market access than the EU was willing to give and then felt politically constrained from offering deeper cuts in subsidies. Some developing countries were unhelpful, too. They converted the Doha development mandate into a series of gigantic loopholes—all exceptions and no access.

But the political economy is more complicated. None of the main players saw much political value in a deal. Lobbying from manufacturers—traditionally pro-trade—was weak, which limited the scope for political trade-offs. The EU had hoped to leverage the services lobby to confront the farmers, but nothing happened—partly because the services talks became so technically complicated that the services industries retreated in frustration. The U.S. farm lobby—a motor of past rounds—has become evenly split between pro-traders and protectionists, primarily because of the competitive strength of countries like Brazil in this sector. And everyone, especially developing countries, is afraid of China. This undermined the willingness to offer more attractive industrial tariffs, which might have brought the agriculture negotiators to their senses.

IMF SURVEY: How will all of this affect Aid for Trade [AFT]?

LANKES: The AFT proposals, which are meant to facilitate the integration of poor countries into the global economy, are not formally part of the Doha Round. Developed and many developing countries differed on how to achieve development through trade instruments, but all could agree on a parallel process, led by development institutions and the IMF, that would provide technical assistance, project finance, and adjustment support.

AFT commitments have been made by development institutions and not trade ministries, and some of the financial pledges are already budgeted. The IMF certainly has no intention of abolishing its Trade Integration Mechanism or its customs reform technical assistance. Later this month, the IMF's Executive Board will consider a paper that reviews AFT activities to date and contains World Bank proposals to address the needs of regional cooperation. ■



Lankes: "The breakdown . . . will trigger an even more pronounced shift toward bilateral deals."

Henrik DeGeyr/IMF

Stand-By, EFF, and PRGF arrangements (as of July 31, 2006)

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
(thousand SDRs)				
Stand-By				
Bulgaria	August 6, 2004	September 5, 2006	100,000	100,000
Colombia	May 2, 2005	November 2, 2006	405,000	405,000
Croatia	August 4, 2004	November 15, 2006	99,000	99,000
Dominican Republic	January 31, 2005	May 31, 2007	437,800	192,620
Iraq	December 23, 2005	March 22, 2007	475,360	475,360
Macedonia, FYR	August 31, 2005	August 30, 2008	51,675	41,175
Paraguay	May 31, 2006	August 31, 2008	65,000	65,000
Peru	June 9, 2004	August 16, 2006	287,279	287,279
Turkey	May 11, 2005	May 10, 2008	6,662,040	4,996,530
Uruguay	June 8, 2005	June 7, 2008	766,250	502,660
Total			9,349,404	7,164,624
EFF				
Albania	February 1, 2006	January 31, 2009	8,523	6,088
Total			8,523	6,088
PRGF				
Afghanistan, Islamic Republic of	June 26, 2006	June 25, 2009	81,000	81,000
Albania	February 1, 2006	January 31, 2009	8,523	7,305
Armenia	May 25, 2005	May 24, 2008	23,000	13,160
Bangladesh	June 20, 2003	December 31, 2006	400,330	117,270
Benin	August 5, 2005	August 4, 2008	6,190	5,310
Burkina Faso	June 11, 2003	September 30, 2006	24,080	3,440
Burundi	January 23, 2004	January 22, 2007	69,300	28,600
Cameroon	October 24, 2005	October 23, 2008	18,570	13,270
Chad	February 16, 2005	February 15, 2008	25,200	21,000
Congo, Republic of	December 6, 2004	December 5, 2007	54,990	39,270
Dominica	December 29, 2003	December 28, 2006	7,688	2,322
Georgia	June 4, 2004	June 3, 2007	98,000	42,000
Ghana	May 9, 2003	October 31, 2006	184,500	26,400
Grenada	April 17, 2006	April 16, 2009	10,530	8,970
Guyana	September 20, 2002	September 12, 2006	54,550	9,250
Honduras	February 27, 2004	February 26, 2007	71,200	30,516
Kenya	November 21, 2003	November 20, 2006	225,000	150,000
Kyrgyz Republic	March 15, 2005	March 14, 2008	8,880	5,080
Madagascar	July 21, 2006	July 20, 2009	54,990	54,990
Malawi	August 5, 2005	August 4, 2008	38,170	27,827
Mali	June 23, 2004	June 22, 2007	9,330	4,007
Moldova	May 5, 2006	May 4, 2009	80,080	68,640
Mozambique	July 6, 2004	July 5, 2007	11,360	3,260
Nepal	November 19, 2003	November 18, 2006	49,910	35,650
Nicaragua	December 13, 2002	December 12, 2006	97,500	27,850
Niger	January 31, 2005	January 30, 2008	26,320	8,695
Rwanda	June 12, 2006	June 11, 2009	8,010	6,870
São Tomé and Príncipe	August 1, 2005	July 31, 2008	2,960	2,114
Sierra Leone	May 10, 2006	May 9, 2009	31,110	26,400
Tanzania	August 16, 2003	August 15, 2006	19,600	2,800
Zambia	June 16, 2004	June 15, 2007	220,095	33,014
Total			2,020,966	906,279

EFF = Extended Fund Facility.

PRGF = Poverty Reduction and Growth Facility.

Figures may not add to totals owing to rounding.

Data: IMF Finance Department.

Grappling with globalization

How can the United States successfully manage the challenges of globalization? A new paper by Peter Orszag (Brookings Institution) and Michael Deich (The Hamilton Project), “Meeting the Challenge of a Global Economy: Trade, Economic Security and Effective Government,” recommends a philosophy of “embracing international competition while investing in workers and market-friendly insurance.”

The paper, which provided the basis for a July 25 seminar at the Brookings Institution in Washington, D.C., calls for boosting overall productivity in the United States through a broader sharing of the benefits and costs of trade, which can be achieved through investment in education, research, and social safety nets.

A new social compact

In separate panels, Gene Sperling (Center for American Progress) and Larry Mishel (Economic Policy Institute), who were skeptical about free trade and globalization, parted company with Robert Rubin (Citigroup, Inc.), Lawrence H. Summers (Harvard University), and Robert Altman (Evercore Partners), who expressed staunch optimism.

Sperling voiced concern over the stagnation of median wages and the job insecurity faced by white-collar workers. He called for a “new social compact on globalization” that takes into account the implications of free trade for the average U.S. worker, social safety nets, and labor and environmental standards. Mishel noted that “trade between consenting adults is fine” but also argued that safety nets and universal health care were essential, too.

A seismic shift in economic history

Rubin, Summers, and Altman were in agreement that the current wave of globalization represented a seismic shift in economic history.

Summers said, “I don’t see how anyone could think that you can add several hundred million people to the world labor market and substantially broaden the range and number of tradable goods without having pervasive effects that will be felt throughout the spectrum.”

Rubin regretted that the U.S. political system has been silent on these issues.

“The conditions for such a debate,” he said, “don’t even exist.” When asked whether ecological issues should be a topic for discussion, Rubin said that “concerns about global warming and climate change are growing and are likely to become an important part of public policy debates.”

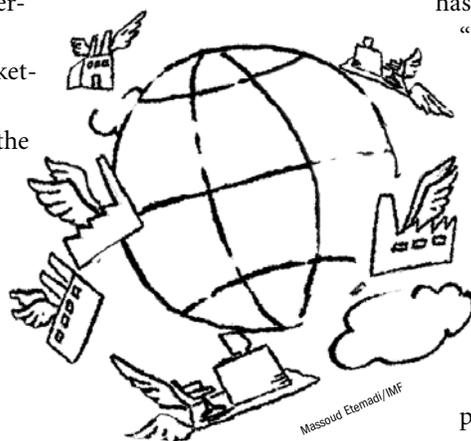
However, Altman cautioned against excessive pessimism about the impact of the seismic shift. China and India are becoming the world’s biggest markets for goods and services, and this, he said, will have a positive impact on the United States by increasing the wealth of its economy. The idea that China’s economic progress will be smooth is fallacious, he added. As with other countries in the past, it will not occur without interruptions or hiccups.

Moving costs

Altman also warned against too much focus on international wage differentials, because moving jobs around the world has costs. The press continually fails to mention the additional costs involved, for example, supervisory management costs, which make net cost differentials significantly smaller, he argued. There are plenty of opportunities for the United States to go on the offensive, Altman pointed out, because the United States “has not been as diligent,” particularly in enforcing existing trade agreements and encouraging freely floating exchange rates, especially in Asia. ■

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