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## In search of better crisis prevention

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Are there lessons to glean from the past and new mechanisms that might help emerging market countries avoid crises or at least minimize their damage? A recent seminar in Singapore—sponsored by the IMF and the government of Singapore—explored the origins of capital account crises and examined instruments that might afford some protection. IMF Deputy Managing Director Takatoshi Kato (right) described a proposed new IMF facility that would offer a high-access credit line to countries with strong macroeconomic policies.



Name/Agency

## France can build on partial labor reform

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Is the “big bang” approach to liberalizing labor markets preferable to a strategy of step-by-step reform? France opted for a partial reform approach, but the IMF’s Luc Everaert and Jianping Zhou find solid evidence that only comprehensive reform will lower unemployment in the long run. Still, France can build on its success with small enterprise contracts if it is able to convince the public of the benefits of and need for reform.



Kristin Jackson/Seattle Times/KRT

## Mekong development: integration holds the key

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Over the past two decades, Cambodia, the Lao People’s Democratic Republic, and Vietnam have made remarkable economic progress. But they are still playing catch-up with their dynamic neighbors. Participants at a high-level conference in Cambodia stressed that the Mekong economies have much to gain from regional integration, particularly if they can expand their participation in East Asia’s regional production networks.



Chris Stowers/InaFoto/ZUMA Press

## How countries can benefit from increased aid

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The prospect of increased aid to developing countries, especially in Africa, highlights the importance of the efficient delivery of aid by donors and its effective use by recipients. The IMF and the United Kingdom’s Royal African Society recently organized a forum to discuss these challenges. Among other findings, the panelists noted that recipient countries needed to improve their policy environments and institutions, and that donors needed to listen more closely to those they are trying to help.



Emmanuel Kwiterna/REUTERS

# What's on

## AUGUST

**14–25** “Achieving the Millennium Development Goals: Poverty Reduction, Reproductive Health, and Health Sector Reform,” World Bank Global Course, Bangkok, Thailand

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

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

## SEPTEMBER

**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

**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

**11–15** World Energy Council, 20th World Energy Congress and Exhibition, Rome, Italy

**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

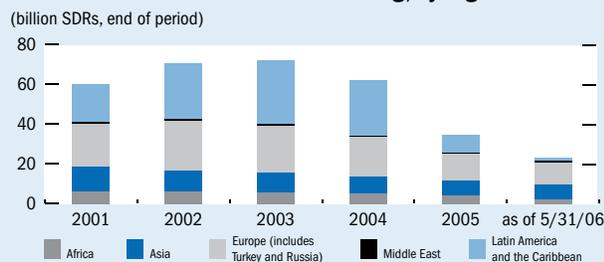
**24–28** World Economic Forum Annual Meeting, Davos, Switzerland

### IMF Executive Board

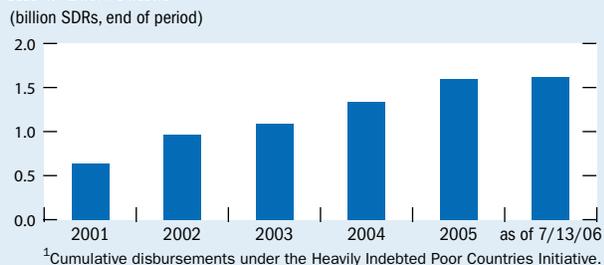
For an up-to-date listing of IMF Executive Board meetings, see [www.imf.org/external/np/sec/bc/eng/index.asp](http://www.imf.org/external/np/sec/bc/eng/index.asp).

# IMF financial data

## Total IMF credit and loans outstanding, by region



## HIPC debt relief<sup>1</sup>

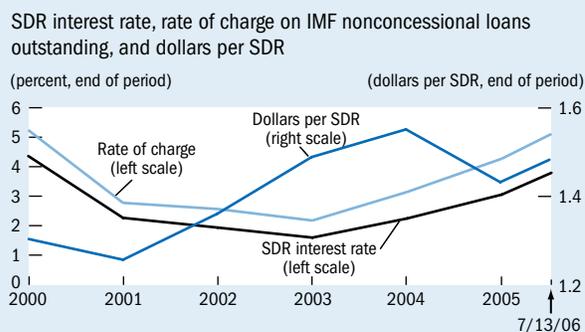


Note: Special Drawing Rights (SDRs) are an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also

## Major currencies, rates per SDR

|              | July 19, 2006 | Year ago (July 19, 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



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.

## More effective instruments sought for crisis prevention

**H**oping to learn from the past and devise more effective tools for the future, a High-Level Seminar on Crisis Prevention in Emerging Markets in Singapore on July 10–11 focused on four key issues: the genesis of capital account crises; effective macroeconomic management in countries with open capital accounts; options for country self-insurance and regional reserve pooling; and the Fund's proposed contingent financing instrument. The seminar—jointly organized by the IMF Institute, the IMF's Policy Development and Review Department, and the Government of Singapore—drew officials from about 40 emerging market countries as well as participants from the private sector.

### Genesis of capital account crises

Countries become vulnerable to capital account crises when they have mismatches on their private or public sector balance sheets—for example, between assets and liabilities in terms of their maturities or currencies of denomination. A crisis, however, usually also requires a specific trigger, either external—contagion, a terms of trade shock, a deterioration in market conditions—or domestic, such as macroeconomic policies that damage investor confidence.

Emerging market countries should seek to minimize balance sheet vulnerabilities and avoid conditions that might trigger a crisis. To minimize balance sheet vulnerabilities, countries should ensure adequate prudential regulation and supervision of the financial system and take precautions to avoid the kind of “one-way” bets on fixed exchange rates that can cause private balance sheet exposures. Countries should also fortify themselves against crises by pursuing sound macroeconomic policies and adhering to internationally accepted transparency and financial sector standards and codes.

### Macromanagement with open capital accounts

While participants agreed that implicit guarantees by the government might encourage risky currency exposures in private sector balance sheets, there was less consensus on the appropriate exchange rate policy. Views split roughly along regional lines. Participants from Latin America and Central Europe advocated flexible exchange rates with inflation targeting frameworks for monetary policy. Policymakers from Baltic countries argued in favor of a pegged exchange rate regime as long as it could be supported by a credible exit strategy (in their case, the eventual adoption of the euro), full financial market integration, and a flexible labor market. The dominant view among Asian policymakers, however, favored an intermediate regime, with discretionary interventions in exchange rate markets.

Also useful, participants concurred, were sound macroeconomic policies, including fiscal cushions; adequate international reserves; and adherence to transparency standards and codes to minimize the likelihood of contagion triggering a crisis. The quality of institutions plays a vital role, too, as this reinforces credibility and thus offers room for countercyclical macroeconomic policies.

### Reserves, self-insurance, and regional pooling

Participants agreed that reserves can play an important role in preventing crises—and that they should be sufficient to cover at least debt payments due within a year. There was less clarity, however, on when the benefits of further reserve accumulation outweigh the costs. Most participants acknowledged that in a few Asian countries reserve accumulation may have gone well beyond prudential requirements.

One alternative—a regional pooling of reserves such as the Chiang Mai Initiative—was viewed as a potentially useful source of support. However, given limited regional diversification possibilities, regional pools were seen at best as a complement to, rather than a substitute for, support from the IMF. Also discussed was the possibility that governments could contract with the private sector, which would provide contingent credit lines with guaranteed drawing rights at a predetermined spread. Generally, participants believed such instruments would entail a substantial insurance premium and be prohibitively expensive. In this regard, any feasible contingent arrangement would have to include covenants, such as prequalifying criteria and activation clauses.

### The IMF's proposed new instrument

The Fund's proposed contingent financing instrument generated considerable interest. As the IMF's Deputy Managing Director Takatoshi Kato explained, several emerging market member countries have asked the Fund to create a financial instrument that meets their need for predictability and flexibility. The proposed new instrument would, he said, be a “high-access line of credit to emerging markets that have strong macroeconomic policies but which remain vulnerable to shocks.” It would provide a liquidity cushion and help countries avoid crises and respond to those that do occur.

Both officials and private sector participants argued that such an instrument would need to provide significant access up-front in the event of market turbulence. They also stressed the need for automaticity for suitably qualified countries, while recognizing that very large access could engender moral hazard.

*Bikas Joshi and Miguel Messmacher  
IMF Policy Development and Review Department and IMF Institute*

## Hong Kong SAR's prospects linked to deepening integration with mainland

According to the most recent data for the first quarter of 2006, Hong Kong SAR has enjoyed 11 consecutive quarters of sustained growth, reflecting a supportive global environment, sound domestic macroeconomic policies, continued structural reforms, and growing links with mainland China. GDP grew by 7¼ percent in 2005—slightly lower than the growth rate of 8½ percent recorded for 2004.

According to the IMF's recent economic review, strong real GDP growth—projected to be about 6 percent—and modest inflation are expected to continue in 2006. Given the economy's general openness and its strong links with the mainland, growth prospects will depend on external conditions and mainland developments—particularly, the economy's effectiveness in fur-

ther integrating with the mainland. Hong Kong SAR's future success as a global financial center will hinge on its ability to assist in the mainland's financial intermediation, and progress will depend on the pace of China's financial liberalization.

The IMF's Executive Board commended the authorities for their skillful macroeconomic management in the face of external shocks over the past few years. Competitiveness will continue to rely on maintaining traditional strengths—namely, flexible product and factor markets—and developing new areas of growth. Directors particularly welcomed the improved fiscal position, which resulted in the first budget surplus (in fiscal year 2005–06) since the Asian crisis—three years ahead of schedule.

Commending the authorities' commitment to the Linked Exchange Rate System, a currency board that keeps the value of the Hong Kong dollar in terms of the U.S. dollar within a narrow trading band, Directors noted that fine-tuning the currency board had reduced uncertainties. Initiatives to strengthen financial market infrastructure and supervisory systems were welcomed, particularly progress toward a deposit protection scheme; preparations for the implementation of Basel II, a multilateral effort to revise international standards for risk management; and the establishment of the Financial Reporting Council. Directors supported the strategy to reduce low-skilled unemployment through training and placement assistance. ■

| Hong Kong SAR                            | 2003 | 2004             | 2005 | Proj. 2006 |
|--|------|------------------|------|------------|
|  |      | (percent change) |      |            |
| Real GDP                                 | 3.2  | 8.6              | 7.3  | 6.0        |
| Consumer prices                          | -2.6 | -0.4             | 0.9  | 2.3        |
|  |      | (percent of GDP) |      |            |
| Current account balance                  | 10.4 | 9.6              | 11.4 | 7.6        |
| Consolidated budget balance <sup>1</sup> | -3.3 | -0.3             | 1.0  | 0.5        |
| Foreign exchange reserves                | 74.7 | 74.5             | 69.9 | 67.3       |

<sup>1</sup>Fiscal year begins April 1.  
Data: Hong Kong SAR authorities and IMF staff estimates and projections.

## Structural reforms can help unlock Brazil's growth potential

Brazil's economic performance has continued to be favorable, with higher real GDP growth and lower inflation projected for 2006, according to the IMF's recent economic review. Brazil's external position has strengthened further: favorable global market conditions have boosted trade and current account surpluses, and positive financial market sentiment, ample global liquidity, and high domestic interest rates have boosted capital inflows.

These favorable external conditions have allowed the central bank to build up international reserves and reduce external debt to its lowest ratio to exports in more than 25 years—in particular, through the early repayment of all outstanding obligations to the IMF and repayments to Paris Club creditors, as well as

through buybacks of private external debt. And the authorities have been able to deepen Brazil's domestic financial markets and enhance their integration with global markets.

The IMF Executive Board welcomed Brazil's strong economic performance, the decline in unemployment, and its significant progress in alleviating poverty and inequality, including through active social policies. Near-term prospects are favorable, but the recent rise in global risk aversion toward emerging markets highlights the importance of maintaining prudent policies and continuing to reduce vulnerabilities.

Unlocking Brazil's growth potential, in the view of Directors, is the country's most important challenge. Meeting this challenge will require consolidating macroeconomic stability by solidifying the institutional underpinnings of policies, improving the efficiency of the public sector, and further strengthening the public sector balance sheet. In this regard, Directors stressed the need to reduce budget rigidities and phase out tax distortions and inefficiencies.

Directors also saw a need for broader structural reforms to improve financial intermediation, open the economy, and strengthen the business environment. Such a combination of policies would provide conditions conducive to productivity growth and investment, setting the stage for continued progress in tackling high poverty and income inequality. ■

| Brazil                          | 2003 | 2004                    | Prel. 2005 | Proj. 2006 |
|---------------------------------|------|-------------------------|------------|------------|
|                                 |      | (annual percent change) |            |            |
| Real GDP                        | 0.5  | 4.9                     | 2.3        | 3.5        |
| Consumer prices (end of period) | 9.3  | 7.6                     | 5.7        | 4.5        |
|                                 |      | (percent of GDP)        |            |            |
| Current account                 | 0.8  | 1.9                     | 1.8        | 1.1        |
| Total revenues                  | 23.1 | 24.0                    | 25.3       | 25.3       |
| Total expenditures              | 27.1 | 25.5                    | 29.1       | 28.2       |

Data: Central Bank of Brazil, Ministry of Finance, and IMF staff estimates.

For more information, please refer to IMF Public Information Notices Nos. 06/16 (Hong Kong SAR) and 06/69 (Brazil) on the IMF's website ([www.imf.org](http://www.imf.org)).

## Stand-By, EFF, and PRGF arrangements (as of June 30, 2006)

| Member                           | Date of arrangement | Expiration date    | Amount approved  | Undrawn balance  |
|----------------------------------|---------------------|--------------------|------------------|------------------|
| (thousand SDRs)                  |                     |                    |                  |                  |
| <b>Stand-By</b>                  |                     |                    |                  |                  |
| 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          |
| Romania                          | July 7, 2004        | July 6, 2006       | 250,000          | 250,000          |
| Turkey                           | May 11, 2005        | May 10, 2008       | 6,662,040        | 4,996,530        |
| Uruguay                          | June 8, 2005        | June 7, 2008       | 766,250          | 502,660          |
| <b>Total</b>                     |                     |                    | <b>9,599,404</b> | <b>7,414,624</b> |
| <b>EFF</b>                       |                     |                    |                  |                  |
| Albania                          | February 1, 2006    | January 31, 2009   | 8,523            | 7,305            |
| <b>Total</b>                     |                     |                    | <b>8,523</b>     | <b>7,305</b>     |
| <b>PRGF</b>                      |                     |                    |                  |                  |
| 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            |
| 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           |
| <b>Total</b>                     |                     |                    | <b>1,965,976</b> | <b>851,289</b>   |

EFF = Extended Fund Facility.

PRGF = Poverty Reduction and Growth Facility.

Figures may not add to totals owing to rounding.

Data: IMF Finance Department.

## French labor market reform: partial versus comprehensive steps

High unemployment and sluggish job creation have prompted much of Europe to pursue labor market reforms. Will a strategy of partial labor market reform pay off for France? Luc Everaert and Jianping Zhou (both IMF European Department) analyze the pros and cons, and find that partial reforms facilitate job creation in the short run, but are unlikely to reduce unemployment over the longer term. Still, partial reforms could be a step forward if the political will is there to use them as a springboard for broader reforms.

France, like most industrial countries, protects employees from dismissal through a combination of legal and administrative rules and financial penalties applying to employers. Some protection is justified to ensure that companies bear some of the cost to society of their individual firing decisions. Think, for example, of a firm that experiences quarterly peaks in its activity. Such a firm could lay off its workers temporarily every quarter and thus force society to subsidize the firm through unemployment benefits for these workers. Overly strict job protection, however, also has downsides. It increases the potential costs of hiring and so may increase unemployment even though it protects those who have jobs. Indeed, countries with strict employment protection tend to experience relatively high unemployment (see chart).

### Debating change

To reduce unemployment and stimulate job creation, France, like other European countries, has been discussing how to liberalize labor markets. Traditionally, the French labor market

### Restrictions for permanent and fixed-term contracts

Despite the recent implementation of partial labor market reforms, France retains two principal types of employment contracts: permanent and fixed-term.

*Permanent contracts* are designed for lifetime jobs. Dismissal is costly—not so much because severance pay is high but because the process is subject to lengthy administrative procedures and legal restrictions. For example, firms can lay off workers to restructure and preserve competitiveness, but they cannot lay off workers to improve performance or increase profits.

*Fixed-term contracts* can only be used when firms face temporary increases in production or need to replace permanent workers who are on leave. These contracts can last for up to 9 months and be renewed only once. In practice, these contracts have an average duration of less than three months. With payment due for the entire period if the worker is dismissed before the end of the contract term, employers may be hesitant to use these contracts for longer periods.

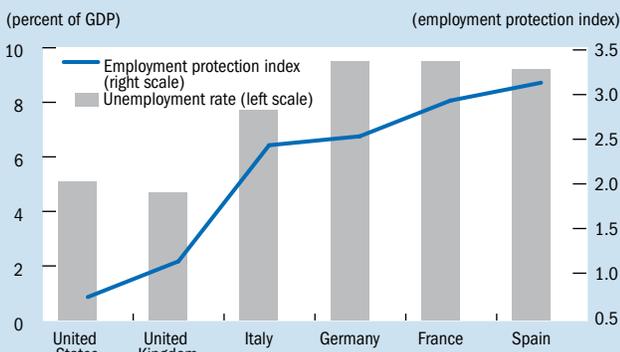
has provided two types of employment: permanent contracts (*contrats à durée indéterminée*) and fixed-term contracts (*contrats à durée déterminée*). Employment protection for workers hired under permanent contracts is very strict, and the use of the fixed-term contract is highly restricted (see box).

Seeking to introduce more flexibility, the French government launched a debate that featured broad consultation with social partners and consideration of a wide range of alternatives. Some proposals advocated partial reform, such as relaxing legal restrictions on the use of fixed-term contracts and removing firing restrictions from these contracts. Others argued that a complete overhaul of the system was needed. This would mean merging permanent and fixed-term contracts into a single contract, with minimal legal and administrative procedures; basing severance pay on the duration of employment; and developing a system of experience-rated unemployment contributions (that is, firms with a history of high layoffs would contribute more to the unemployment insurance system).

In the end, the government opted for partial reform, which left protection for permanent employment contracts unchanged. In August 2005, the authorities introduced a new employment contract for small companies (*le contrat nouvelle embauche*). Under the new contract, firms with fewer than 20 employees can now hire workers for up to two years without hiring and firing restrictions.

### When protection does not work

High levels of employee protection have translated into high levels of unemployment.



## The short and long of it

Can such partial reforms succeed in creating new jobs? In the short run, introducing flexibility does facilitate job creation. Indeed, small enterprises signed half a million new employment contracts between August 2005 and May 2006. Most of these jobs, however, would have been created regardless of the new contract. Recent estimates point to only about 30,000 net additional jobs. And, given that the new contracts last for two years, it is still too early to tell whether these jobs will lead to permanent ones.

The study suggests, though, that partial reform may be ineffective in reducing unemployment over the longer term and may have negative consequences for workers' welfare and productivity. Easing restrictions on fixed-term or temporary jobs fosters both job creation and job destruction, while strict employment protection legislation discourages both. Hence, the overall effect on unemployment of reform, whether partial or comprehensive, seems ambiguous.

However, when model simulations are run with parameters reflecting the features of the French labor market, the results suggest that when reform is partial the job destruction effect dominates in the long run. In fact, it is estimated that France's specific partial reform could raise the unemployment rate by almost 1 percentage point (see table, Scenario 1). The chief effect of partial reform, then, is a significant increase in turnover of fixed-term or temporary workers, but without a proportionate reduction in the length of time individuals remain unemployed.

Conversely, a reform that simultaneously reduces the firing restrictions of all contracts would lower the unemployment rate by about 1 percentage point (Scenario 2). Even better, if all contracts are merged into a single one and firing restrictions are reduced, the unemployment rate would drop by about 2 percentage points (Scenario 3). Of course, as with all model-based simulations, caution is advised in interpreting the magnitude of the estimates. In particular, if high minimum wages keep wages from reflecting high hiring costs, and inefficient employment services slow down the matching of vacancies with unemployed workers, the gains from comprehensive reforms may not be as large as predicted.

The direction of the study's findings is well established, however, and is supported by evidence from the experiences of other countries, in particular Spain. When Spain expanded the use of fixed-term contracts in the 1980s, the number of these contracts rose exponentially, and this initially reduced the unemployment rate. After a few years, however, the unemployment rate began to rise again, eventually exceeding its prereform level. At that stage, the Spanish authorities introduced comprehensive reforms that relaxed restrictions on permanent contracts, and unemployment has been trending down since then.

## Reforms and their potential effects

Broader reforms are likely to make a larger dent in unemployment rates.

|             |   | (percentage point change) |
|-------------|---|---------------------------|
| Scenario 1. | Reduce firing restrictions by 50 percent on fixed-term contracts.               | 0.9                       |
| Scenario 2. | Reduce firing restrictions by 50 percent on permanent labor contracts.          | -0.9                      |
| Scenario 3. | Merge contracts into a single one and reduce firing restrictions by 50 percent. | -1.8                      |

Recent simulations by Pierre Cahuc and Stéphane Carcillo (2006) of the likely long-term effect of the new, single contract suggest that the French reforms are expected to produce a 0.3 percentage point decline in unemployment.

## The next steps

Proponents of partial reform contend that such an approach may have the merit of gradually building support for reform and serving as an intermediate step toward complete reform. In France, this was clearly the government's intention. Indeed, in early 2006 it proposed another new labor contract with identical features (*contrat première embauche (CPE)*) intended this time for young workers (age 26 and under)—mainly to tackle the very high youth unemployment rate. However, there is a danger that, should partial reform fail to deliver notable employment results or to generate public support, the position of those opposing reform would be strengthened. This seems to have happened in France: after weeks of protests from students and labor unions, the *CPE* initiative was withdrawn.

What should France do now? On economic grounds, the case for complete rather than partial reform seems solid. Reducing employment protection across the board, in particular by replacing legal and administrative regulations with straightforward financial incentives (that is, severance pay and experience-rated unemployment contributions) would reduce the unemployment rate. From a political economy perspective, a window of opportunity exists to build on the success of the small enterprise contract to expand reform, but the public will need to be better informed of its benefits and of the need for it. ■

Luc Everaert and Jianping Zhou  
IMF European Department

For more information, see IMF Working Paper No. 06/108, "Reforming Employment Protection Legislation in France," by Jianping Zhou. Copies are available for \$15.00 each from IMF Publication Services. See page 224 for ordering details. The full text is also available on the IMF's website ([www.imf.org](http://www.imf.org)).

## Seigniorage: are central banks spending it wisely?

Low inflation and high international reserve holdings have increased financial pressures on many central banks, heightening concerns about their efficiency and governance. A new IMF Working Paper by Alain Ize argues that the central banks facing serious governance issues are the least independent. There are also indications that many central banks, whether independent or not, could benefit from strengthening their governance through, among other steps, more transparency in financial reporting, periodic reviews of expenditures, and more systematic efforts to ensure that their services are adequately sized and priced.

Central banks' exclusive rights on currency issue give them privileged access to seigniorage—the difference between the value of money and the cost of producing a currency within an economy. In the past, the siphoning off of seigniorage to governments raised familiar issues of fiscal dominance (monetary policy becoming hostage to fiscal policy) and inflationary finance. In recent years, many countries have taken substantive steps to curtail such linkages and enhance the independence of central banks by reforming their charters, prohibiting direct financing to governments, and getting rid of quasi-fiscal expenditures. Still, keeping seigniorage inside central banks has brought to the forefront issues of efficiency and governance. Is seigniorage spent “wisely”? Do central banks have adequate governance standards and safeguards?

**Keeping seigniorage inside central banks has brought to the forefront issues of efficiency and governance.**

These concerns have intensified because many central banks are seeing their financial position deteriorate. On the one hand, seigniorage has followed a clear downward trend, reflecting both declining inflation and a declining demand for currency (see chart below, left). On the other hand, the cost of carrying foreign reserves has tended to rise, reflecting an expanded accumulation of reserves (see chart below, right). Such trends have led to sustained losses and negative capital

in many central banks, triggering intense technical and political debates about the need for (as well as extent and modalities of) central bank recapitalizations.

### Generating and allocating seigniorage

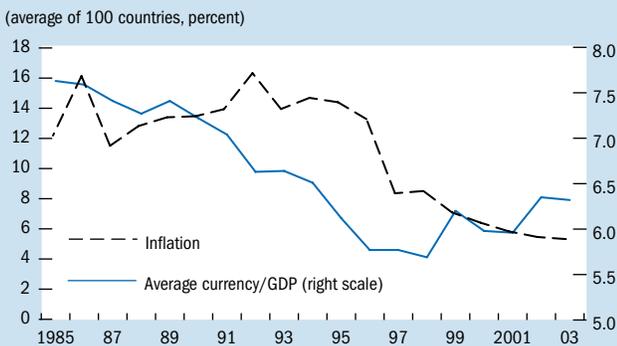
An empirical analysis of the 2003 audited financial statements of over 100 central banks shows very clear differences between “strong” central banks (those that have positive structural

profits—for example, profits adjusted for valuation gains and other nonrecurrent income and expenses) and “weak” central banks (those with negative structural profits).

Despite generating higher seigniorage through looser monetary policies (higher inflation), weak central banks found themselves in worse financial condition, reflecting much higher operating expenditures and larger nonperforming assets. At the same time, despite their negative profitability and capital, these weak central banks transfer, on average, nearly as many dividends as strong central banks; accumulate foreign assets at a higher rate than strong central banks; and

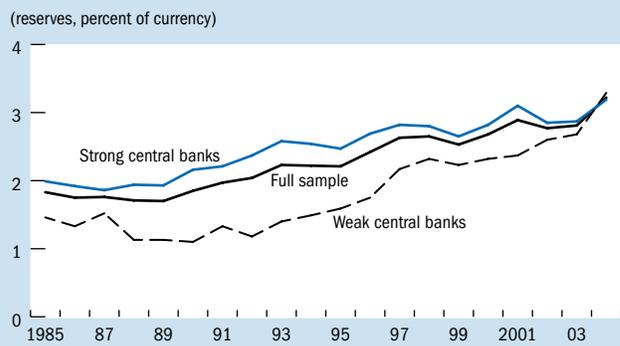
### On the decline

Over the past nearly two decades, declining inflation and demand for currency have kept seigniorage on a clear downward trend.



### Rising reserves, ballooning costs

While seigniorage has been declining, the cost of holding reserves has tended to rise, reflecting a sharp growth in reserves.



provide more financing to governments. Given these constraints—and in sharp contrast with strong central banks—weak central banks lose capital.

These findings, on the whole, suggest that independence and governance are both major issues for many central banks. Faced with generally soft budget constraints (a product of large and expandable seigniorage revenues) and despite their own efforts to limit explicit new financing to governments, many central banks still seem to be used by governments as residual sources of cheap finance. Remarkably, these same central banks also generally overspend on operating expenses. Lack of independence and lack of governance seem to go hand in hand.

### What determines operating expenditures?

An empirical analysis of central banks' operating expenditures—controlled for country size, GDP per capita, currency issue, and the provision of full-fledged bank supervisory services—predictably reflects large country size and wealth effects. Central banks in smaller and poorer countries clearly have a harder time covering their fixed costs. Once adjusted for such structural differences, the analysis still shows a wide disparity across the sample, however. The best performer spends over three times less than the group average; the worst performer spends five times more (see chart below).

The fact that weak central banks tend to have worse expenditure performance indices supports the hypothesis that these banks face acute governance issues. But strong central banks also seem to have governance concerns. Their operating expenses vary widely, are strongly related to profitability, and do not appear to be clearly correlated with broad indicators of macrofinancial performance. The analysis also suggests that many central banks may operate on the basis of a limited

perspective of public welfare. They try to fulfill demand for services as best they can, but do not question whether the marginal dollar used in such a quest would be better used elsewhere in the public sector.

### Improving central bank governance

The fact that the least independent central banks have more governance problems seems to strengthen the case for independence and should allay concerns that giving central banks more independence will lead to a free-for-all increase in their expenditures. Indeed, allowing central banks to freely manage their budget and set their wage scale is particularly critical at a time when many of them need to evolve toward a modern concept of central banking—that is, with few, but highly skilled, employees.

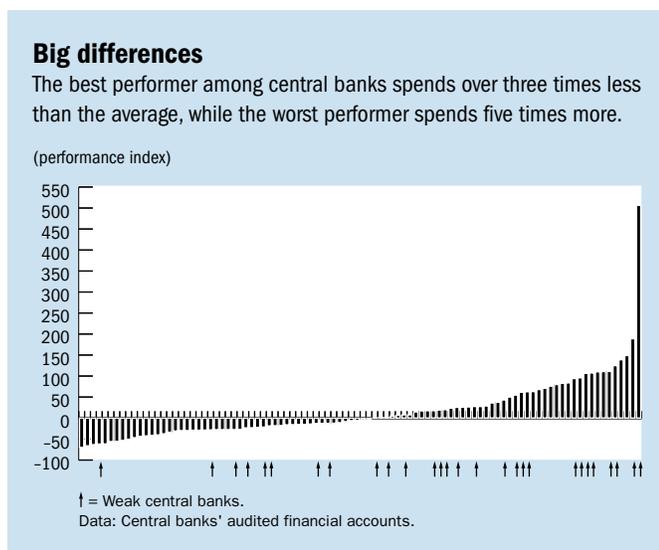
With independence, however, should come accountability, and a prerequisite for accountability is transparency. By facilitating comparisons, transparency gives central banks a clearer idea of where they stand vis-à-vis other central banks and helps them take appropriate corrective action when needed. For those central banks that do publish their financial accounts, there is much room for improvement in making them more easily accessible and understandable. For those that do not yet make their income statements public, it is, of course, high time they do so.

It might also be desirable to have governments periodically review central bank expenditures (including the cost of reserve accumulation). This would help ensure that the criteria for comparing the provision of public goods are sufficiently uniform across the public sector. New Zealand's recently introduced arrangements designate that seigniorage income belongs to the state, but a share of it (renegotiated every five years) is retained by the central bank. This arrangement provides an interesting example of the kind of systematic stock-taking opportunities that other central banks may wish to follow.

Finally, central banks need to take further steps to ensure that the services they provide are adequately priced and paid for by the users. Indeed, the high carrying costs associated with large international reserves provide some justification—at least in principle and within reasonable bounds—for central banks to consider unremunerated reserve requirements or the use of other fee-based mechanisms. ■

*Alain Ize*

*IMF Monetary and Financial Systems Department*



Copies of IMF Working Paper No. 06/58, "Spending Seigniorage: Do Central Banks Have a Governance Problem?" by Alain Ize are available for \$15.00 each from IMF Publication Services; see page 224 for ordering details. The full text is also available on the IMF's website ([www.imf.org](http://www.imf.org)).

## Tracking Chinese inflation's effects on United States and Japan

**A**round the turn of the decade, low inflationary pressures in many emerging market and industrial countries prompted some to argue that China was bringing down prices in the rest of the world by exporting cheap goods to more mature markets. More recently, as inflationary pressures have started to build up around the globe, these arguments have been turned on their head, with some asserting that demand from China is now pushing up prices in the rest of the world. What's going on? A new IMF Working Paper looks at the empirical evidence and finds some intriguing, and unexpected, linkages.

How can a country export inflation or deflation? After all, isn't inflation in any country a monetary phenomenon determined by domestic policies? The short answer is that it is theoretically possible for countries to export and import inflation or deflation, and there is empirical evidence that they do so. In fact, when there was a global system of fixed exchange rates (such as during the gold standard era), it was not uncommon to see periods of synchronized deflation in a number of countries, as falling prices in the reserve country led to falling prices in others. And, more generally, for any relatively small open economy with a pegged exchange rate, domestic inflation will tend to be determined to a large extent by inflation in its trading partners.

This phenomenon of exporting inflation or deflation can also occur for a country with a flexible exchange rate regime, provided the exporting country is large. For example, deflationary pressures could be exported directly when exports of final goods, whose prices in the domestic currency of the exporter are falling, directly lower the import price indexes of other countries. Deflation could also be exported indirectly if cheaper final goods lower prices in other countries because they adversely affect demand in those countries when producers lose markets and profits. Also, cheaper exports to third countries could affect the cost structure of enterprises in those countries, enabling them to reduce the prices of their exports. Similarly, inflation brought on by demand pressures in a country could increase imports from its trading partners, reducing domestic supply and causing inflation in the exporting economies.

A number of these arguments have been used to claim that China has exported deflation or inflation. Some said that during the boom-bust cycle of the early 1990s, China built huge excess capacity in its manufacturing sector that later caused

the price of manufactured goods to decline, causing deflation in China. With China's share in global trade increasing rapidly, this deflation spread to the rest of the world through cheap Chinese exports. As deflation in China ended in 2003 and China's import demand for various goods surged, the arguments changed somewhat. Several claimed that China was, at this time, exporting inflation because it was sucking in goods at such high rates that consumers in other countries had to pay higher prices.

### What the data show

To examine the validity of these claims, the Working Paper uses a number of progressively more complicated econometric models to investigate what happened. As a first step,

a simple autoregressive model is used to run the Granger causality test. This model and test impose minimal economic assumptions on the estimates and potentially capture both direct and indirect effects of inflation in one country on inflation in another.

When applied to China, Japan, and the United States, the results are intriguing: there is no strong evidence that inflation in China caused inflation in the United States or Japan, but there

is some evidence of the reverse. Although these reverse effects are not emphasized in the media, they should not be surprising. China's imports from the United States have been growing strongly for more than a decade. This finding is also consistent with the notion that in regimes with limited flexibility, inflation tends to be transmitted from the reserve-currency country (the United States) to other countries (such as China).

For the next step, the Working Paper uses a more sophisticated model to capture a broader picture of these economies and to explain how inflation is transmitted. Specifically, linkages among consumer price inflation, commodity and import prices, the exchange rate, and output growth are estimated jointly in a vector autoregression setting. This allows supply and demand shocks in China to have contemporaneous effects on inflation in the United States through import prices. To circumvent a typical weakness of such models—the ordering of the variables affects the results—two separate models are estimated, one of them biased toward finding a positive effect of inflation in China on inflation in other countries.

The results of this model confirm the earlier results. There is no significant effect of inflation in China on U.S. or Japanese inflation. In fact, whereas inflation in the United States responds positively to higher import prices and higher

**There is no strong evidence that inflation in China caused inflation in the United States or Japan, but there is some evidence of the reverse.**

output growth, and its import prices respond positively to increases in world commodity prices, these import prices do not respond to inflation in China. Similarly, inflation in China explains only about 5 percent of the variation in U.S. import and consumer prices.

On the other hand, there is some evidence that U.S. economic activity affects China: shocks to output in the United States are found to affect inflation in China, and variance decomposition suggests that more than 10 percent of the variation in Chinese inflation is explained by changes in U.S. output growth. The results for Japan are broadly similar.

These models have one potentially important drawback, however. They may underestimate the current effect of inflation in China on inflation in the United States and Japan because the data span two decades, including the period when trade between China and these two countries was relatively small. To address this potential problem, the Working Paper also used a variable coefficient model, which allows the coefficient that captures the effects of Chinese inflation on other countries to change across time as the trade volume between these countries changes. An increase in this coefficient over time, and as trade volumes grow, would be expected, reflecting strengthening links between these countries' inflation rates.

Contrary to expectations, however, taking into account the increasing trade between China and its trading partners does not change the conclusions of the simpler models. There are only a few instances of inflation in China having statistically significant effects on the United States and Japan, and they are short-lived (see chart). Again, inflation in the United States appears to have a stronger impact on inflation in China.

**There do appear to be stronger and possibly growing sector-specific linkages between prices in China and those in the United States and Japan.**

**What's going on**

Why is there scant evidence of a growing link between inflation rates as China's trade volume increases? One possibility is that the effects of the various subcomponents of this relationship are canceling each other out. For example, over 2003–04, Chinese prices of household appliances declined, possibly depressing global prices for these goods, while food prices in China—which were affected by drought as well as by domestic policies—increased.

To test this hypothesis, a stochastic coefficient model was run using the components of the consumer price inflation (CPI). One component examined is food inflation, and the other—an important export category for China—is household furnishings, including appliances. The results suggest that changes in the prices of food and household furnishings in China do indeed explain a part of the corresponding U.S. prices. The results on household furnishings are less clear, possibly owing to the shorter sample period. Nevertheless, they do point to an increase in the link between price changes in China and the United States. These results also provide some support for the hypothesis that components of the CPI have been negating each other. Specifically, in 2003, as food prices pushed up the CPI, prices of household furnishings worked in the opposite direction. Results for Japan are again broadly similar.

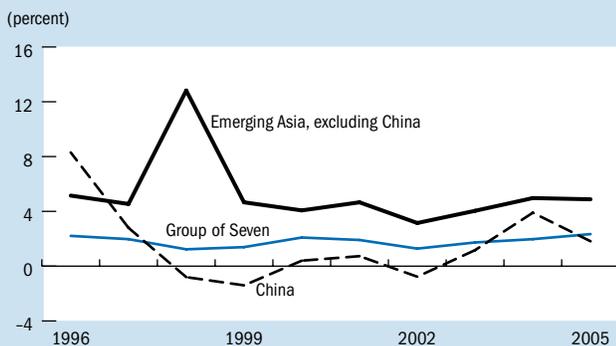
In sum, there is only limited evidence at the aggregate level that inflation in China has led to price changes in the United States and Japan. And there is some evidence that U.S. inflation has had an impact on Chinese inflation—consistent with the literature that argues that inflation is propagated from the reserve-currency economy to other economies. In either case, the effect is short-lived. At a more disaggregated level, though, there do appear to be stronger and possibly growing sector-specific linkages between prices in China and those in the United States and Japan.

More broadly, however, it is other factors—notably common global shocks (for example, oil price developments) and the similar behavior of central banks (in particular, their shared commitment to keep inflation low)—that offer more likely explanations for similarities in inflation patterns among the world's major economies. ■

*Tarhan Feyzioğlu*  
IMF Asia and Pacific Department

**Tracking inflation**

There is no clear evidence to date that Chinese inflation is influencing inflation rates elsewhere.



Data: IMF, *World Economic Outlook*.

Copies of IMF Working Paper No. 06/36, "Does Inflation in China Affect the United States and Japan?" by Tarhan Feyzioğlu, are available for \$15.00 each; see page 224 for ordering information. The full text is also available on the IMF's website ([www.imf.org](http://www.imf.org)).

## China explores options for improving monetary policy

Considerable attention has been devoted to China's monetary policy and the benefits that greater exchange rate flexibility would bring—in particular by allowing a truly independent monetary policy. But the debate should not overshadow the significant modernization that has already taken place in how the People's Bank of China (PBC) conducts monetary policy. A recent workshop, organized at the invitation of the PBC, discussed options for the central bank to formalize its monetary policy framework and improve its monetary operations, drawing on central bank expertise from around the world.

Since it began performing the functions of a central bank in 1984, the PBC has moved gradually to a monetary strategy anchored on intermediate monetary targets. The PBC aims to keep inflation low and growth high, and it announces targets for the growth of narrow and broad monetary aggregates—M1 and M2—in line with these objectives. The PBC has also developed an array of monetary policy instruments similar to those used by the most advanced central banks. In particular, it uses reserve requirements and open market operations, including to sterilize foreign exchange inflows. The use of open market operations has been made possible, in turn, by the development of nationwide foreign exchange and money markets.

China's monetary policy framework appears broadly appropriate at this stage of its economic and financial market development but, over time, its effectiveness may diminish as the economy's sophistication increases. With this in mind, the PBC asked the IMF to organize a workshop in the context of the Joint China-IMF Training Program. The workshop, *Determining the Intermediate Target for Monetary Policy: Practical Issues*, sought to distill best practices and discuss their relevance for China. Experts from the central banks of Israel and Chile and from the European Central Bank (ECB) reviewed the building blocks needed for a robust monetary policy decision-making process in an economy moving toward a market-based monetary framework, while IMF and PBC experts discussed China's monetary policymaking and the challenges ahead.

### An international perspective

In addressing how monetary management is handled in a country with an open capital account and large capital inflows, Barry Topf (Bank of Israel) observed that efforts to pursue an independent monetary policy while simultaneously maintaining a fixed exchange rate and unrestricted capital flows are unlikely to be successful. When capital inflows become substantial, they can pose a serious challenge to monetary policy or the pegged exchange rate. If the exchange rate



On the dais are panelists (from left) Barry Topf (Central Bank of Israel), Bernard J. Laurens (IMF), Yan Wei (People's Bank of China), Rodolfo Maino (IMF), Klaus Masuch (ECB), and Igal Magendzo (Central Bank of Chile).

peg is given priority, price stability can be endangered; and if the exchange rate is allowed to appreciate, there are implications for competitiveness and economic activity. Most countries have responded to the dilemma with a combination of steps that generally include greater exchange rate flexibility.

Does official intervention in the foreign exchange market have a role in the transition toward greater exchange rate flexibility? Intervention, Topf noted, can have a number of goals, including adjusting the level of reserves, trying to change the exchange rate's level or volatility, or responding to disorderly markets. The last two are important to the monetary regime and the central bank's role in monetary policy. In advanced and some emerging market economies, the trend has been to intervene less. Intervention, however, has remained an important instrument for many developing countries that still use the exchange rate as an intermediate target, and exchange controls make its use more effective. In Israel, intervention gradually became less effective and more costly. Eventually, exchange rate flexibility, and a credible monetary policy with a different nominal anchor (an inflation target) obviated the need for intervention. Avoiding moral hazard and ensuring the efficient assignment of risk were crucial features of the shift from a pegged exchange rate, but these could be established only after the markets tested the authorities' commitment.

Igal Magendzo (Central Bank of Chile) stressed that communication and transparency are needed to bolster the accountability and perceived legitimacy of independent central banks and strengthen their operational effectiveness by clarifying agents' understanding and expectations of monetary policy, especially when the policy relies on open market operations. Effective communication allows the central bank

to make its objectives clear, inform outsiders about how policy decisions are made, and disseminate information.

Klaus Masuch (ECB), describing the importance the ECB gives to *monetary analysis*, underscored that monetary growth and inflation are closely related in the medium to long run. This relationship means that monetary policy needs a nominal anchor separate from the variables used to construct short-term inflation forecasts. Thus, monetary analysis underpins the medium-term orientation of the ECB's monetary policy as the "second pillar" of its framework, although no quantitative targets are assigned to monetary aggregates. Other indicators considered within *economic analysis* (including projections) are a broad range of price and cost indicators, aggregate demand and its components, labor market conditions, fiscal developments, financial market conditions, and private sector expectations based on financial market prices and surveys.

Asset prices also need to be considered because they are relevant to the objective of price stability over the medium term, Masuch said. Thus an overly expansionary monetary policy may initially show up in high money and credit growth and asset price inflation—not in higher inflation of goods and services prices. This is another reason why thorough monetary analysis is vital. Ultimately, a medium-term orientation and a focus on money and credit aggregates allow the central bank to respond to asset price developments in a way that best contributes to price stability over longer horizons.

### The options

In China's experience, PBC experts said, the correlation of M1 and M2 growth with economic growth and inflation has not been stable over time, and the objectives for growth of the monetary aggregates have frequently been missed (see table). According to the IMF experts, international experience has also shown that anchoring monetary policy on money targets often lost its effectiveness as a result of domestic and external financial liberalization.

It is difficult, the PBC experts emphasized, to assess how fast China should move to make interest rates an intermediate or operating target for monetary policy. The discussions highlighted the adverse effect of excess liquidity and the segmentation of the money market on the development of a robust benchmark yield curve. This, together with the limited scope that banks have to carry out operations on a purely commercial basis, has hindered the effectiveness of the interest rate as an instrument of monetary policy. As a result, the PBC's market-based monetary policy actions currently have limited effects on the cost of funds, and the PBC has had to rely on reserve requirements to a greater extent than other major central banks. It has also resorted to moral suasion to provide

### Missing the targets

The objectives for growth of monetary aggregates have frequently been missed.

| Year | M1 growth <sup>1</sup><br>(percent) |        | M2 growth <sup>1</sup><br>(percent) |        |
|------|-------------------------------------|--------|-------------------------------------|--------|
|      | Target                              | Actual | Target                              | Actual |
| 1994 | 21                                  | 26.2   | 24                                  | 34.5   |
| 1995 | 21–23                               | 16.8   | 23–25                               | 29.5   |
| 1996 | 18                                  | 18.9   | 25                                  | 25.3   |
| 1997 | 18                                  | 16.5   | 23                                  | 17.3   |
| 1998 | 17                                  | 11.9   | 16–18                               | 15.3   |
| 1999 | 14                                  | 17.7   | 14–15                               | 14.7   |
| 2000 | 15–17                               | 16.0   | 14–15                               | 12.3   |
| 2001 | 13–14                               | 12.7   | 15–16                               | 14.4   |
| 2002 | 13                                  | 16.8   | 13                                  | 16.8   |
| 2003 | 16                                  | 18.7   | 16                                  | 19.6   |
| 2004 | 17                                  | 13.6   | 17                                  | 14.6   |

<sup>1</sup>Measures of the money supply: M1 includes currency and checking accounts; M2 includes M1 plus savings deposits, certificates of deposit, and money market funds.  
Data: Michael Geiger, 2006, "Monetary Policy in China (1994–2004), Targets, Instruments and Their Effectiveness," Wurzburg Economic Papers No. 68.

guidance for credit growth and its sectoral allocation—a practice no longer used by major central banks.

IMF experts pointed out that in a low-inflation environment, many central banks have abandoned monetary targeting. As inflationary pressures diminish, the informative role played by monetary aggregates also declines, even when they have a clear long-run relationship with inflation. This experience argues for a monetary targeting strategy that is not overly rigid and that monitors macroeconomic indicators to gauge the appropriateness of correcting a deviation from initial assumptions. At the same time, there are good reasons to monitor money and credit aggregates, without giving these indicators the status of intermediate targets.

Finally, in implementing monetary policy, the IMF experts agreed that if a policy interest rate is to be set as an intermediate or operating target, China will need to decrease the level of excess reserves in the banking system. The aim would be to provide banks with incentives to borrow from each other in the interbank market and then use a short-term PBC rate as a policy signal. Greater reliance on interest rates would not only strengthen the effectiveness of China's monetary policy but also ensure a more efficient allocation of financial resources and savings and help prevent the buildup of risks in the financial sector. ■

Bernard Laurens and Rodolfo Maino  
IMF Monetary and Financial Systems Department

This article is partially based on a forthcoming IMF Working Paper, "China: Developing Effective Strategic and Operational Monetary Frameworks."

## Mekong countries: regional integration holds key to accelerated development

**H**ow to tackle uneven development within Southeast Asia has been a hot topic among policymakers in the Association of Southeast Asian Nations (ASEAN) in recent years and the focus of several regional initiatives. Although Cambodia, the Lao People's Democratic Republic, and Vietnam—the three Mekong countries—have made impressive strides since launching their economic reform programs in the 1980s and early 1990s, more needs to be done to help these less developed economies catch up with their more advanced neighbors. There is broad understanding that this catch-up is important not only for the Mekong countries themselves but also for efforts to accelerate economic integration in the region. As Cham Prasidh, Cambodia's Minister of Commerce, observed, "We are like wagons hooked to a fast-speed train . . . if our wheels are not round like the ASEAN-6, we will bounce on the rails or just derail. When we derail, the locomotive will derail, too."

Can regional integration help quicken the pace of development in the Mekong countries? A high-level conference in Cambodia on June 26–27 took up this question. The conference, organized by the ASEAN Secretariat, the IMF, and the royal government of Cambodia, brought together government officials from the three Mekong countries, neighboring countries, and development partners, as well as officials from multilateral financial organizations, businesspeople, and academics.

Cambodian Prime Minister Samdech Hun Sen set the tone, stressing the potential benefits of regional development and the vital role played by cooperation. "Our past experiences,"

he said, "have taught us that the lack of cooperation among nations in the Mekong region has made the region vulnerable to external shocks and mired in poverty." The lesson to be learned from this, he added, is the value of greater integration and the resilience that can be gained through regional development. In their opening remarks, IMF Deputy Managing Director Takatoshi Kato and ASEAN Secretary-General Ong Keng Yong echoed these sentiments.

### Recipe for progress

In the view of Suiwah Leung (Professor, Australian National University's Crawford School of Economics and Government), if the Mekong countries are to reach their potential, they must complete the transition to more efficient market-oriented economies. Market orientation is also essential if these economies are to compete in an increasingly integrated and globalized economic environment.

What specific steps are needed? According to Leung, the key reforms are improving legal and regulatory systems, developing stronger banking and financial sectors, and reducing the role of the state in the economy. Leung also pointed out the importance of reducing the costs of services, such as telecommunications, transport, and electricity, to enable the Mekong economies to increase foreign direct investment inflows and participate in the production networks of East and Southeast Asia. Although most participants subscribed to this thesis, many also emphasized that major investments would be needed in infrastructure and human resources, especially in education and health care. Such investments—important for any country—are particularly critical in the Mekong countries, they argued, given the legacies of war and upheaval. There was a clear consensus that corruption in all its forms must also be tackled if these economies are to attract private investment on any scale.

A paper by Martin Stuart-Fox, Emeritus Professor of History at the University of Queensland, Australia, explored the extent to which political culture might also influence a country's pace of development. He argued that economic development potentially faced more obstacles in cultures where patronage and hierarchy were more deeply rooted—such as in Cambodia and Lao P.D.R.—because there was an inherently higher risk of resistance to policies and programs that ben-



The international community has had an important role to play in the Mekong region's development. Japan is providing funds for the construction of this bridge in Ha Long, Vietnam.

efit the nation-state but threaten the ruling party's monopoly on power.

Stuart-Fox's thesis prompted a vigorous debate, with a number of participants contesting the assertion that certain cultures were more prone to political patronage or less conducive to economic development. Stuart-Fox agreed that such an outcome was not preordained. He cited the example of Thailand, a country with a cultural background similar to that of Cambodia and Lao P.D.R. but one that has been successful in encouraging development. However, he argued that the first step to overcoming the obstacles to development is to recognize the potential problems that a culture of political patronage poses.

### Integration and its rewards

The role of regional integration and cooperation in advancing reform and development in the Mekong countries was a prominent topic of discussion. Fukunari Kimura, Professor of Economics at Japan's Keio University, highlighted the substantial benefits that less developed economies could draw from regional integration. His research suggested potentially big payoffs for the "ASEAN latecomers," as production processes in the manufacturing sector can be efficiently divided into many segments, with labor-intensive segments located in those countries that can offer inexpensive labor *and* low "service link" costs that facilitate cross-border integration with other production segments. Implemented effectively, regional integration could greatly accelerate the capacity of the Mekong economies to participate in the regional production networks that are a growing feature of the East Asian economy.

Another important integration issue is the role of bilateral and regional trade agreements. Conference participants had a lively exchange of views on this topic, and opinions were divided on whether the benefits outweighed the risks when it came to the contribution these agreements made to the region's development. Some participants, such as Kimura, suggested that the risks associated with the proliferation of regional trade agreements were rather low—mainly because most intraregional trade is already taking place at very low tariff levels. He also discounted the dangers posed by the oft-cited "spaghetti-bowl" phenomenon, where overlapping trade arrangements result in excessively complex and opaque trade regimes.

Others were more cautious. Fred Burke, Managing Partner of Baker & McKenzie in Ho Chi Minh City, argued that the proliferation of trade agreements was imposing significant costs on the private sector. IMF economist Patrizia Tumbarello also cautioned that the proliferation of regional trade agreements could lead to an undesirable diversion of trade unless



HOANG DINH NAM/ATF PHOTO

An elementary school in Phnom Penh, Cambodia. In addition to key reforms, the region would benefit from major investments in human resource development, including education.

"Asian countries continue to complement regional integration with most-favored-nation-based trade liberalization."

### Regional and global partners

What was not contested was the importance of ASEAN's evolution in recent years—notably, the greater involvement of newer member countries and the strong links being established with China, Japan, and Korea. Chalongsob Sussangkarn, President of the Thailand Development Research Institute, emphasized the importance of accelerating economic integration within ASEAN. He said that unless further progress is made on this front, "there is a real danger that each of the ASEAN economies will become marginalized within a large Asian region dominated in size by China and India and dominated technologically by Japan and South Korea." His view found wide support among participants from the region.

There was broad agreement, too, that the international community had an important role to play in supporting the Mekong region's development. Continued financial and technical support for much-needed investments in education, health care, and infrastructure will clearly be one priority. Greater access to markets, technology, and know-how will also be critical, as will capacity-building efforts, to help the Mekong countries participate effectively in the Asian region. However, there was a plea from participants for greater donor coordination of the vast array of initiatives that are springing up to develop the Mekong region. ■

*Benedict Bingham*  
IMF Asia and Pacific Department

For more information on the conference, see Press Release No. 06/145 on the IMF's website ([www.imf.org](http://www.imf.org)).

## Addressing the challenges of scaled-up aid

Efforts by the international community to accelerate progress toward the Millennium Development Goals received a boost in June 2005, when the heads of government of the Group of Eight industrial countries pledged to increase aid, especially to Africa. But the prospect of more aid also highlights the importance of donors delivering aid efficiently and of recipients using it effectively. To discuss these challenges, the IMF and the United Kingdom's Royal African Society organized a forum in London on July 4. The panelists were Tony Venables (U.K. Department for International Development), Elliott Harris (IMF), and Christopher Eads (Economist Intelligence Unit).

Leading off, Venables pointed to evidence that aid can be particularly effective in countries with low per capita incomes and good policy environments, as well as in countries just emerging from conflict. But many countries receive less aid than they can use effectively, whereas other countries are "overaided." Not only can aid fund poverty reduction programs and investment in economic infrastructure, it can also help build capacity if delivered in ways that strengthen public administrations and institutions, and make public resource management more transparent. Venables stressed the importance of careful macroeconomic management when aid is increasing, particularly to limit the risk of Dutch disease, and the need to guard against becoming overly dependent on aid.

Countries face four key issues in managing increased aid, Harris said: absorbing and spending the aid effectively; dealing with unpredictable and volatile aid flows; ensuring that additional aid-financed spending is fiscally sustainable, particularly as aid flows taper off; and using the new "borrowing space" created by debt relief prudently to avoid renewed debt distress. The appropriate macroeconomic response to additional aid requires careful coordination of fiscal, monetary, and exchange rate

policies, but this is often complicated by unpredictable or volatile aid disbursements.

In all of these areas, Harris said, the Fund can offer policy advice and technical assistance and help countries develop alternative macroeconomic scenarios for preserving stability and growth as aid increases.

### Budget support and its pitfalls

Eads observed that donors are increasingly providing general budget support—rather than earmarked aid and project financing—because it can be better aligned with recipients' poverty reduction priorities and has lower transaction costs. However, donors also attach greater importance to the political context of budget support recipients. Political developments that are considered unfavorable are more likely to lead to an interruption of the flow of budget support, introducing additional uncertainty into the aid relationship.

Eads argued for mutual agreement on the conditions under which donors would reconsider their provision of general budget support.

### Accountability needed

Speakers cautioned donors against scaling up aid under a "business as usual approach" that would repeat past mistakes. If recipient countries do not improve their policy environments and institutions and strengthen governance, more aid might fuel additional capital flight or be wasted. Mutual accountability between recipients and donors should be the foundation of an aid relationship based on clearly defined rules. Donors need to listen more closely to those they are trying to help in poor countries and, above all, focus on results to ensure that their assistance is having the intended effect at the local level—a necessary condition for it to have its intended effect of contributing to development and poverty reduction nationally. ■

Elliott Harris

IMF Policy Development and Review Department



Aid is important for financing education and thereby supporting human capital development.

Emmanuel Kwittemy/REUTERS



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Graham Hacche  
Senior Advisor

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