

INTERVIEW WITH ANTOINETTE SAYEH

Africa Strives to Preserve Recent Economic Gains

Facing high food and fuel prices, some African countries are in danger of seeing the progress achieved in recent years slip away, Antoinette Sayeh tells the *IMF Survey*.

But if African governments pursue appropriate policies, they can limit the impact of the price shocks on the poor and, at the same time, tackle their long-run structural problems, says Sayeh, who recently assumed the post of Director of the IMF's African Department after serving as Liberia's Finance Minister. The IMF can help by providing policy advice, technical assistance, and concessional financing to the continent, Sayeh adds.

IMF Survey: For the past five years, Africa's economies have been making good progress. What is the Fund's view of the immediate economic outlook for Africa?

Sayeh: Africa is coming out of a very strong period of performance. From 1995 to 2007, we saw growth at an average of 5 percent in Africa underpinned by good policies in most countries. Africa

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Antoinette Sayeh, the IMF's newly appointed African Department Director.

IMF photo

IMF Clarifies Surveillance Process

The IMF has published new procedures on how it will monitor member countries' economic policies, clarifying in particular how it will discuss with countries exchange rate issues and their impact on the global economy.

The new procedures are designed to facilitate the implementation of a landmark decision adopted by the Executive Board last year. This decision strengthened the IMF's surveillance of the economic policies of its member countries by placing external stability at the heart of IMF surveillance, and promoting greater focus and candor in its operations (see box).

These additional steps reinforce the effectiveness of surveillance at a time of increasing strains in the global economy, with high commodity prices, slowing world growth, and continuing global imbalances.

The IMF has made good progress in implementing the 2007 decision. Discussions between mission teams and

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IMF Approves \$750 Million Loan for Georgia

The IMF and Georgia have agreed on a \$750 million loan package to mitigate the adverse economic and financial impact of the country's recent conflict (see page 148).

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Pornchai Kittiwongsakul/AFP

The IMF has put in place procedures designed to reinforce the effectiveness of surveillance.



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Blanchard Appointed IMF Chief Economist



Courtesy of O. Blanchard

Olivier Blanchard

Olivier Blanchard, Professor of Economics at the Massachusetts Institute of Technology (MIT), became Director of the IMF's Research Department on September 1. Blanchard spoke to the *IMF Survey* about the global economy and the IMF's evolving role.

IMF Survey: What are the current challenges facing the global economy?

Blanchard: Behind the current crisis are two major shocks: The oil and commodity shock and the financial shock. The effects of the first have been much smaller than one would have feared based on similar shocks in the 1970s. The effects of the second have been much bigger than most of us expected when the crisis started.

In retrospect, we should not have been so surprised. Workers are much weaker than they were in the 1970s, and have no choice but to accept the real wage cuts implied by higher oil prices: this explains why the effects of the first have been so limited. In the financial sector, leverage is much higher than it used to be: this explains why the bad subprime loans have led to such enormous financial effects.

What makes the crisis so complex is the combination of these two shocks. I believe we have a good sense of how to handle each one separately. But the combination is tougher. The lower interest rates which would help fight the financial crisis run against the risk of inflation triggered by the oil shock. And one can think of many bad scenarios where low activity makes the financial crisis worse, and macroeconomic policy has little room for maneuver.

At the same time, one can easily think of more optimistic scenarios, and I actually see them as more likely. If the price of oil stabilizes, I believe we can weather the financial crisis at limited cost in terms of real activity. And if, for example, the price of oil returned toward \$100—not a crazy scenario, as few of us understand how it got much above \$100 in the first place—then inflation pressure would rapidly subside, and I would be even more optimistic.

IMF Survey: How do you see the role of the IMF evolving?

Blanchard: The IMF can and must play at least three roles. First, provide advice to countries, or groups of countries, about appropriate macroeconomic policies. The rich countries may not need it very much, although it is often useful to remind them politely of basic economic principles. But, even for them, the current crisis shows the complexity of the issues and of the optimal policies.

Second, make it easier for countries in macroeconomic trouble to borrow by providing them with commitment devices, namely adjustment plans. While this role has waned recently, I am afraid some countries will get in trouble again, and the need will not go away.

Third, help policymakers coordinate policies, if only through better exchange of information and better understanding of policy intentions. There is no magic number—7, 8, 24, or any other—for the right-size G-group meeting; it all depends on the issue at hand. The Fund seems to provide a natural environment for such flexible-sized, multilateral discussions, virtual or physical.

IMF Survey: What is your background?

Blanchard: I came from France in 1973 to start a Ph.D. in economics at MIT. I intended to specialize in development but, soon after I arrived, I realized development economics, as a field, was barely alive, and the action was in macroeconomics. I have been working in macroeconomics ever since, at Harvard from 1977 to 1982, and at MIT since then. I look forward to engaging with the issues faced by the low-income members of the IMF. ■

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Exchange rate surveillance

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member governments are now better focused on how members' economic policies impact the stability of their economies and of the economies of their partners, as mandated under Article IV of the IMF's Articles of Agreement. But progress has been hampered at times by technical difficulties in assessing exchange rate equilibria, and the frankness called for in some discussions of exchange rates has proved a sensitive matter.

The IMF has now issued a paper that provides additional guidance to help overcome these difficulties. The new procedures will help ensure that countries in similar circumstances are treated in a similar fashion, and will also improve the dialogue between member countries and the Executive Board.

The paper clarifies a number of concepts relating to external stability, building on the staff's first year of experience with implementing the decision in different country cases.

So far, arriving at definitive findings about exchange rates (for instance, about a possible fundamental misalignment) has proved challenging. In the past year, staff and management have had intensive discussions with several members for whom such findings are being considered. These discussions were very useful, in part because they focused attention on the

appropriateness of exchange rate levels and regimes—topics that previously lacked such a high profile—and allowed staff and the authorities to carefully consider each other's views.

But because this dialogue has taken place outside the Executive Board, the IMF's Executive Directors and the member countries they represent have not had a chance to listen to the arguments of the country concerned or present their own points of view.

In light of this experience, the paper lays out procedures to formalize a more intensive dialogue with member countries. In particular, the IMF's Managing Director is proposing the use of "ad hoc consultations" as a complement to regular Article IV consultations whenever the IMF has significant concerns that a member country may not be observing one or more of the four principles spelled out in the 2007 decision or that its exchange rate may be fundamentally misaligned—even if this misalignment does not stem from the active use of exchange rate policies (for instance, when the exchange rate is floating). An Executive Board decision will be required before initiating the ad hoc consultation.

There are several advantages to this procedure:

- First, it will ensure that the voice of the international community is also heard

(through the involvement of the Board), that the nature of the discussions is well understood, and that the process is conducted in an evenhanded fashion.

- Second, it will provide a clearer opportunity for member countries to frame and present their own views comprehensively and, if they deem it desirable, to adjust their policies.

- Third, it will help the IMF reach final conclusions on specific findings, such as whether a country's exchange rate is in fundamental misalignment or whether a member is in nonobservance of one or more of the four principles.

An ad hoc consultation would in no way prejudice the final conclusions, nor would it mean that the underlying concerns over the exchange rate would only—or best—be resolved by a change in the nominal exchange rate.

"The exchange rate must be seen against the background of the entire economic situation of a country and against the evolving global and regional backdrop; and misalignment can often be just a signal of a policy inconsistency that is best resolved without a change in the exchange rate," said Mark Allen, Director of the IMF's Strategy, Policy, and Review Department. ■

*Jean-Francois Dauphin
IMF Strategy, Policy, and Review Department*

The 2007 Decision on Bilateral Surveillance

By crystallizing a shared vision of what bilateral surveillance is about, the 2007 decision was intended to ensure that the policy dialogue between the IMF and its member countries is more focused, more candid, and more effective overall.

The decision provides a consistent conceptual framework to assess how members' economic policies impact the stability of their economies and that of the global monetary system. It also sets out four principles to guide members in the management of the exchange rates for their currencies. They are:

- A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.
- A member should intervene in the exchange market if necessary to counter disorderly conditions, which may be characterized by, among

other things, disruptive short-term movements in the exchange rate of its currency.

- A member should take into account in its intervention policies the interests of other members, including those of the countries in whose currencies it intervenes.
- A member should avoid exchange rate policies that result in external instability.

The decision also lists seven indicators that would require thorough review by the IMF and might indicate the need for discussion with a member country. These include situations when the exchange rate is fundamentally misaligned—that is, when the underlying current account is not in equilibrium, which may be due to exchange rate policies but could also be caused by unsustainable domestic policies or market imperfections.

Sayeh interview

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now has to preserve that achievement as the basis for making progress toward the Millennium Development Goals.

Overall growth in sub-Saharan Africa is expected to dip to 6 percent in 2008 before rebounding to 6½ percent in 2009, but with a somewhat larger difference between oil exporters and oil importers. On the inflation front, of course, we have seen an acceleration in prices this year. We think that we will get into double-digit inflation during the course of 2008, but if countries pursue appropriate policies, we expect that rate to decelerate below 10 percent in 2009.

IMF Survey: Rising food and fuel prices could potentially undo the progress that Africa has made in recent years. How is the IMF responding?

Sayeh: All countries now face a more difficult external environment. Some African countries are in danger of losing the progress and the momentum that they've made these past years. The poor are particularly affected, of course, by increases in the price of food, with food constituting some 50 percent of the budget of most poor people in Africa. So it's a major concern to us that governments are able to preserve the gains that they've made and are not tempted, as is often the case, to resort to populist policies to respond. The Fund has been very much at the forefront in advising our member countries about the appropriate policies to adopt to help in the short term to limit the impact on the poor, and in a way that preserves their ability to tackle the long-run structural problems that most African countries still have to address. We have provided financing, we have also provided advice, and we'll continue to provide technical assistance as well to help African countries cope with a very difficult environment.

IMF Survey: Many countries in Africa see the lack of adequate infrastructure as a key impediment. What advice does the Fund offer to countries wanting to explore debt financing and support from emerging creditor countries, such as China?

Sayeh: We agree with countries that it is important to find ways of financing infrastructure. It's a serious and very important constraint to accelerating growth in many African countries. We welcome new partners and new aid providers such as China. We want to work with African countries and China, and other new providers of aid, to make sure that the financing made available to African countries is, for the most part, concessional and helps all of us to protect the gains we've made under the HIPC [Heavily Indebted Poor Countries] process in dealing with the unsustainable debt that most African countries faced. We want to look, on a case-by-case basis, at how particular infrastructure projects support growth and fit into the overall macroeconomic framework, and then ensure that financing for those projects is sustainable.

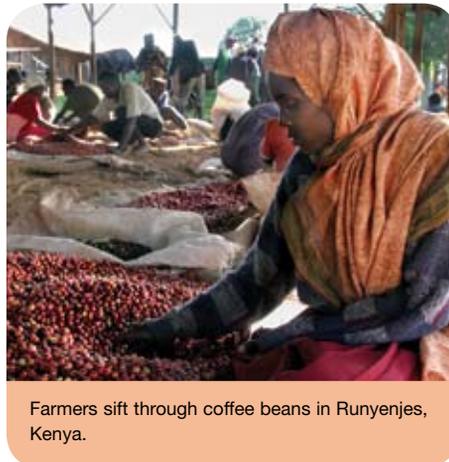
IMF Survey: As a former finance minister for a country emerging from civil strife, how will your experience shape your view of the IMF's priorities when it comes to dealing with fragile states?

Sayeh: I think some of the most critical characteristics of fragile states are the fragility of the peace in those countries, the absence of capacity, and the need for quick results. The Fund can do a lot to help with all of those challenges. The lack of capacity can be addressed with technical assistance that we can provide, including advice to help governments craft a medium-term reform strategy to deal with some of the challenges in a post-conflict environment, so that they are able to respond quickly and make visible results obvious to the average person, which is important in those environments. So how the Fund works with governments and other partners to accelerate growth and facilitate the resumption of private sector based activities is extremely important. And, of course, with respect to the inherited debt that many fragile coun-

tries have, finding a more coordinated way of dealing with the challenges of clearing long-standing arrears and getting access to debt relief is also an important challenge. The IMF has been discussing and looking at the instruments we have to help respond to those challenges with our fragile member states and we will continue to work on those issues.

IMF Survey: The IMF continues to provide a lot of technical assistance to Africa. How effective is this work?

Sayeh: The IMF does provide significant technical assistance. Of the total technical assistance provided by the Fund, some 38 percent goes to African countries. Technical assistance, of course, is only productive when it's provided in a context of strong demand for such assistance, as well as a strong commitment to using the results of technical advice. In that context, we're certainly looking at our capacity-building effort in the Fund to make sure that what we do in providing technical assistance is not supply driven—as it has been, at times in the past—and to make sure that countries really are committed to moving forward with the advice that we provide. Technical assistance is extremely important in the context of several challenges in African countries: on the one hand, a fragile state just emerging from conflict with very little capacity of its own—and so needing assistance from the Fund on practical management of public finances and dealing with the inheritance of debt—to the more mature reformers among African countries that are now frontier emerging market countries and need a different type of assistance in understanding the links between capital flows and their financial sectors and how to manage those new challenges.



Farmers sift through coffee beans in Runyenjes, Kenya.

Evelyn Hockstein/KRT

IMF Survey: What are the key messages that you would like to convey to the Fund's African members at the IMF and World Bank Annual Meetings this fall?

Sayeh: I'm very much looking forward to my first Annual Meetings as Director of the African Department. I'll be on the other side this time and so I certainly understand many of the concerns that our African governors will be bringing to the table when we meet. First and foremost on their minds will be the impact of the fuel and food crisis, how they have responded, and how the Fund has helped them to respond. Here, we want to reiterate the advice that we've been giving African countries in terms of short-term efforts to protect the poor from the impact of the shock, and emphasize the need to make sure that the policy response is sustainable and that countries mitigate the impact on inflation by pursuing appropriate monetary policies. There will be some countries

with which we discuss possible additional financing from the Fund, and there will be other countries where we talk about the advice that we can give them in managing their own response to the crisis.

Second, we will also be talking about how to mitigate the risk to debt sustainability from borrowing to finance infrastructure and, hopefully, looking at some of the issues around debt management and the challenges of financing infrastructure.

Finally, we want to also talk about how we're positioning the Fund to respond to the needs of fragile states and how we're looking at the reform of different lending instruments to help countries deal with various shocks. To this end, we're in the process of proposing reforms to the Exogenous Shock Facility, as well as reviewing Fund instruments more generally. So we have a full agenda for the Annual Meetings, and I'm looking forward to them. ■

Africa Needs More Spending on Health, IMF Tells Accra Panel

Africa needs a significant increase in spending on health, IMF Deputy Managing Director Murilo Portugal told an international conference in Accra, Ghana.

Speaking in a panel discussion on financing health sector interventions at the Third High Level Forum on Aid Effectiveness, he noted that health spending in Africa had "only increased marginally" from an average of 1.6 percent of GDP in 2000 to 1.8 percent of GDP in 2007.

"The IMF is in favor of increasing spending for priority sectors, including health," Portugal said on September 2, adding that higher health spending is important for meeting the Millennium Development Goals, three of which are health related.

Portugal stated that public spending on health is low in low-income countries, especially in Africa, although spending totals often do not aggregate all health-related expenditure, since much health spending is off budget.

Portugal said creating sustainable fiscal space for priority spending has been a key element of the IMF's policy advice in recent years. Countries have several options for creating such space:

- Mobilizing additional domestic revenues;
- Shifting resources from less productive areas, such as untargeted subsidies or unproductive activities of the civil service;
- Borrowing additional resources; and
- Increasing external financial assistance, which is why aid predictability is so important.

Increasing health spending on its own is not sufficient to achieve better health outcomes, Portugal stated. Improved health outcomes are



Improving aid effectiveness and further scaling up development assistance are essential to meeting development goals, the IMF says.

driven by complex factors such as female education, which influences infant mortality and fertility rates. Improvements in water and sanitation are also critical for better health outcomes.

"Therefore, when we advocate additional financing for health, we should also call for adequate financing for these complementary sectors, without which our ultimate objective of improving health outcomes may remain unrealized," Portugal told the panel.

Agenda for action

Ministers from more than 100 countries and heads of international financial institutions, donor organizations, and civil society organizations from around the world attended the Accra meeting.

In months of preparation for the event, the IMF staff worked with others to help define a consensus on the meeting agenda, stressing, in particular the need for predictable aid flows.

At the end of the three-day forum, the Accra Agenda for Action (AAA) was adopted. The

AAA emphasized the importance of deepening country ownership, building more effective and inclusive development partnerships, and achieving development results and accounting for them. The forum agreed that country systems should be strengthened and used to the maximum extent, the fragmentation of aid should be reduced, and that aid should be further untied and made more transparent.

Specific commitments were made to change, over time, the nature of donor conditionality to support ownership; increase the medium-term predictability of aid; and strengthen developing-country capacity to lead and manage development strategies.

The forum also recognized that aid policies must be adapted to the specific requirements of fragile states, and committed to deepen the engagement of parliaments, civil society organizations, and other stakeholders in aid relationships.

"The IMF fully endorses the AAA and we will continue to support our member countries and the donor community in meeting the objectives laid down in the agenda," Portugal said in a statement in Accra. "Improving the effectiveness of aid, together with further scaling-up of development assistance, will be essential to helping low-income countries achieve the Millennium Development Goals."

The Accra meeting was held at the halfway point toward the 2010 target date set by the 2005 Paris Declaration on Aid Effectiveness. The Paris Declaration set 11 objectives for reforming aid delivery and management and achieving better results. ■

IMF Expertise Helps Bolster Africa's Financial Sector

Across Africa, IMF monetary and financial sector experts are helping to develop and strengthen institutions, markets, and capacity to formulate and implement sound monetary and financial policies. Positive impact from this help is reflected in stronger financial systems that support high sustained growth rates.

IMF technical assistance has also enabled cross-fertilization of skills among member countries and helped to disseminate and promote compliance with international standards. Beneficial spinoff includes increased participation of donor agencies in funding the IMF's capacity-building activities.

Supporting improved growth

The stronger financial systems complement the improved macroeconomic environment in many sub-Saharan African (SSA) countries. As noted in the IMF's *Regional Economic Outlook* for SSA, the region in 2007 experienced one of its highest growth rates in decades as real GDP expanded by about 6½ percent, fueled by growing production in oil exporters, improved credit intermediation, and rising domestic investment and productivity across the region.

Several African countries have developed financial markets that now attract institutional financial investors, and are promising candidates to become part of a second generation of emerging market countries. *Finance & Development* magazine says trends that heralded the arrival of institutional investors in emerging markets in the 1980s are visible in parts of SSA today—growth is taking off, the private sector is the key driver of that growth, and financial markets are opening up.

While solid global demand for commodities, greater flows of capital to Africa, and debt relief have helped increase resources and lift growth, impetus was also supplied by successes in stabilizing economies and implementing structural reforms, including in the monetary and financial sector. Specific areas of progress include:

- **Reducing and containing inflation.** Capacity to manage liquidity has improved and—helped by the development of monetary instruments, strengthened liquidity forecasting, and policy formulation processes—has contributed importantly to lowering trend inflation in many countries. Many SSA countries have successfully upgraded their payment and settlement systems and now have real time gross settlement, thus improving the efficiency with which central banks can manage liquidity. They have also established money and debt markets, although further progress would be desirable in the functioning of these markets.

- **Functioning of foreign exchange markets.** In the foreign exchange area, significant progress has been made in unifying



Street-side money trader in Lagos, Nigeria: The IMF helped unify the country's formal and informal foreign exchange markets.

Akintunde Akinleye/Reuters

previously segmented markets and in reducing or unifying parallel markets. Many SSA countries now have functioning interbank markets for foreign exchange, although these markets are still largely inefficient, transactions are low, and forward markets and hedging instruments such as derivatives have yet to develop.

- **Strengthened financial sectors.** Strengthened supervision and recapitalization have improved the resilience of banks to shocks and enhanced credit intermediation, although some structural weaknesses have yet to be addressed and financial systems in several countries remain underdeveloped. Although bank regulation and supervision have also improved significantly, full compliance with international standards is yet to be attained in several countries, and notable weaknesses remain in the subregions of the Economic and Monetary Community of Central Africa and the West African Economic and Monetary Union.

- **Rebuilding in post-conflict countries.** Capacity-building efforts continue to restore basic banking and payment system functions in post-conflict economies where the central bank or central monetary authorities have ceased to exist and public institutions and banks have been destroyed or severely damaged. Post-conflict countries, such as Burundi, Central African Republic, Democratic Republic of the Congo, Côte d'Ivoire, Eritrea, Liberia, and Sierra Leone, together account for about one-quarter of all IMF technical assistance to SSA.

Scaling up technical assistance

As SSA countries strengthen their financial systems and infrastructure and achieve macroeconomic stability, new challenges are emerging and IMF assistance is now focusing on financial sector

issues. Many countries need help in dealing with the liquidity impact of either donor aid inflows or those associated with high oil and other commodity prices.

Modernization of monetary policy frameworks has become a priority for many countries, and several—Ghana, Nigeria, Botswana, and Uganda—have shifted to, or expressed interest in, implementing inflation targeting (IT) regimes. The IMF is assisting countries with the requirements for adopting IT, including designing the IT frameworks, enhancing data quality, developing inflation forecasting models, and setting communications strategies.

In the banking sector, the importance of maintaining financial stability has increased the need for relatively specialized skills, and several countries are turning to the IMF for assistance on a range of banking topics, such as stress testing, the Basel II capital adequacy rules, and risk-based supervision.

The growth of capital markets and the nonbank financial institutions (NBFIs) has added another dimension to the Fund's capacity-building activities in SSA. A common feature is the growth of deposit-taking NBFIs, such as credit cooperatives and microfinance institutions. These sectors, while still small, may pose risks to financial stability, and the IMF has been supporting countries in improving their supervision and regulation, among them Benin, Burkina Faso, Côte d'Ivoire, Guinea, Senegal, and Togo.

In Botswana, Malawi, Mauritius, Namibia, Rwanda, and Swaziland, the IMF has also provided assistance related to supervisory structures, governance, and the regulatory framework for pensions and insurance. In addition, the IMF has been responding to countries' needs to strengthen regulation and risk management in securities markets, and provide advice in the management of public assets and liabilities.

Case study: Rwanda

Rwanda's economy and its financial sector all but collapsed following the 1994 genocide. In the aftermath of this conflict, the Bank of Rwanda (BNR) embarked on far-reaching reforms that included liberalizing the economy. A flexible exchange rate regime was quickly adopted, but new risks emerged for monetary management.

The BNR did not have adequate monetary instruments to cope with the large amount of foreign aid. The Ministry of Finance faced challenges issuing treasury bills for monetary policy purposes and the BNR's financial situation was weak, ruling out the use of central bank bills or remunerated deposits as monetary instruments. At the same time, there were few profitable lending opportunities for newly formed commercial banks.

In parallel with IMF financing under the Poverty Reduction and Growth Facility, the Fund provided extensive technical assistance to the BNR to build capacity in key central banking operations and support functions. Support focused on areas including monetary operations and bank liquidity management, internal audit, monetary policy research, foreign exchange operations, foreign reserve management, and banking supervision.

This support was financed by a mix of donor funding and IMF resources, and was provided from Washington and through

the IMF's African Regional Technical Assistance Center in Dar es Salaam, Tanzania, notably through the placement of long-term experts, expert visits, advisory missions, and offsite assistance in drafting financial legislation.

To date, the BNR has made good use of IMF assistance. The BNR—the main regulator and supervisor of the financial sector—has restored all its core functions, although it still faces formidable challenges, including the shallowness of the financial sector; a shortage of human capital; and the need to further strengthen institutional, legal, and judicial frameworks.

Significant progress has also been made in central bank operations, although further improvements are needed, including in bolstering the internal audit function. Even though Rwanda continues to receive IMF technical assistance in traditional areas such as bank supervision and payment systems, the focus has shifted to the nonbanking sector, improving exchange rate management, and development of interbank foreign exchange and capital markets.

Case study: Nigeria

Technical assistance was intensified after Nigeria's 2002 Financial Sector Assessment Program and has combined traditional capacity-building with targeted assistance. In particular, the IMF supported a homegrown financial sector restructuring program and helped build capacity to implement policy changes in an increasingly market-oriented economy.

In mid-2004, the Central Bank of Nigeria (CBN) started reforms to consolidate the banking system through increased capitalization and greater reliance on market-based monetary management. IMF assistance sought to minimize the risks and costs associated with the program.

IMF support focused on key elements of the consolidation program, including how to set up the institutions overseeing the process, establishing sound accounting standards to value banks' assets, dealing with banks unlikely to meet minimum capital requirements, and strengthening the CBN's legal powers to close insolvent banks.

The authorities also needed help with the legal processes for establishing an asset management company to minimize the budgetary costs of liquidating some banks, and with reforming the supervision of consolidated banks. In addition, the IMF helped unify the foreign exchange markets, enhance the balance sheet position of the central bank, and strengthen the CBN's capacity to build a monetary policy framework and intervene in the foreign exchange markets.

Although challenges remain in maintaining bank soundness, the authorities concluded the banking consolidation program within the planned time frame. The formal and informal markets for foreign exchange have been successfully unified, while the other projects have achieved varying degrees of success. ■

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Euro Marks Milestone as Currency Union Faces Slowdown

Ten years ago, heads of state of the European Union (EU) gave the go-ahead for the third stage of Economic and Monetary Union (EMU), approving the introduction of the euro in 11 EU member states on January 1, 1999.

Since then, four more EU member states have adopted the currency, and the Slovak Republic is set to follow at the beginning of 2009.

Distinct success

On the occasion of its annual review of the euro area's economic policies, the IMF's Executive Board hailed this anniversary, noting that monetary union has been a distinct success and that EMU's policy frameworks have turned the euro area into a zone of stability in the international economy.

But the IMF's Executive Directors also emphasized that economic union remains a work in progress: the euro area's productivity growth has been disappointing and there are wide economic disparities among the 15 countries that are using the euro today.

Beset by shocks

A number of developments are compounding these structural challenges. The euro area economy is under strain following a series of shocks, including from the commodity and financial markets. Oil prices have recently hit record highs, financial stocks have fallen substantially, borrowing costs and credit default spreads have risen, and term spreads in money markets remain at elevated levels.

Most of these shocks are global, but the euro area faces the specific problem that the euro has borne a disproportionate burden of the dollar's depreciation (see Chart 1). IMF staff estimate that the real effective exchange rate of the euro is now at least 10 percent more than what is warranted by medium-run fundamentals.

Although the euro area economy initially held up well, it now faces a combination of uncomfortably high inflation

and decelerating activity. Inflation has reached an EMU record of 4.1 percent (although it remains below 2 percent if energy and food are excluded), and growth is rapidly losing steam. IMF staff expects growth to remain weak for the next few quarters before reaccelerating toward trend during 2009 (see Chart 2).

Difficult policy choices

In this setting, monetary policy has to balance the risk that the current price shock could result in a generalized and durable increase in inflation, against the prospect that slowing growth will gradually start exerting downward pressure on prices and wages.

Much depends on how labor costs and inflation expectations evolve. The wage moderation seen over the past decade has been a consistent positive surprise, indicating that past labor market reforms have improved the trade-off between inflation and employment. This is reassuring, as is the absence of signals that inflation expectations are becoming unhinged. Nonetheless, risks of second-round effects remain.

The ongoing financial turmoil complicates the policy challenge: financial conditions have tightened substantially since last



Pornchai Kitwongsakul/AFP

Much depends on how labor costs and inflation expectations evolve in the euro area.

summer and the financial environment remains under strain. In this context, monetary policy tightening carries risks of its own. After raising its main policy rate to 4.25 percent on July 3, the European Central Bank (ECB) announced that it would continue to monitor all developments very closely and do what is necessary to deliver price stability—the single needle in its policy compass. IMF staff believe that policy rates are best kept on hold.

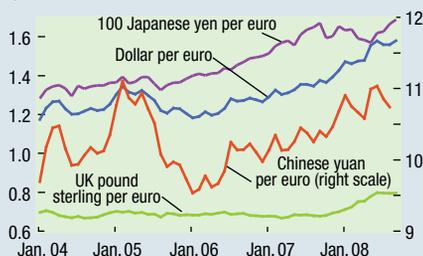
Managing the credit crunch

The ECB has played a crucial role in containing the impact of the global financial turmoil, within a liquidity management framework that has proved itself flexible and robust. The key issue going forward is

Chart 1

Too much of a good thing?

The euro has appreciated against the main global currencies.



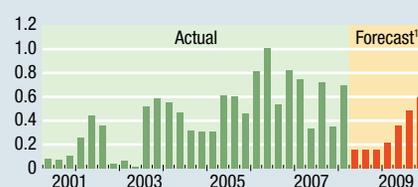
Source: Haver Analytics.

Chart 2

Rough patch

Growth in the euro area is expected to be sluggish for several quarters.

(GDP growth quarter/quarter, percent)



Sources: Eurostat; and IMF staff calculations.

¹Preliminary IMF *World Economic Outlook* forecast.

restoring the depth and orderly functioning of interbank markets. In this regard, the ECB is rightly keeping its operational framework under continuous review, notably with respect to the collateral it accepts.

But the ECB's liquidity operations cannot address the basic problems behind the turmoil, and the outlook for financial stability remains highly uncertain. While the euro area's banking system is essentially sound, its operating environment and profitability have been adversely affected.

If there is a silver lining to the turmoil, it is perhaps that it has added impetus to the debate on the EU's financial stability framework. The EU's commitment to build a single market for financial services requires a move toward greater joint responsibility and accountability for financial stability. Important progress has recently been made toward this objective, including the adoption of common principles for cross-border crisis

management and a related Memorandum of Understanding that is intended to put these principles into practice.

However, national financial stability frameworks will need to be aligned with these principles. This will require strong political leadership—of the kind that led to the creation of the euro 10 years ago.

A disciplined approach

Financial and other stresses should not divert attention from the sound fiscal and structural policies that remain key to the euro area's long-term economic performance.

The euro area and its member states are best served by sticking to a rules-based fiscal policy framework—as provided by the Stability and Growth Pact (SGP). The SGP has helped deliver greater fiscal discipline, but further progress in lowering government deficits and debt is key to meeting

the costs of population aging, which are set to mount rapidly after 2010.

Moreover, past and ongoing structural reforms are bearing fruit, most notably in raising labor utilization. To capitalize on this and build a prosperous economic union, structural policies will need to focus in a coordinated way on still-sheltered services markets and on countries' ability to adjust to shocks.

In sum, the euro area has much to celebrate as it ponders the first 10 years of its existence. And it is well positioned to head off the risks stemming from the continued fallout of the credit crunch—provided it makes the right policy choices. ■

Martin Cihák and Wim Fonteyne
IMF European Department

This article is based on the IMF staff report on Euro Area Policies and associated documents (<http://www.imf.org/external/np/sec/pn/2008/pn0898.htm>).

Emerging Europe Closing Income Gap with Advanced Europe

Europe's emerging economies have been growing fast. The region's annual real GDP growth has averaged close to 6 percent in the past five years, accelerating the recovery that started in the late 1990s. Growth has been particularly rapid in the Baltics, followed by Southeastern and Central Eastern Europe.

Compared with other emerging economies, only emerging Asia has been growing faster in the current decade. This performance has allowed emerging Europe to start closing its large income gap with the advanced European economies. But the region still has far to go. Even if growth continues at the average rate of the past five years, it would take 20 years for Central and Eastern Europe to catch up with Western Europe.

The new EU members in the Baltics and most of Central Eastern Europe have made substantial progress on the structural front, reducing the role of the state in the economy and creating a business-friendly environment that has led to a wave of new investment, including foreign direct investment. They are also very open to international trade and have labor markets that are more flexible than those of the euro area.

In contrast, and despite recent progress, Southeastern Europe has fallen behind on reforms compared with the rest of emerging Europe, partly because many of the countries have yet to join the EU and so have not benefited fully from the EU harmonization process. That said, these countries' lower incomes per capita could facilitate fast growth once the right policies are put in place.

Though macroeconomic policies could do more to address overheating concerns in some countries, they have been broadly conducive to the region's catching up. Partly due to cycle-driven revenues, most countries have relatively low fiscal deficits, or even small surpluses, and low levels of government debt.

Independent central banks across the region have also improved their credibility in safeguarding macroeconomic stability. But rising inflation, primarily

driven by developments in commodity markets, poses new challenges.

Although Central and Eastern Europe will likely continue catching up with Western Europe, growth is expected to slow down in 2008–09. In fact, the region has been growing at rates faster than even its strong fundamentals seem to justify.

Estimates from an empirical growth model that quantifies the impact of such fundamentals on growth suggest that although potential growth is high throughout emerging Europe, actual growth rates have been even higher in recent years in all countries but Hungary. The difference is the largest in the Baltics, primarily in Latvia, followed by Southeastern Europe and by Central Eastern Europe. On average, the region is estimated to have grown about 2 percent faster than its potential during 2003–07.

The catching-up process may prove volatile in countries with large external imbalances. Current account deficits, although not inconsistent with regional convergence, are well above estimates justified by fundamentals, making those countries subject to risks of an abrupt adjustment. High levels of external debt are also a source of vulnerability.

Moreover, the recent speed of financial deepening in the region has been extreme—indeed, it has been slowing during 2008. The pace of credit expansion relative to economic growth has exceeded that in other emerging economies, especially if lending by nonbank financial institutions and direct borrowing from corporates and, increasingly, households abroad is included in addition to bank lending.

Together with sound macroeconomic policies, further progress in structural reforms will be key to ensure smooth catching up in emerging Europe. ■

Athanasios Vamvadakis
IMF European Department

Large EU Transfers Could Speed Catching-Up Process

Large transfers from the European Union (EU) will have a significant impact on the economic future of its new members.

The EU's cohesion policy provides the basis for substantial transfers to member countries lagging in GDP per capita or facing particularly high unemployment. For the new member states in Central and Eastern Europe and in the Baltics, transfers amounting to as much as 3–4 percent of GDP are poised to flow in annually during 2008–15 (see chart).

Some programs, such as the Common Agricultural Policy, provide direct income support to households. Others, such as the Structural and Cohesion Funds, are channeled through public infrastructure projects and enhanced employment policies. Private firms can also benefit in the form of aid to upgrade their equipment.

These funds offer an opportunity for the new member states to close their income gaps with the rest of the EU. But concerns have been voiced that the large inflows could exacerbate inflationary pressures and create bottlenecks. By identifying the economic channels through which these funds will affect the economies of the new member states, the IMF is advising countries on how best to take advantage of the EU transfers.

Funds channeled directly to households tend to boost private consumption. With no improvement in the way companies produce, this extra demand will drive up prices and interest rates, crowding out productive investment. The temporary increase in households' wealth can also reduce the amount of hours people are willing to work, further raising production costs.

Real appreciation of the currency will follow in the footsteps of increased private consumption, which will have a negative impact on the trade balance. Therefore, while the EU transfers will temporarily improve households' purchasing power, this effect will likely be short lived, with no long-term impact on GDP per capita and, hence, on the country's ability to catch up with living standards in the rest of Europe.

This general advice to limit transfers to households should not be seen as ruling out targeted and temporary income support to cushion against high food and energy prices for those worst off in society.

Households benefit indirectly

When, conversely, these countries spend the EU transfers on improving their capital stock, either publicly or privately, the lift this gives to productivity enables firms to

increase their production and boost employment and wages while maintaining profitability. Households will benefit indirectly through higher wage earnings.

Some price pressures might initially emerge as demand rapidly increases but, as private investment gradually picks up, these pressures will fade

away. Competitiveness will be boosted, permanently lifting GDP per capita and accelerating income convergence with the richer neighbors.

The new member states are still in the early stage of absorbing EU funds, and it is unclear which of the two scenarios outlined above will prevail. Still, inflationary pressures have emerged throughout the region, and, if the current expansion is to outlive the period of EU inflows, these countries will need to continue to strengthen their investment efforts.

Maintain existing monetary policy regime

A conservative fiscal policy would mitigate the pressures on the demand side at a time when higher investment and consumption are likely to push prices up. Additionally, this boost to activity offers an opportunity for significant fiscal consolidation for those countries in the region whose public debt ratio hovers close to the Maastricht limit. Conversely, a more procyclical policy would run the risk of exacerbating inflationary pressures, eventually holding back income convergence.

Containing inflationary pressures and ensuring a smooth catching-up process requires continuing adherence to sound monetary policy frameworks and policy choices that support the credibility of existing exchange rate regimes. In the Central and Eastern European countries, the temptation to loosen the inflation target should be resisted, because it would only delay the interest rate reaction—the sharper hikes required later would, in fact, slow the pace of convergence.

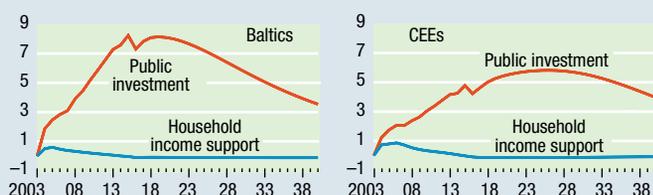
In sum, EU transfers to the new member states represent a tremendous opportunity to catch up with income levels in the richer part of Europe. But countries must spend the money wisely through investment in their own productive sectors. ■

Celine Allard
IMF European Department

Two different scenarios

Countries will be better off if they invest the EU funds rather than spend them on income transfers.

(Illustrative impact on GDP in the event EU funds are spent either entirely on income support or on public investment)¹



Source: Allard (2008), Selected Issues paper for Poland Article IV Consultation, SM/08/86, IMF.

Note: CEEs = Central and Eastern European countries.

¹Results based on simulations using the Global Integrated Monetary and Fiscal model developed at the IMF. The impact is more important in the Baltics mainly because the EU funds amount to a larger share of GDP there than in the CEEs. The impact on GDP diminishes after 2020–25, because the EU funds are assumed to flow in until 2015 only.

Lipsky: SWF Principles Will Help Cross-Border Investment

Proposed voluntary principles and practices for sovereign wealth funds (SWFs), along with an Organization for Economic Cooperation and Development investment code on behalf of recipient countries, will help create a global environment that enables more effective cross-border investing, according to John Lipsky, IMF First Deputy Managing Director.

Lipsky was speaking in Santiago, Chile, on September 3 at a seminar organized by Chile's Ministry of Finance. In a meeting on September 1–2, representatives of 26 SWFs said they had reached a preliminary agreement on a draft set of Generally Accepted Principles and Practices (GAPP), also known as the Santiago Principles. The GAPP is a voluntary framework to guide the conduct of appropriate investment practices, as well as governance and accountability arrangements, of sovereign wealth funds.

"The GAPP seeks to help maintain the free flow of cross-border investment and sustain open and stable financial systems," Lipsky said. "By embracing the GAPP's principles and practices, SWFs could reduce concerns and thereby help to mitigate the risk of protectionist pressures on their investments and restrictions on international capital flows," he added.

Positive role in global financial system

Highlighting the increasing importance of SWFs not only in their own countries but also in the international financial system, Lipsky said that such funds today account for between one-fourth and one-third of all foreign assets held by sovereigns. "SWF assets are projected to surpass the stock of foreign exchange reserves in the not-so-distant future and to top \$7–\$11 trillion by 2013," he said.

Praising the "shock-absorbing role" that the SWFs had played by providing capital during the past year's financial turmoil, Lipsky said it reflected the funds' typically long-term investment horizons, limited liquidity needs, and mainly unleveraged positions. Also, the funds clearly understand "their long-term interest in preserving well-functioning, open, liquid markets," he noted.

However, recipient countries have raised concerns about the potential noncommercial motives of SWF investments. Such negative perceptions could be damaging to all parties as well as diminish the stability of the global financial and monetary system by undermining the efficient flow of global capital, he said.

In this context, both SWF sponsor and recipient countries would benefit from the "enhanced clarity" provided by the voluntary principles and practices. The GAPP would improve the understanding of SWFs and allow the newly established funds to benefit from the experience of others, Lipsky pointed out.



Santiago, Chile, where preliminary agreement was reached on the Santiago Principles to guide sovereign wealth funds.

Newscom

Next steps for GAPP

Speaking on September 2 at the conclusion of the Santiago meeting, the co-chair of the International Working Group of Sovereign Wealth Funds (IWG), Hamad al Suwaidi, said the next step is for each IWG member to recommend the GAPP to their respective governments in the coming weeks. The IWG then expects to present the GAPP to the International Monetary and Financial Committee, the IMF's key policy-guiding body, when it convenes on October 11 in Washington. The GAPP is expected to be published after that meeting.

The IWG members are also exploring the establishment of a standing group of sovereign wealth funds. This recognizes the need to carry forward the work relating to GAPP, as necessary, and to facilitate dialogue with official institutions and recipient countries on developments that affect SWF operations.

IMF as facilitator

The Working Group was co-chaired by Jaime Caruana, Director of the IMF's Monetary and Capital Markets Department, with the IMF acting as the group's secretariat.

David Murray, chairman of the Future Fund Board of Guardians—the Australian SWF—lauded the role of the IMF as facilitator and coordinator of the work of the IWG. "The IMF, with its 185 members, is the only institutional body in the world that has sufficient understanding of the macroeconomic policies and central bank arrangements of those countries and precedents in some of the work they've done that could help us understand ways of approaching the GAPP."

He emphasized that the "GAPP remains a voluntary document of sovereign wealth funds," but noted that "the IMF is easily the best institution to help guide this work." ■

Twin Global Shocks Dent United Kingdom Outlook

For more than a decade, the British economy has had a remarkable run.

Owing to strong policies, years of structural reforms, and some help from benign global conditions, the economy has enjoyed a long stretch of stable growth and low inflation.

But even before the onset of the recent global shocks, macroeconomic strains were developing. Buoyant domestic demand was running ahead of growth, with household savings declining and investment spending edging up.

Inflation expectations were rising and the housing market was overheating. And the headroom under the government's fiscal rules was gradually eroded by sizable fiscal deficits—despite the fact that the economy was operating close to potential.

As a result of these growing imbalances, the external current account deficit has approached historical highs, and net external liabilities have swelled (see Chart 1).

Twin global shocks

The financial market turmoil and high commodity prices have compounded the strains affecting the economy, creating a challenging environment. The shock to the global financial system has led to a liquidity crunch that triggered the first bank run in the United Kingdom in more than a century, and writedowns and losses by national banks have so far totaled about \$50 billion.



Shaun Curry/AFP

Bank of England: inflation is already above target, and it is likely to remain so for an extended period, the IMF says.

The impact is most visible in mortgage lending, which has slowed significantly, but banking spreads are also widening.

The spike in global commodity prices has put a further dent in the outlook. This is most apparent in consumer prices. Although core inflation has remained subdued, soaring food and energy prices have catapulted headline inflation to almost 4 percent, putting a squeeze on firms' profit margins and households' real income. The terms of trade shock may also hurt output.

Markets have expressed their concern about the outlook by selling off sterling. As a result, sterling has depreciated by more than 10 percent in real effective terms since mid-2007, as risk premiums have gone up.

Policy responses so far

The U.K. government has already taken a number of steps in response to the shocks.

Providing liquidity. Besides broadening its money market operations with extended maturity and collateral, the Bank

Chart 1

Growing imbalances

The external current account and fiscal balance were weakening before the recent global shocks.

(percent of GDP)



Source: IMF.

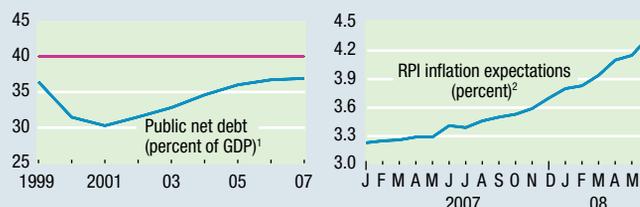
¹Percent of potential GDP.

²Corresponds to fiscal year, from April of the referred year to March of the following year.

Chart 2

Under pressure

Public debt is in imminent danger of breaching the ceiling, and inflation expectations have been worryingly ticking up.



Source: IMF.

¹Corresponds to fiscal year, from April of the referred year to March of the following year.

²10-year inflation implied forward, derived from gilts.

of England launched a special liquidity scheme in April 2008, allowing banks to swap mortgage-backed securities for treasury bills for up to 3 years.

The liquidity relief provided by the Bank of England has, in turn, encouraged banks to raise capital. Notwithstanding some difficulties, the aggregate capital raised by the major banks has slightly exceeded their total reported writedowns and losses.

With tight financing conditions, rapidly falling house prices, depressed equity markets, and weak real income growth, private domestic demand is set to slow sharply.

Reforming financial sector rules.

Substantive changes to the financial stability framework are under way. With lessons learned from Northern Rock's downfall, the government wants new rules to ensure the orderly and swift resolution of failing banks and increase the coverage and payout speed of deposit insurance. It is also seeking to boost the supervisory capacity of the Financial Services Authority, and provide the Bank of England with a statutory basis for its role in protecting financial stability.

Easing macroeconomic policies. Interest rates have been reduced by a cumulative 75 basis points since December 2007, and the 2008 budget allows automatic fiscal stabilizers to operate fully.

Although the flexibility of the economy and prompt policy responses by the government will provide some cushion against the ongoing shocks, a significant economic slowdown can be expected. With tight financing conditions, rapidly falling house prices, depressed equity markets, and weak real income growth, private domestic demand is set to slow sharply.

Although the recent depreciation of sterling has strengthened competitiveness, exports will be held back by softening global demand. Overall, the IMF expects growth to dip to 1.4 percent in 2008 and 1.1 percent in 2009.

The inflation outlook is similarly sobering. As the surge in global commodity prices and the depreciation of sterling continue to work their way through the economy, headline inflation is expected to peak at about 5 percent toward the end of

2008. But continued wage discipline and increased slack in the economy are likely to guide inflation back to the target of 2 percent by 2010.

Tests ahead

The difficult economic circumstances represent a major test to the United Kingdom's much-heralded fiscal and monetary policy frameworks. A protracted breach of the

public net debt ceiling of 40 percent of GDP appears imminent, and inflation is already well above target and will likely remain so for an extended period (see Chart 2).

In this context, any steps to loosen the targets on either the budget or inflation fronts would compromise the integrity of the frameworks and the credibility of policies. This would threaten both stability and growth.

On the monetary policy side, attempts to expand the Monetary Policy Committee's

mandate or raise the inflation target would do nothing to address the terms of trade losses or lower their economic costs. Instead, policymakers should focus on preventing a wage-price spiral, and continued emphasis on moderation in wage growth will be essential.

On the fiscal policy side, a relaxation of the current framework would undermine the credibility of any new framework. By accommodating a weaker fiscal outlook, it would also constrain monetary policy and compound the external imbalances.

If the debt limit is breached, the credibility of fiscal policy should be safeguarded by adopting concrete plans to return debt below the ceiling in a reasonable timeframe. In that regard, the planned cumulative fiscal adjustment of 1½ percent of GDP over 2009–12 is unlikely to be sufficient to ensure a reduction of the debt, and more will be needed over the next few years. A stronger fiscal adjustment could also facilitate a more balanced policy mix and help reduce external imbalances. ■

M. K. Tang

IMF European Department

IMF Survey

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Uruguay's Monetary Policy Effective Despite Dollarization

Monetary policy can be effective in Uruguay despite the importance of dollarization in the small South American nation, the IMF has concluded. Moreover, the Fund found, a flexible exchange rate can help absorb external shocks even in a system as heavily dollarized as Uruguay's, largely because most nonfinancial transactions are carried out in pesos.

These were among the issues explored by the Uruguayan authorities and IMF staff last year in one of the first consultations to reflect the IMF's increased emphasis on financial issues. Uruguay was selected for such a consultation for several reasons.

First, the country had a recent major crisis (in 2002) that began in the financial sector and was largely caused by external factors—primarily a financial crisis in neighboring Argentina, during which Argentines withdrew a large portion of their deposits in Uruguayan banks.

Second, Uruguay is a small open economy. Little analysis has been conducted on smaller economies that are open to trade and financial relationships with the rest of the world.

Third, foreign currency plays an important role in the economy—close to 60 percent of bank lending is in U.S. dollars, for example. That so-called dollarization—reliance on a foreign currency for larger transactions and as a store of value—presents Uruguay with both vulnerabilities and policy questions.

There is a general concern about the effectiveness of monetary policy in such highly dollarized economies. In Uruguay, for example, the central bank can only issue pesos while many financial transactions take place in dollars. There are questions about how well exchange rate policy can cope with external shocks, such as import price increases, when much of the transmission of a shock is directly in dollars.

The consultation also sought to analyze how macroeconomic shocks are transmitted in a highly dollarized economy, and how they affect the soundness of the



Vegetable prices in Montevideo, Uruguay, where authorities are moving toward inflation targeting.

Andres Stapff/Reuters

financial system, as well as ways to protect against external shocks in such an environment.

Uruguay has pursued key monetary and financial reforms since 2002. It has abandoned an exchange rate peg in favor of a float, improved financial prudential norms and banking supervision, and accumulated significant central bank reserves. Since the crisis, the dollarization of the banking system has declined, but it is still high.

In this environment, Uruguay has been modifying the way it conducts monetary policy, moving gradually from an exchange rate anchor toward an inflation-targeting regime in which the central bank's goal is to keep overall price increases within a target range.

The consultation yielded several findings:

- There is potential for monetary policy to be effective in Uruguay, mainly through three channels—influencing inflation expectations, the exchange rate, and bank lending in pesos, which is limited but growing. Moreover, evidence indicates that good monetary policy contributes to reducing the role of the dollar: there is a clear correlation between measures of monetary credibility and the degree of dollarization. Still, dollar lending is found to be influenced by U.S. monetary policy.

- A flexible exchange rate can play a role as a “shock absorber” of external events, such as price increases, even in highly dollarized Uruguay. This is because most nonfinancial transactions are valued and carried out in

pesos. The pass-through from exchange rates to domestic prices is not one-for-one and has declined over time. Exchange rate movements can help restore balances and deal with shocks. At the same time, instruments other than the exchange rate, such as interest rates, are likely to be more appropriate to manage monetary policy as Uruguay moves to inflation targeting.

- International reserves are close to desirable levels, even after taking into account that dollar-denominated deposits, particularly those of nonresidents, could be potential demands on reserves.

- External financial developments still play a substantial role in Uruguay. Despite improved macroeconomic fundamentals and banking system indicators, Uruguay's fortunes are still tied to those of other emerging markets. Uruguay is now in a better position to withstand shocks, including those from the region. That said, global developments still have an important impact. Indeed, looking at international market perceptions, as revealed by country spreads, Uruguay moves more in tandem with other emerging markets now than before the crisis.

Sustaining sound policies over the medium term will be essential. Much progress has been made in reducing vulnerabilities imposed by dollarization, but medium-term vulnerabilities remain. For example, many companies that do not earn in dollars have dollar debt and are thereby exposed to the risk of sharp exchange rate movements, with ensuing risk for the financial system. Similar risks apply to the public debt-to-GDP ratio in the presence of foreign currency debt.

A clear monetary framework and continued commitment to the inflation objectives, within a flexible exchange rate regime, appear important to increase central bank credibility and reduce real costs of lowering inflation. In time, this could help reduce dollarization. ■

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Saudi Arabia: Managing the Oil Bonanza

Saudi Arabia has achieved strong growth since the recent oil boom started in 2003. The economy grew by an average of 4.3 percent during 2003–07, driven by a continued rapid expansion in the non-oil private sector (in particular, financial and construction services). Non-oil private growth has averaged 5.4 percent during 2003–07, leading to substantial job creation, including for foreign workers mainly from low-income countries in the region and Asia, who sent home \$16 billion in remittances in 2007. However, unemployment among the young remains high, reflecting skill mismatches and high reservation wages.

Saudi Arabia continues to play a key role in the stability of the international oil market, accounting for 22 percent of global oil reserves and around two-thirds of global spare production capacity (2 million barrels per day (mbd)). Investments of about \$90 billion over the next few years will boost crude production output to 12.5 mbd by 2009 and increase refining capacity. After hosting a summit of industry experts and representatives from oil-producing and oil-consuming countries in June 2008, the Saudi Arabians decided to boost oil production to 9.7 mbd in July 2008 to contain volatility in global oil markets.

Complex challenges

Surging oil revenues have provided a complex set of challenges. On the one hand, Saudi Arabia has major development needs in infrastructure and social services, and fiscal spending aimed to improve education, housing, transportation, and other infrastructure needs has been stepped up in recent years (much of it managed through public-private partnerships). This has boosted imports and, in line with policy plans discussed under the Multilateral Consultation on Global Imbalances, helped contain global imbalances.

On the other hand, because oil is a non-renewable resource, part of the oil wealth should be preserved for future generations

through the accumulation of external financial assets—i.e., a current account surplus. Indeed, a significant portion of oil revenues is being used to accumulate net foreign assets at the central bank, which at end-2007 stood at \$301 billion (the equivalent of 19 months of imports), and, to a lesser extent, in pension and state investment funds. These reserves also provide a safety cushion in the event of adverse developments to oil prices.

Inflation emerges

After several years of very low inflation rates, inflation has recently emerged as a major short-term challenge, similar to other countries in the area, accelerating to a 30-year high of 11.1 percent (year over year) in July 2008. Domestic demand pressures arising from higher income and wealth, supply constraints (housing), and imported inflation (food) have been the main factors. Given the peg to the dollar, Saudi Arabia was also importing the easing monetary stance of the United States since mid-2007, further fueling inflation. The authorities remain committed to the peg, which has served successfully for decades as a nominal anchor and was reaffirmed in 2003 as a stepping stone toward monetary union among the members of the Gulf Cooperation Council.

With monetary policy tied up by the peg to the dollar, fiscal policy remains the main demand management tool—but the Saudi authorities face difficult trade-offs between restraining spending to curb inflation and increasing capital outlays to address infrastructure bottlenecks that are driving inflation on the supply side.

The authorities have sought to cope with the impact of inflation through several structural measures, including the passage of a mortgage law to facilitate housing development, a 15 percent wage increase over three years, subsidies on food, reduced import tariffs, and the waiving of several administrative fees. To curb credit growth, the central bank increased reserve

requirements in four steps by a cumulative 600 basis points and issued bills to mop up liquidity. Inflation is expected to gradually subside starting in late 2008 as global commodity prices ease, U.S. monetary policy firms, and supply bottlenecks are overcome, with infrastructure and housing investments coming on stream.

Consolidating recent gains

Saudi Arabia's medium-term outlook remains very favorable, with growth being sustained by strong private sector investment and government spending on key infrastructure. Large fiscal and external surpluses are projected to continue, given high oil prices. Even sharply lower oil prices would be unlikely to endanger macroeconomic stability—the oil price that would balance the current account in 2013 is estimated at about \$70 per barrel. Nonetheless, the fiscal framework could be further strengthened by anchoring budgets in a medium-term setting and by managing the oil wealth with an explicit long-term, inter-generational perspective.

Policymakers have long understood the importance of structural reforms to boost job creation and diversify the economy, now compounded by the need to address supply constraints that contribute to inflation. As an outcome of the sweeping structural reforms already undertaken, the International Finance Corporation's *Doing Business* report ranked Saudi Arabia first among Arab countries for three consecutive years and twenty-third globally in 2008.

But to consolidate these gains and further diversify the economy, the authorities will need to implement vigorously the planned second-generation reforms critical to private sector development and employment creation, notably improvements in education, financial sector deepening, contract enforcement, and the modernization of the legal system. ■

Klaus Enders and Oral Williams
IMF Middle East and Central Asia Department

IMF Outlines \$750 Million Loan for Georgia

Following a request by the Georgian authorities for IMF financial support, an IMF mission visited Tbilisi in late August and reached agreement on a \$750 million financial package.

The 18-month Stand-By Arrangement is intended to support the economic policies of the Georgian authorities and to help mitigate the adverse economic and financial consequences of the recent conflict, said David Owen, head of the IMF mission team that visited Georgia to discuss the financing.

The main objectives of the arrangement are to cover part of the expected temporary external financing gap, and to help sustain the confidence of markets and investors by supporting policies that will ensure continued macroeconomic stability and promote the recovery of private sector investment and economic growth, the IMF said. Georgia's strong record of reform and sound macroeconomic policies has strengthened the resilience of the economy and bodes well for a solid recovery from this shock.

The IMF Executive Board approved the arrangement on September 15, paving the way for an immediate disbursement of \$250 million.



Alexander Klimchuk/Itar-Tass

IMF Announces Director Appointments

IMF Managing Director Dominique Strauss-Kahn announced the appointments of three new IMF department directors: Nicolás Eyzaguirre, Western Hemisphere Department; Caroline Atkinson, External Relations Department; and Carlo Cottarelli, Fiscal Affairs Department.

Eyzaguirre, who will take up his post on January 1, 2009, served as Chile's Finance Minister from 2000 to 2006. Currently Professor of Economics at the University of Chile, Eyzaguirre was the IMF Executive Director for Argentina, Bolivia, Chile, Paraguay, Peru, and Uruguay from 1998 to 2000.

Atkinson and Cottarelli, who are currently on the IMF staff, will assume their new posts on November 1.

IMF Completes Review of Iraq's Stand-By Arrangement

The IMF Executive Board completed on September 2 the first review of Iraq's Stand-By Arrangement, which is designed to support the country's economic program through March 2009. The \$746.3 million arrangement, approved in December 2007, is being treated as precautionary by the authorities, which means they do not expect to draw on it.

"After several very difficult years, economic prospects for Iraq are improving," said IMF Deputy Managing Director Takatoshi Kato following the Executive Board's discussion of Iraq's economic performance. "With the recent improvement in security, oil production and exports are increasing, while inflation has been reduced. The strengthened fiscal and external positions offer Iraq a good opportunity to rebuild its institutions and infrastructure in order to achieve sustained higher economic growth." Kato added that the success of these endeavors would hinge on continued improvements in security, sound management of oil revenues, and implementation of key structural reforms.

IMF Research Conference

The IMF will hold its Ninth Annual Jacques Polak Research Conference on November 13–14 in Washington, D.C. The conference provides a forum for discussing innovative research in economics, by both IMF staff and outside economists, and facilitates the exchange of views among researchers and policymakers. Jean Tirole, Scientific Director of the Institut d'Economie Industrielle in Toulouse, France, will deliver the Mundell-Fleming lecture.

Strauss-Kahn Appoints Governance Reform Panel

IMF Managing Director Dominique Strauss-Kahn announced the appointment of a committee of eminent persons to assess the adequacy of the Fund's current framework for decision making and advise on any modifications that might enable the institution to fulfill its global mandate more effectively.

The committee, chaired by Trevor Manuel, South Africa's Minister of Finance, includes: Michel Camdessus, former Managing Director of the IMF; Kenneth Dam, Max Pam Professor at the University of Chicago; Mohamed El-Erian, co-CEO and co-CIO of Pacific Investment Management Co.; Sri Mulyani Indrawati, Minister of Finance of Indonesia; Guillermo Ortíz, Governor of the Bank of Mexico; Robert Rubin, Senior Counselor at Citigroup; and Amartya Sen, Lamont University Professor at Harvard University.

"The committee's perspective, which I hope to have by next April, will provide yet another important input to our reform efforts," said Strauss-Kahn, adding that he hoped concrete proposals would emerge from the group's work by September 2009.



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