

G-20 SUMMIT

World Leaders Launch Action Plan to Combat Financial Crisis

Leaders of the world's major economies have drawn up an action plan to combat the burgeoning financial crisis and pull the global economy back from one of the worst downturns in decades.

Leaders of the Group of 20 (G-20) industrialized and emerging market economies announced a series of immediate and longer-term actions to stabilize the financial system, stimulate domestic demand, help emerging and developing economies battered by the crisis, and strengthen the regulatory framework. They said they would hold a second summit by April 30, 2009.

They stressed their commitment to ensuring that the International Monetary Fund (IMF), the World Bank, and other multilateral financial institutions have sufficient resources to continue playing their role in overcoming the crisis. Japan has announced its intention to lend the IMF an extra \$100 billion to boost its resources.



Stephen Jaffe/IMF

G-20 leaders gathered in Washington, D.C., on November 14–15 to agree on a global plan for stabilizing the financial system.

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IMF Launches Short-Term Lending Facility

The IMF has created a new short-term lending facility to channel funds quickly to emerging markets that have a strong track record but that need rapid help during the current financial crisis

to get them through temporary liquidity problems.

In a press announcement, the IMF said the Short-Term Liquidity Facility (SLF) is designed to help emerging market countries with a track record of sound policies address the fallout from the crisis. The new facility, approved by the IMF's Executive Board on October 29, comes with no conditions attached once a loan has been approved and offers large up-front financing to help countries restore confidence and combat financial contagion.

"Exceptional times call for an exceptional response," said IMF Managing Director Dominique Strauss-Kahn. "The Fund is responding quickly and flexibly to requests for financing. We are

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IMF Approves Loans for Hungary and Ukraine

The IMF has announced loans totaling more than \$32 billion for Hungary and Ukraine, which have both been hit by the effects of global financial turmoil (see page 174).

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New loan facility will help IMF members fortify defenses against temporary capital account outflows.

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Short-Term Lending Facility

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offering some countries substantial resources, with conditions based only on measures absolutely necessary to get past the crisis and to restore a viable external position,” he said.

Until recently, emerging markets were one of the few bright spots left in a world economy hit by massive deleveraging, failing banks, and corporate profit warnings. But now, the crisis is spreading beyond the advanced economies where it originated, with emerging markets all over the world suffering from the squeeze in global financial markets. The IMF has already reached financing agreements with Hungary and Ukraine, and is in advanced talks with several other countries.

The SLF will allow the IMF to help its members at a critical time. “Even countries that have excellent track records of implementing strong macroeconomic policies have been caught up in the global financial market crisis. They need support, and the IMF is ready to give it,” Strauss-Kahn said.

“The SLF will support the authorities’ efforts to reduce the impact of the crisis. Approval of a request for support under the SLF will help members fortify defenses against temporary capital account outflows, boost confidence, and provide needed policy space,” he said.

Despite the current surge in demand for IMF resources, there is a growing recognition that the Fund’s traditional facilities may not be the optimal means of addressing short-term balance of payments pressures in every case.

“While existing Fund loan facilities offer flexibility, they are fundamentally used for countries that require both financing and policy adjustment, and not for countries that despite strong initial macroeconomic positions and policies are facing short-term liquidity pressures. This facility addresses that gap in the Fund’s toolkit of financial support,” Strauss-Kahn said.

The unique features of the SLF will address the needs of emerging market

countries more directly than would a traditional IMF stand-by arrangement:

- **Purpose.** Provide large, up-front, quick-disbursing, short-term financing to help countries with strong policies and a good track record address temporary liquidity problems in capital markets.

- **Eligibility.** Countries with a good track record of sound policies, access to capital markets, and sustainable debt burdens may qualify (the IMF’s standard debt sustainability analysis should indicate a high probability that both public and private debt will remain sustainable). Policies should have been assessed very positively by the IMF’s most recent country assessment.

- **Conditions.** Financing is made available without the standard phasing and loan conditions of more traditional IMF arrangements. However, borrowers are expected to certify that they are committed to maintaining strong macroeconomic policies.

- **Size of loan.** Disbursement of IMF resources can be up to 500 percent of quota, with a three-month maturity. Eligible countries are allowed to draw up to three times during a 12-month period.

The IMF’s liquidity currently stands at historically high levels. But this could rapidly change as the IMF approves new lending under its more traditional facilities, and if there is wide demand for the SLF. “The IMF will respond with all the necessary financing,” Strauss-Kahn said. “We are prepared to use our own resources and to work with others to generate additional resources to make sure that countries have the money they need to restore confidence and maintain stability.”

The new facility is part of a wider review of the IMF’s financing role in member countries, launched earlier in 2008 to make sure the Fund has the right instruments to meet countries’ needs in a world characterized by growing—and increasingly complex—cross-border financial flows. ■

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World Leaders Launch Action Plan to Combat Financial Crisis

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IMF Managing Director Dominique Strauss-Kahn welcomed the outcome of the two-day summit in Washington, calling the agreed action plan a significant step by the international community toward stronger cooperation aimed at resolving the global financial crisis and supporting the IMF's capacity to contribute to these efforts. The declaration gives the IMF a central role both in terms of crisis response and suggesting how to reform world financial markets.

"I am very pleased about the G-20 leaders' strong support for the important role of the Fund in crisis management and the reform of the international financial architecture," Strauss-Kahn said. "In addition to helping some member countries that are facing difficult circumstances with rapid and effective support, we have also created a new short-term liquidity facility and continue to review our instruments and facilities."

Broad-based summit

The G-20 comprises the seven major industrialized nations—Britain, Canada, France, Germany, Italy, Japan, and the United States—plus Argentina, Australia, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea, and Turkey. It also includes the 27-nation European Union, which was represented by Spain. Also attending the November 15 meeting were the heads of the United Nations, the IMF, the World Bank, and the Financial Stability Forum.

"Today's summit was significant because of the people present. A new world economic order is developing that is more dynamic and more inclusive than any we have yet seen," Strauss-Kahn said. "The meetings are also significant because of what was agreed. The most important outcome of this weekend's meeting is agreement on an action plan and the commitment of all participants to implement the plan vigorously and fully. The IMF will give strong support to these efforts."

Strauss-Kahn, a former French finance minister who took over as head of the IMF a year ago, noted the G-20 leaders' commitment to act together to meet global macro-

economic challenges, using both monetary and fiscal policy. Lower inflation risks provide room to ease monetary policy, he said, adding that this will be important, but will not be enough.

"I welcome the emphasis on fiscal stimulus, which I believe is now essential to restore global growth," the Managing Director said, a point he had stressed in an earlier letter to G-20 finance ministers. "Each country's fiscal stimulus can be twice as effective in raising domestic output growth if its major trading partners also have a stimulus package."

He noted that the declaration recognizes that some countries have more room for maneuver than others. "We believe that those countries—advanced and emerging economies—with the strongest fiscal policy frameworks, the best ability to finance fiscal expansion, and the most clearly sustainable debt should take the lead," he said, adding that the IMF stands ready to advise on which measures, such as tax cuts or additional spending, will be the most effective.

He said the global stimulus needs to be large, on the order of 2 percent of world GDP, to make a sizable difference to global growth prospects. "We are going to work on this with countries in the coming weeks and months," he added. He welcomed China's recent announcement of a \$586 billion stimulus plan, saying this would shift Chinese policy and economy in the right direction.

Strauss-Kahn noted the G-20's endorsement of strengthening the IMF's mandate in the areas of macroeconomic surveillance, lending to member countries in need, and providing assistance to build up capacity in emerging market and developing countries. He welcomed agreement that the role of the IMF in providing macro-financial policy advice would be enhanced, including the request that the Fund and others develop recommendations to mitigate pro-cyclicality in regulatory regimes. "This is very important at this time," he added.

Strauss-Kahn noted that the action plan agreed at the summit pointed to the role of the IMF in supporting the plan's

implementation, including some immediate actions by March 31, 2009. He praised the agreement on principles for the reform of financial markets, and especially the commitments to reinforce international cooperation.

"The IMF's role in reform of financial markets is based on our responsibility for surveillance of the global financial system, which was part of the original Bretton Woods agreement," he said. "It is also based on our capacity to analyze the relationships between financial markets and the real economy. We have already seen how important these relationships can be. The world must understand them better, and the IMF will do its part to make this happen."

"I am particularly pleased that all G-20 members have committed to participating in the IMF's Financial Sector Assessment Program," he added. "This will ensure a transparent review of countries' regulatory systems."

Ensuring sufficient resources

Strauss-Kahn stressed to reporters the important role of the IMF in crisis response and developing early warning systems to spot when countries may be getting into trouble. He welcomed the leaders' commitment to strengthen the IMF's capacity to fulfill its mandate of macroeconomic surveillance, lending to member countries in need, and providing assistance to build up capacity in emerging market and developing countries.

"It is an important signal that the world is committed to ensuring that the IMF, World Bank, and other multilateral development banks have sufficient resources to help our members overcome the crisis," he stated.

In a separate statement, Strauss-Kahn welcomed Prime Minister Taro Aso's announcement that Japan is prepared to lend up to \$100 billion to the IMF. "This is a major contribution to maintaining the stability of financial and capital markets, and clearly demonstrates Japan's leadership and strong commitment to multilateralism," he said. ■

IMF Urges Stimulus as Global Growth Marked Down Sharply

The IMF is urging countries to stimulate their economies to counter a bigger-than-expected slowdown in the global economy triggered by recent financial turmoil.

In its latest forecast for world economic growth, the IMF sharply revised its growth projections downward, saying that “global activity is slowing quickly.”

“Prospects for global growth have deteriorated over the past month, as financial sector deleveraging has continued and producer and consumer confidence have fallen,” the IMF said in its updated *World Economic Outlook* (WEO), published on November 6.

It said that world output is projected to expand by 2.2 percent in 2009, down by some $\frac{3}{4}$ percentage point of GDP relative to the projections in the October WEO. In advanced economies, output is forecast to contract on a full-year basis in 2009, the first such fall in the postwar period. In emerging economies, growth is projected to slow appreciably but still reach 5 percent in 2009.

But the IMF noted that these projections were based on currently announced policies, and advocated further policy actions to sustain demand. “Global action to support financial markets and provide further fiscal stimulus and monetary easing can help limit the decline in world growth,” the outlook said.

Global activity slowing quickly

The IMF said that world growth is projected to slow from 5 percent in 2007 to $3\frac{3}{4}$ percent in 2008 and to just over 2 percent in 2009, with the downturn led by advanced economies.

• **Activity in the advanced economies is now expected to contract by $\frac{1}{4}$ percent on an annual basis in 2009, down $\frac{3}{4}$ percentage points from the October 2008 WEO projections.** This would be the first annual contraction during the postwar period, although the downturn is broadly comparable in magnitude to those that occurred in 1975 and 1982. A recovery is projected to begin late in 2009. The U.S. economy will suffer, as households respond to depreciating real and financial assets and tightening financial conditions. Growth in the euro area will be hard hit by tightening financial conditions and falling confidence. In Japan, the support to growth from net exports is expected to decline.



Global economic activity is slowing quickly amid deepening financial stress, the IMF says in its latest world forecast.

Paulo Whitaker/Reuters/Newscom

• **The downward revisions to 2009 real GDP growth projections are somewhat larger in emerging and developing economies, averaging 1 percent.** This would leave their growth rate at 5 percent, higher than in earlier business cycle troughs (for example, in 1990, 1998, and 2001). However, the cyclical downturn in emerging economies is of a similar magnitude to that in the advanced economies when measured relative to higher trend growth rates, in line with past cycles. Downward revisions vary considerably across regions. Among the most affected are commodity exporters, because commodity price projections have been marked down sharply, and countries with acute external financing and liquidity problems. Countries in East Asia—including China—generally have suffered smaller markdowns, because their financial situations are typically more robust, they have benefited from improved terms of trade from falling commodity prices, and they have already initiated a shift toward macroeconomic policy easing.

Reduced inflationary pressures

The forecast said that a combination of stabilizing commodity prices and increasing economic slack will help to contain inflation pressures.

In the advanced economies, headline inflation should decline to below 1½ percent by the end of 2009. In emerging economies, inflation is also expected to moderate, albeit more gradually. However, in a number of these countries, inflation risks are still manifest, as higher commodity prices and continued pressure on local supply conditions have affected wage demands and inflation expectations.

Limiting the damage

Comprehensive policy actions are being implemented to address the root causes of financial stress and to support demand, but it will take time to reap their full benefits. The initiatives include programs to purchase distressed assets, use of public funds to recapitalize banks and provide comprehensive guarantees, and a coordinated reduction in policy rates by major central banks.

The IMF forecast said that a stronger macroeconomic policy response to the crisis could help limit the damage. “There is a clear need for additional macroeconomic policy stimulus relative to what has been announced thus far, to support growth and provide a context to restore health to financial sectors. Room to ease monetary policy should be exploited, especially now that inflation concerns have moderated,” it stated.

But the forecast said that monetary policy easing may not be enough. “Fiscal stimulus can be effective if it is well targeted, supported by accommodative monetary policy, and implemented in countries that have fiscal space.”

Cross-border consistency

The IMF said that policies need to be coordinated across borders. “Crucially, there must be better cross-border consistency of policies,” the forecast said.

“A key task will be to develop cooperative arrangements for the resolution of large cross-border institutions where none currently exist, given the limitations of individual country frameworks. Moreover, the extension of financial support and guarantees must consider potential cross-border effects, including for emerging economies. Finally, exit strategies for the public sector from financial system ownership need to be developed.”

“Dramatic fall in confidence”

At a press briefing, IMF Research Department Director Olivier Blanchard noted that an abrupt decrease in demand in advanced economies, coupled with a sharp worsening of credit conditions for emerging economies, had led the IMF to revise its global growth forecast.

“What we have seen here is a dramatic fall in confidence, both by consumers and by firms,” Blanchard said. “For consumers, their wealth has gone down. What is going to happen over the next few years is highly uncertain, and this has led them to cut spending.”

Emerging economies have experienced not just a sharp worsening of credit conditions but also lower exports owing to decreased demand in advanced countries, said Blanchard. These developments prompted the IMF to lower the growth forecast for emerging economies by 1 percent.

Latest IMF projections

Prospects for global growth have deteriorated over the past month.

(year-over-year percent change)

| | Projections | | | Variance from last IMF forecast | |
|---|-------------|------------|-------------|---------------------------------|-------------|
| | 2007 | 2008 | 2009 | 2008 | 2009 |
| World output | 5.0 | 3.7 | 2.2 | -0.2 | -0.8 |
| Advanced economies | 2.6 | 1.4 | -0.3 | -0.1 | -0.8 |
| United States | 2.0 | 1.4 | -0.7 | -0.1 | -0.8 |
| Euro area | 2.6 | 1.2 | -0.5 | -0.1 | -0.7 |
| Germany | 2.5 | 1.7 | -0.8 | -0.2 | -0.8 |
| France | 2.2 | 0.8 | -0.5 | -0.1 | -0.6 |
| Italy | 1.5 | -0.2 | -0.6 | -0.1 | -0.4 |
| Spain | 3.7 | 1.4 | -0.7 | — | -0.5 |
| Japan | 2.1 | 0.5 | -0.2 | -0.2 | -0.7 |
| United Kingdom | 3.0 | 0.8 | -1.3 | -0.2 | -1.2 |
| Canada | 2.7 | 0.6 | 0.3 | -0.1 | -0.9 |
| Other advanced economies | 4.7 | 2.9 | 1.5 | -0.2 | -1.0 |
| Newly industrialized Asian economies | 5.6 | 3.9 | 2.1 | -0.1 | -1.1 |
| Emerging market and developing economies | 8.0 | 6.6 | 5.1 | -0.3 | -1.0 |
| Africa | 6.1 | 5.2 | 4.7 | -0.7 | -1.3 |
| Sub-Saharan Africa | 6.8 | 5.5 | 5.1 | -0.6 | -1.2 |
| Central and eastern Europe | 5.7 | 4.2 | 2.5 | -0.3 | -0.9 |
| Commonwealth of Independent States | 8.6 | 6.9 | 3.2 | -0.3 | -2.5 |
| Russia | 8.1 | 6.8 | 3.5 | -0.2 | -2.0 |
| Excluding Russia | 9.8 | 6.9 | 1.6 | -0.7 | -4.6 |
| Developing Asia | 10.0 | 8.3 | 7.1 | -0.1 | -0.6 |
| China | 11.9 | 9.7 | 8.5 | -0.1 | -0.8 |
| India | 9.3 | 7.8 | 6.3 | -0.1 | -0.6 |
| ASEAN-5 | 6.3 | 5.4 | 4.2 | -0.1 | -0.7 |
| Middle East | 6.0 | 6.1 | 5.3 | -0.3 | -0.6 |
| Western Hemisphere | 5.6 | 4.5 | 2.5 | -0.1 | -0.7 |
| Brazil | 5.4 | 5.2 | 3.0 | — | -0.5 |
| Mexico | 3.2 | 1.9 | 0.9 | -0.1 | -0.9 |

Source: IMF, *World Economic Outlook*, November 2008.

Another factor was the migration of the financial crisis to emerging markets. “That comes from continued deleveraging—that is, the sale of assets—by financial institutions in advanced countries,” Blanchard said. “We had anticipated it, but it has been broader and stronger than we had anticipated, affecting a large number of countries.”

As for the appropriate policy response, Blanchard said that there is still scope in some countries to use monetary policy, citing the European Central Bank and the Bank of England’s recent interest rate cuts. But he stressed that global fiscal expansion was very much needed, and noted that there was room for additional fiscal stimulus in a number of countries, including the United States, Germany, and China.

“There are always risks to expanding fiscal deficits, but here the benefits exceed the risks in a number of countries,” Blanchard said. ■

To read the full text of the *World Economic Outlook* update, visit the WEO website at www.imf.org/external/pubs/ft/weo/2008/update/03/index.htm

IMF Approves Loans for Crisis-Hit Hungary and Ukraine

The IMF's Executive Board has given the green light to loans totaling \$32.1 billion for Hungary and Ukraine to help these struggling economies recover from the effects of the global financial crisis.

Hungary and Ukraine were among the first in a series of countries to approach the IMF about loans to help fend off the impact of the global financial crisis, which has triggered a worldwide economic downturn.

Bolstering Hungary's finances

The \$15.7 billion IMF loan for Hungary is part of a program designed to ease financial market stress in the East European country, buffeted by global financial turmoil.

Key measures concentrate on the areas of greatest stress—government finances and the banking sector. The measures are designed to be compatible with longer-run economic goals of reforming government finances and ensuring continued high levels of capital in the banking sector.

Hungary's 17-month Stand-By Arrangement is part of a \$25 billion financing package to which the European Union has committed €6.5 billion (\$8.4 billion) and the World Bank \$1.3 billion.

The IMF approval makes \$6.3 billion available immediately and the remainder in five installments subject to quarterly reviews. The Stand-By Arrangement entails exceptional access to IMF resources, amounting to 1,015 percent of Hungary's IMF quota, and was approved under the Fund's fast-track Emergency Financing Mechanism.

Two key objectives

Specifically, the IMF-supported economic program is based on two key objectives: to implement a substantial fiscal adjustment to ensure that the government's debt-financing needs will decline; and to maintain adequate liquidity and strong levels of

capital in the banking system. Ultimately, the program should help restore stability in the financial sector and create the conditions for an economic recovery.

"The economic program rightly focuses on the fiscal and the banking sectors, which were the two key areas of vulnerability at the outset of the difficulties," said Anne-Marie Gulde, the IMF's mission chief for Hungary, who was involved in discussions on the financing package.

"In the fiscal sector, a necessary reduction in the size of the public sector through lower expenditures will ease the country's short-term financing pressures and bring down the high levels of debt," she said.

"In the short term, the rollover of debt will become easier and debt will become more sustainable in the medium term. The fiscal measures are also in line with the country's goal to slowly reduce the large size of its public sector and to provide more room for private activities to grow," she added.

Given the structure of the Hungarian budget, among other areas, adjustment will need to include revisions of wages and pensions. Under the authorities' program, expenditure restraint will be achieved in part through reductions in the overall government wage and pension bill. Nominal wage adjustments will be postponed and pension bonuses suspended.

While this path is painful, the authorities have chosen it because failure to achieve credible budget goals could have led to a government financing crisis with more severe consequences for the entire economy. In designing the measures, low-income pensioners were excluded from benefit reductions. Furthermore, Hungary's comparatively good social benefits will also help to buffer the social effects of these measures.

Hungary, a country of around 10 million people, became a member of the European Union in 2004. It made a successful transition from a centrally planned to a market

economy, but the government deficit and the size of the public sector are still relatively large compared to other countries at similar income levels.

Fallout from global crisis

The second pillar of the program is decisive measures in the banking sector. They include a preemptive recapitalization of eligible banks and a strengthening of the supervisory and crisis management abilities of the Hungarian supervisory agency. These steps will ensure that banks' capital remains high and that the supervisory authorities are well prepared to recognize risks and take necessary early measures should vulnerabilities occur.

Hungary was among the first emerging market countries to suffer from the fallout of the current global financial crisis. As financial difficulties in advanced economies led to a decline in global liquidity and an increase in risk aversion, investors increasingly started differentiating among emerging markets.

Hungary's high external debt levels—which amounted to 97 percent of GDP at end-2007—and significant balance sheet mismatches negatively affected investor appetite for Hungarian assets. Even though macroeconomic and financial policies had been strengthened since 2006, with substantial fiscal consolidation and tax administration improvements, Hungary was hit hard by the global deleveraging. Financial markets in Hungary have come under significant stress in recent weeks, reflecting the rise in perceptions of counterparty risk.

Gradual economic recovery

The IMF estimates that growth in Hungary is expected to contract to -1 percent in 2009 from around 1¾ percent in 2008. Already weak private consumption and investment will be negatively affected by both a sharp reduction in new bank lending and the depreciation of the exchange rate. Inflation,

which peaked at 9 percent in early 2007, is projected to continue a downward trend and reach 4 percent at end-2009.

In a difficult global environment and with low domestic demand, the economy is projected to recover only gradually owing to the fact that the slowdown is simultaneously occurring in Hungary's main trading partners and because of the global deleveraging process that will leave less foreign capital available to quickly return to Hungary. Growth is not expected to resume until 2010 or converge toward its estimated potential of 3 percent until after 2011.

Helping Ukraine avoid a hard landing

The \$16.4 billion loan for Ukraine, approved by the IMF's Executive Board on November 5, will help the government strengthen confidence and restore economic stability after the country became the latest victim of the financial crisis sweeping the global economy.

Until the financial crisis hit the world economy in mid-2008, Ukraine was riding on the coattails of a global economy that had an insatiable demand for steel—a commodity that constitutes 40 percent of the country's exports, earning \$17 billion a year in revenues. The government passed on the gains from high economic and steel exports growth to the population through generous incomes policies.

Together with rising capital inflows, this fueled an unprecedented consumption boom—and a rising current account deficit. By 2008, the economy had overheated, with inflation running at 25–30 percent, wages rising by 30–40 percent, and the import bill growing by 50–60 percent.

From boom to bust

When the financial crisis hit the world in the summer of 2008, Ukraine was among the many emerging markets to suffer from the fallout. Access to international capital markets was curtailed sharply, currency markets sold off the hryvnia, and the credit rating agencies downgraded the country's debt.

Ukraine's government acted proactively by putting together a comprehensive package of policies and requesting IMF support in mid-October. Later that month, a tenta-

tive agreement on a program was reached through use of the IMF's emergency lending procedures. And on November 5, the IMF's Executive Board gave the agreement its stamp of approval.

"The authorities' program, supported by a two-year Stand-By Arrangement with the IMF, aims to restore financial and macroeconomic stability," Deputy Managing Director Murilo Portugal said in a press release. "The commitment of leaders of the main political parties to the core elements of the program increases the prospects for successful program implementation. All these elements give confidence that the program will succeed in stabilizing economic and financial conditions."



Restoring confidence

Ukraine's program is underpinned by policies aimed at restoring economic and financial stability. The package includes a flexible exchange rate, measures to recapitalize the banking system, and prudent fiscal and incomes policies that take into account the need for additional social spending to address the impact of the recession on the population.

The government is hoping to achieve three key goals.

- **Help the economy adjust to the new economic reality.** Allowing the exchange rate to float will act as a shock absorber, and will help the economy recover some of its lost competitiveness. The government is also planning to achieve a balanced budget in 2009, although this goal

will be reviewed in light of economic developments. To achieve this, the authorities intend to phase in increases in energy tariffs. They also plan to pursue a balanced incomes policy that protects the population while slowing the rapid increase in prices: the minimum wage and other social transfers will be adjusted in line with projected inflation.

- **Restore confidence and financial stability.** Recapitalizing viable banks will help shield the economy from a potential credit crunch. Dealing promptly with banks in difficulty will help the rest of the financial sector recover more quickly, and will allow solvent banks to resume lending to households and companies.

- **Protect vulnerable groups in society.** Ukraine already has an adequate social safety net, but the economic downturn is bound to put pressure on vulnerable groups. To counter the immediate effects of the crisis, the IMF-backed program envisages an increase in targeted social spending amounting to 0.8 percent of GDP to shield vulnerable groups. The government has indicated that it is prepared to expand the social safety net further if necessary.

Recovery in sight

Ceyla Pazarbasioglu, the IMF's mission chief for Ukraine, told reporters on November 5 that the IMF believes the Ukrainian economy could be back at its estimated potential growth rate of 5-6 percent by 2011 while inflation will come down to single-digit levels, assuming that the global economy starts recovering in the second half of 2009.

"The road ahead is difficult," Pazarbasioglu told reporters. "But Ukraine has enormous potential and should be able to reach it with consistent implementation of adequate policies."

Asked about the worst-case scenario for Ukraine, Pazarbasioglu said that the country's recovery could be impeded if global conditions continue to deteriorate and if there is further deleveraging in global financial markets. But she pointed out that the authorities' program is based on conservative assumptions and that contingency plans have been specified. ■

Future Role of IMF Is Debated as Financial Crisis Takes Toll

Amid hectic meetings of world leaders trying to stem the collapse of the financial system, leading economists and politicians debated the IMF's future role and governance in a reformed financial order.

British Prime Minister Gordon Brown said on October 15 that the IMF should be reshaped to help regulate the world's financial system and avoid a repeat of the global credit crisis, a proposal similar to that of the Egyptian Finance Minister Youssef Boutros-Ghali, the new head of the IMF's policy guidance committee, the International Monetary and Financial Committee.

"The IMF should, in the near future, step in to put some coherence in financial regulations and in the surveillance of financial markets—cross-border surveillance, cross-border coherence between regulatory practices, accounting practices, and so on," Boutros-Ghali told the *IMF Survey* in an interview. "Many of these things have been suggested by a number of study groups and experts, and I think the IMF is eminently capable of being the institution that implements these recommendations."

Taking on new role

How the IMF should be reformed to take on a new role following the financial crisis was debated by a high-level panel organized by the Per Jacobsson Foundation during the IMF–World Bank Annual Meetings on October 12.

Acting as moderator, Andrew Crockett, Chairman of the Per Jacobsson Foundation and President of JPMorgan Chase International, said that the IMF, in the course of its 64-year history, had shown itself to be quite adaptable as the world economy changed. But this time, he said, "the transformation of the IMF's role in the international financial system will need to be more wide-ranging than in the past."

He asked the panel to consider four questions:



The Per Jacobsson Foundation panel, comprising (from left) Andrew Crockett, Jean Pisani-Ferry, Raghuram Rajan, and Trevor Manuel, discussed how the IMF should be reformed to take on a new role.

- How can the IMF be more effective in helping prevent, and deal with, global financial instability?
- How can the IMF be more effective in ensuring that exchange rates play their appropriate role in facilitating adjustment?
- How can the IMF adapt its lending facilities in the light of changing realities?
- If governments were starting afresh in 2008, how would the international monetary institution they might design differ from the IMF?

Trevor Manuel, South Africa's Finance Minister, said the IMF had, until now, seemed remote from the crisis, a bad sign for the relevance of the institution. "The big challenge, then, is to try and bring the IMF back into center stage."

At the heart of the issue of the IMF's relevance was the issue of legitimacy—developing and emerging market economies must feel that their voices are being heard. "Ownership at a time like this is fundamentally important," Manuel said.

Raghuram Rajan, a former IMF Economic Counsellor and now Professor of Finance at the University of Chicago

Graduate School of Business, said the origins of the current crisis went much beyond the role of the IMF. "Clearly, the United States tried to boost demand to compensate for a collapse in demand elsewhere," he said. "The multilateral system has been failing over the last so many years in putting the onus of being the demander of last resort on the United States."

Global imbalances

Stanley Fischer, a former IMF First Deputy Managing Director and now Governor of the Bank of Israel, said there were good reasons why the IMF had not been successful in addressing the buildup in global imbalances that had preceded the crisis. "The Fund's role in patrolling the exchange rate system didn't work—something we already know."

"But we also know why it didn't work," Fischer continued. "For the Fund to have succeeded, it would have had to mediate between the country with the largest population in the world and the country with the largest GDP in the world, and get them to reach an agreement that they were incapable of reaching bilaterally. China was not willing

to change its strategy of operating with an undervalued exchange rate, which has been an extremely successful one from the viewpoint of growth," he said.

Intellectual credibility

Jean Pisani-Ferry, Director of Bruegel, the Brussels-based think tank, agreed that the IMF wasn't solely to blame for its lack of influence and ability to prevent the current crisis. The IMF's Spring 2007 *Global Financial Stability Report* (GFSR) had accurately described the first phases of the crisis, he said, and the Spring 2008 GFSR had also been much more accurate than analysis provided by other international institutions and national governments. "The IMF has gained—or regained—intellectual credibility," he said.

Fischer agreed with Pisani-Ferry on the quality of the IMF's analysis, which was criticized in April 2008 for being overly pessimistic. "The *Global Financial Stability Report* can rightly claim to have foreseen and warned about many of the developments that led to the present situation," he said.

The panelists had less kind words for the IMF's policy dialogue with its member countries. Pisani-Ferry suggested that recent Article IV consultations with the United States represented a missed opportunity. "We cannot remember what the IMF told the U.S. authorities," he said.

Panelists also commented on the impact of the IMF's 2007 Decision on Bilateral Surveillance on its monitoring of exchange rates. "After the revision of the 1977 decision on surveillance, the only thing that has been weakened in the process is the credibility of the Fund because it has not been able to resist U.S. pressure, and it has not been able to tell China what it was supposed to tell it about its exchange rate policy," Pisani-Ferry said.

Rajan used another example—the IMF's advice on short selling, a practice that some viewed as exacerbating the recent collapse of stock market prices—to illustrate what he saw as a lack of evenhandedness on the part of the Fund. In 2007, the IMF had explicitly encouraged the Indian authorities to allow short selling by all institutional investors, he said. But the Fund did not publicly criticize the United States when it banned short sales in the middle of the financial crisis.

"What we are missing in these moments is the absence of a strong international, independent voice which stands for the world economy and fights for the world economy," Rajan said.

Most speakers saw an enhanced role for IMF lending. Fischer accurately predicted that a number of countries at the periphery of the financial crisis would be needing help and would turn to the Fund for support.

"There will be more IMF programs in the months ahead," he said. And if IMF programs could help leverage financing from other sources, including surplus countries such as Japan, "that would be very useful in ensuring the success of those adjustment packages."

Reinventing the IMF

There was agreement among the panelists that the world still needed an IMF. But the Fund faces significant challenges in fulfilling its mandate in today's world. As Fischer put it, "How should the Fund operate in the modern world in which financial markets are a much more important source of financing than they were 60 years ago, in which governments are less inclined to think in terms of what's good for the international system as a whole, and in which there are many more international economic organizations? This is really at the heart of many of the dilemmas currently facing the Fund."

According to Manuel, it is not just up to the Fund: countries must accept the rules of multilateralism. "One has to start from the fundamental view that if you accept public policy and you accept the interconnectedness of the global economy, then you need an institution appropriate to its regulation."

The problem is that not all players in the international system are willing to accept the need for such rules and regulation, while other players are trying to use international financial institutions as levers for their own foreign policy goals. "You either accept multilateralism and the need for it, or you try and opt out," Manuel said.

Closer cooperation

Fischer also spoke about the need to strengthen the IMF's role in ensuring global financial stability and its relationship with the Financial Stability Forum (FSF), established in 1999 by the world's advanced econ-

omies to promote international financial stability through information exchange and international cooperation in financial supervision and surveillance. "The FSF was set up after the Asian crisis in a way that ensured the IMF would not be closely involved in this area. It was an industrialized country move to keep the IMF in its place—that is, as an institution that the G-7 would not have to listen to. That was simply a mistake.

"The FSF is doing excellent work, but it is not a global institution as is the Fund. There is a need for much closer cooperation between it and the Fund, and this requires more than lip service from the industrialized countries. It requires that they increase the IMF's role in the area of financial stability," Fischer said.

There were a number of questions and comments from the audience following the panel debate. Edwin M. Truman of the Peterson Institute for International Economics wondered whether the current financial crisis was "made in Washington or made in the world." And was the crisis brought on by failures at the microeconomic level—lack of proper supervision and oversight—or by the imbalances at the macroeconomic level that contributed to the buildup of the massive housing bubble in the United States?

"There is an important, new, practical, and urgent mission for the IMF, and that is to protect the countries at the periphery from the consequences of a storm at the center," George Soros, the well-known investor and philanthropist, said. "One way to do that would be for the IMF to act as an honest broker, helping channel funds from surplus countries, such as Japan, to countries in urgent need of financing."

And according to Nancy Birdsall of the Center for Global Development, "the IMF had benefited in the 20th century from the reality that the United States was a benign hegemon, at least for the market economies. But in this century, as demonstrated by the current crisis, the United States, although it still is the superpower in many respects, cannot act alone—and yet that is not yet reflected effectively in the way the IMF is organized, managed, and governed." ■

Camilla Andersen
IMF External Relations Department

Developing Countries Need Strategy to Face Global Crisis Impact

Low-income countries should position themselves to respond to ripple effects from the global financial crisis, David Carew, Sierra Leone's Finance Minister, said during the IMF-World Bank Annual Meetings.

Carew, noting the interventions by advanced economies to support their banking systems, said that it is clear that countries in Africa do not have the capacity to take such steps. He said that low-income countries cannot yet deal with the impact of future credit problems in developing markets but stressed it is essential that developing countries “develop a strategy to take on the crisis when it happens.”

Carew and Ali Lamine Zeine, Minister of Finance and Economy in Niger, said it was critical to the poorest countries that advanced economies do not back off aid commitments because of the global financial crisis. Carew and Zeine spoke at an October 12 press conference after the release of a communiqué by the finance ministers of the 33 countries eligible for the IMF's Heavily Indebted Poor Countries (HIPC) initiative.

Separately, IMF Managing Director Dominique Strauss-Kahn also stressed that advanced economies must not cut aid budgets because of the financial crisis.

He emphasized on October 9 the IMF's readiness to act quickly through its emergency financing procedures to lend to countries needing help during the present financial crisis. The IMF has more than \$200 billion of loanable funds and can draw on additional resources through two standing borrowing arrangements.

Falling remittances

The ministers said the financial crisis, with the attendant slowdown of growth in advanced economies, will affect low-income countries in many ways—among them falling remittances, reduced capital flows, higher borrowing costs, and reduced demand for their exports.

The ministers pledged steps to improve their economies on their own, but also urged donors to fulfill their pledges of development financing and cited the need for more concessional loans. They said such steps are essential if the poorest countries are to make progress toward meeting the Millennium Development Goals. The ministers also urged the IMF and World Bank to produce comprehensive analysis of the impact of the crisis on low-income countries.



Ali Lamine Zeine, Niger's Minister of Finance (at left), and David Carew, Sierra Leone's Finance Minister, speak at the IMF-World Bank Annual Meetings, where participating ministers voted to expand their HIPC network group.

Eugene Salazar/IMF

They noted that there has been little progress toward increasing the number of non-Paris Club governments in the debt reduction strategy of the HIPC initiative and toward dealing with the actions of so-called vulture funds, which buy poor-country debt and then seek to enforce payment in the legal system.

Debt sustainability problems

The ministers also voted to change the name of their network to the Low-Income Countries' Debt Sustainability Network and to expand membership to include all low-income countries with debt sustainability problems, whether or not they are eligible for the HIPC initiative.

The IMF said on October 10 that growth in sub-Saharan Africa is projected to ease, reflecting increases in food and fuel prices, slower world growth, and global financial turmoil. The forecast also raised the risk of a decline in resource flows to Africa in the form of private capital, remittances, and aid.

Speaking at a November 7 conference in Arusha, Tanzania, IMF African Department Director Antoinette Sayeh stressed that policymakers should be vigilant and flexible in response to the crisis.

“Even though the circumstances and policies implemented in reaction to the crisis may vary sharply across countries, these should not derail the growth strategies that have been put in place in the past decade and have started to bear fruit,” Sayeh said. ■

Foreign Currency Borrowing Is More Risky for Eastern Europe

Europe's emerging markets are increasingly exposed to currency risk, heightening these countries' exposure to the banking crisis that is currently sweeping across Europe and raising the alarm among those concerned with financial stability.

New research by the IMF shows that 15 percent of outstanding private sector credit in Eastern Europe today is either denominated in or indexed to foreign currencies, compared with only 4 percent a decade ago. Euroization (taking out loans in euros rather than the local currency) has also accelerated, adding to the risks.

Reasons for changed behavior

Why are borrowers and lenders switching from local currencies to euros and Swiss francs? New research by the IMF shows how economic incentives interact with country-specific characteristics, leading to striking differences among the new member states that joined the EU in 2004 (see chart).

Four main factors explain why Eastern European households and companies are now switching to loans in euros and Swiss francs.

- The difference between domestic and euro zone interest rates drives foreign currency borrowing, as suggested by economic theory. But unlike other parts of the world (for instance, Latin America), past exchange rate volatility has no statistically significant effect. One reason may be that EU membership increases people's willingness to assume currency risk. If anything, people expect their currencies to further appreciate as their countries converge toward Western European price and income levels. The currency regime per se or membership in the Exchange Rate Mechanism—the EU's antechamber to euro adoption—have no measurable impact.

- The banking sector's dependence on foreign capital, as measured by the loan-to-deposit ratio, is a strong contributor to

foreign currency borrowing. Banks refinance themselves abroad and then pass on the currency risk to their clients, if only because they often are not allowed to hold open currency positions. It is irrelevant whether such foreign funding is channeled through domestic banks borrowing abroad (for instance, through syndicated loans) or through foreign-owned banks drawing on credit lines from their parent banks.

- Openness, captured by the relative size of foreign trade, also matters. Revenues from abroad make it easier for companies to hedge their foreign currency exposure. However, this does not seem to be the case for households—remittance flows do not seem to increase foreign currency borrowing.

- Regulatory policies (for instance, higher risk weights for foreign currency loans) have some measurable effect, but it is pretty weak. The impact of such policies disappears entirely if direct borrowing from abroad is included. This illustrates that regulations imposed by domestic supervisors are largely ineffective if borrowers have direct access to lenders abroad, as is the case within the EU.

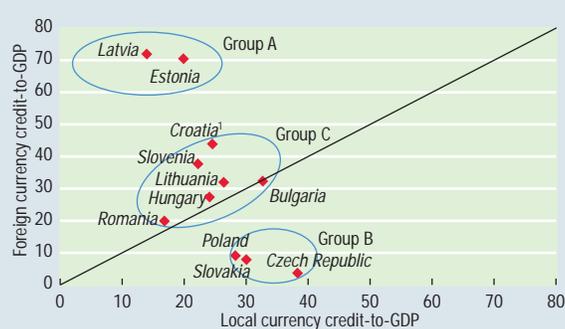
In sum, foreign currency borrowing is a by-product of EU membership. First, by fully liberalizing the capital account, the EU offers borrowers increased access to foreign funding, both through domestic banks affiliated with foreign parents and directly from abroad.

Second, by increasing trade openness, the EU provides hedging opportunities, especially for the corporate sector. Finally, EU membership seems to boost the private sector's confidence in exchange rate stability and imminent euro adoption, making devaluation seem like a low probability.

Change in behavior

Foreign currency borrowing is up dramatically in some new member states but not in others.

(percent, 2007)



Sources: National authorities; and IMF staff.

Protecting against risk

As Europe's policymakers ponder the need for stronger bank regulation and shared rules in the wake of the current banking crisis, the EU's new member states should seek to quickly implement measures that will reduce the risk associated with unhedged foreign currency exposure.

Regulation should be tailored to the new playing field created by the EU and should seek to steer borrowers and lenders away from currency risk, at least until the new member states adopt the euro and currency mismatches largely disappear.

As the IMF's research shows, regulatory measures have limited effect, at least for corporate lending, because access to foreign financing directly from abroad makes it easy to circumvent them. And because capital account restrictions are not an option under EU law, any measure to address foreign currency exposures will require even closer cooperation between supervisors in home and host countries. In that sense, the crisis presents Central and Eastern Europe with an opportunity to improve financial stability in a coordinated manner, working closely with their counterparts in Western Europe. ■

Christoph Rosenberg
Senior IMF Regional Representative
for Central Europe and the Baltics

Wealth Funds' Long-Term View May Help Stabilize Markets

The International Working Group of Sovereign Wealth Funds (IWG) published October 11 a set of 24 voluntary principles—dubbed the Santiago Principles—designed to ensure an open international investment environment.

The IWG also started examining the creation of a permanent international body to represent sovereign wealth funds. The *IMF Survey's* Simon Willson spoke with IWG Co-Chair Hamad Al Suwaidi during the 2008 IMF–World Bank Annual Meetings in Washington, D.C.

IMF Survey: What is different, now that the Santiago Principles have been published, from the situation beforehand?

Al Suwaidi: Publication of the Santiago Principles in itself is going to enhance understanding of the way in which SWFs [sovereign wealth funds] operate. Also, given the voluntary commitment of the SWFs and the effort they have shown to come and draft these commitments, I expect that the participants will publicly endorse the principles.

IMF Survey: Is there any mechanism for the IWG to monitor its members' compliance with the Santiago Principles?

Al Suwaidi: Now that the principles are a public document, nonimplementation or noncompliance will become clear in a short period of time, especially as some of the principles call for certain information to be disclosed. In addition, we are considering the establishment of a permanent representative body for SWFs and, although we don't yet know what the body's constitution will look like, part of it would be discussion of implementation of the principles. Some SWFs have decided to use independent third parties to confirm compliance with the Santiago Principles.

IMF Survey: SWFs are seen by some commentators as shock absorbers in volatile



Michael Spillito/IMF

Al Suwaidi: "By their very nature, sovereign wealth funds have a big stake in stable global financial markets."

markets, because wealth funds typically take a long-term view on their investments. Does this make SWFs potential contributors to market stability during the current global turmoil?

Al Suwaidi: Yes, I agree with that. One of the main principles of SWFs is to invest on an economic and financial risk-and-return basis. By law, these funds will not be able to get involved in noncommercial activity. The crisis that we are going through now is presenting excellent investment opportunities and, given the long-term nature of these funds, some have taken advantage of these opportunities. Because of their long-term approach, they could find investment options that would indeed add to the stability of markets. By their very nature, SWFs have a big stake in stable global financial markets.

IMF Survey: If the Santiago Principles have been drafted to guide SWFs, do the wealth funds now expect some similar document to emerge to guide host countries in the same way?

Al Suwaidi: We are aware of the work in this direction by the OECD (Organization for Economic Cooperation and Development), which has synchronized its activities with those of the IWG. We

and the OECD are two sides of the same coin on this issue. We see the principles as building trust further between host countries and SWFs, and we look forward to a positive reaction to the Santiago Principles from host countries. The new permanent body for SWFs would be a focal point of contact between wealth funds and recipient countries.

IMF Survey: The IWG is now exploring the creation of a standing group for SWFs—the proposed permanent international body for wealth funds. Would this new entity replace the IWG?

Al Suwaidi: The IWG was established to meet the request from the IMFC at the 2008 IMF–World Bank Spring Meetings that a set of principles be drafted, so that task ends with the publication of the Santiago Principles. Going forward, given the importance and the commitment of the SWFs to enhance the understanding between recipient countries and SWFs, the group decided to create a formation committee to consider the establishment of a standing group of SWFs that could meet to review the principles and consider other issues.

Yes, we will be monitoring the appropriateness of the principles going forward and making adjustments where necessary, but the standing group's purpose is to be defined by the formation committee. When the terms of reference are set, we will meet, and it will be more a forum for interaction than just a body editing the principles. ■

The International Working Group of Sovereign Wealth Funds (IWG) has made public the set of 24 voluntary principles and related explanatory material. To read the full text of the Santiago Principles and other information on the IWG, visit its website at www.iwg-swf.org/pubs/gaplist.htm

Middle East, Central Asian Growth Set to Remain High

The Middle East and Central Asia (MCD) region has continued to see strong growth in 2008, outpacing global growth for the ninth year in a row, the IMF says in its latest regional economic outlook.

Growth is underpinned by high commodity prices, strong domestic demand, and also the credibility of regional economic policies. So far, the Middle East and Central Asia region has been largely resilient to the ongoing international credit crisis and the downturn in the United States and other advanced economies.

“However, inflation has emerged as a key issue in the region, and is well above the average of all developing and emerging market countries,” said the IMF’s MCD Department Director Mohsin Khan at a press briefing in Dubai on October 20.

“For 2008 we expect real GDP in the region to grow about 6½ percent. In 2009, growth is projected to continue at a slightly slower pace, around 6 percent. This is still significantly higher than the global average,” Khan added.

The *Regional Economic Outlook* (REO) covers 30 countries, divided into three groups: oil exporters, low-income countries, and emerging markets. Oil exporters comprise Algeria, Azerbaijan, Bahrain, Iran, Iraq, Kazakhstan, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syria, Turkmenistan, and the United Arab Emirates. Low-income countries comprise Afghanistan, Armenia, Djibouti, Georgia, the Kyrgyz Republic, Mauritania, Sudan, Tajikistan, Uzbekistan, and Yemen. Emerging markets include Egypt, Jordan, Lebanon, Morocco, Pakistan, and Tunisia.

Oil-exporting countries are expected to continue to expand in 2008 at about the same rate as in 2007, supported by oil prices that are still high relative to historical averages, and a pickup in oil production compensating for a moderate slowdown in nonoil activity. But growth is expected to

Solid growth

Low-income oil importers are the region’s fastest-growing countries.

(annual change, percent)

| | Estimate 2007 | Projection 2008 | Projection 2009 |
|------------------------------|------------------|--------------------|--------------------|
| Middle East and Central Asia | 6.5 | 6.4 | 5.9 |
| Caucasus and Central Asia | 12.0 | 7.7 | 8.2 |
| Middle East and North Africa | 5.8 | 6.3 | 5.9 |
| By category | | | |
| Oil exporters | 6.4 | 6.4 | 6.1 |
| Low-income countries | 8.6 | 6.9 | 7.4 |
| Emerging markets | 6.1 | 6.4 | 4.9 |

Sources: National authorities; and IMF staff estimates and projections.

decelerate to 6 percent in 2009 in the wake of the global slowdown and lower oil prices.

Average growth in low-income countries is estimated to moderate to 7 percent, essentially because of the impact of rising international food and fuel prices during the first half of the year. In addition, drought has affected agricultural output in Afghanistan, and winter weather-related electricity shortages have hit economic activity in Tajikistan.

In emerging markets, growth is likely to remain strong in 2008, driven by a surge this year in foreign direct investment, including from the Gulf Cooperation Council (GCC) countries. Other factors include a rebound in Morocco’s agriculture sector and strong tourism in Lebanon. But growth in these countries is expected to slow in 2009 as the effects from the global slowdown take hold.

Inflation in the region is projected to rise to 15 percent in 2008, before easing somewhat in 2009 as world food prices drop. The main sources of inflationary pressures differ, however, across countries.

They range from the surge in food and fuel prices, which has affected mostly low-income and emerging market countries, to strong domestic demand pressures and supply bottlenecks in the GCC countries, to

the weakening of the U.S. dollar (through mid-2008), to which many MCD countries are pegged.

The REO sees some downside risks to the outlook. Growth could be lower than forecast in case of a sharper and more protracted slowdown in advanced economies, and if the effects from the financial turmoil become more pronounced. Inflation could be higher if international food and oil prices surge again, or if macroeconomic policy is eased too much.

In contrast, a drop in commodity prices would lessen inflationary pressures in the region, as would a further recovery of the U.S. dollar for those countries that peg to it. Although financial institutions in MCD countries are unlikely to suffer greatly from the global financial turmoil, a few countries are at risk from external contagion, and the financial sector in some has a significant exposure to regional real estate markets.

In addition to continued high unemployment in a number of countries, reflecting a rapidly expanding labor force, two main policy challenges are facing the region in the short term, says the report: the risk of rising inflation and the need to boost the resilience and flexibility of the region’s financial sector.

Many central banks in the region have already raised interest rates in response to rising inflation, but policy responses so far have been modest and interest rates generally remain negative in real terms. All countries should be particularly attentive to potential second-round inflation effects, and for this reason should avoid further broad-based wage increases.

Strengthening the banking system should be considered an important objective, in particular given the global environment. Policymakers should also closely monitor developments in real estate prices and assess vulnerabilities of the financial system to property price corrections and liquidity pressures. ■

High Food, Fuel Prices Are a Threat Where Protection Is Limited

Inflation has been rising in the Pacific islands on the back of strong increases in commodity prices.

Even though commodity prices have declined from recent peaks, food and fuel prices are still above historical levels and remain a concern in the islands, as most have only limited social protection systems.

Headline inflation in the islands has picked up since end-2007 beyond most central banks' comfort zone (see chart). The inflation seems largely imported: local fuel prices have increased steadily since December 2007. Food price inflation has also increased substantially.

Rising fuel and food costs put pressure on household budgets. The food share in total household spending is on average 50 percent for these islands—about twice as much as in the emerging markets.

There are also signs of homegrown demand pressures. Credit growth remains high and excess liquidity pervasive in Papua New Guinea and the Solomon Islands. Fiscal policies appear to have turned expansionary in the Solomon Islands, Timor-Leste, and Vanuatu.

Higher input costs (of animal feed and fertilizer, in addition to energy) have created pressures on prices. Wage pressures are

mounting, notably in Papua New Guinea and the Solomon Islands.

The impact of the higher commodity prices on the Pacific islands' domestic and external balances has been uneven. Most of the islands rely heavily on imports—mostly of food and fuel—while their export base remains narrow. As a result, their external balances are vulnerable to commodity price spikes. The Pacific island countries rely almost exclusively on oil-based fuel for their energy needs, limiting the scope for substitution in production and consumption.

Net food and oil importers such as Fiji, Kiribati, Samoa, and Tonga have been hit the hardest, and these countries are currently facing wider current account deficits.

By contrast, commodity producers such as Papua New Guinea (an exporter of oil, metals, and agricultural products) and Timor-Leste (an oil and gas producer) have benefited from a positive terms of trade shock. These countries still have a window of opportunity to convert the windfall gains into benefits for the economy as a whole, but they remain vulnerable to commodity price volatility.

Because most of the islands are either dollarized or have a pegged exchange rate regime, the exchange rate has a diminished role in curbing imported inflation. The weakening of both the Australian and New Zealand dollars has generated terms of trade losses for those countries whose exchange rates are pegged to these currencies.

The recent decline in commodity prices from record highs in mid-July may provide some respite. However, inflation is likely to decline only gradually in the Pacific islands as high transportation costs continue to feed through with a lag.

Commodity exporters still face an opportunity to increase their

medium-term growth prospects. Despite declines, oil prices remain elevated. In Papua New Guinea and Timor-Leste, the oil sector is for the most part foreign owned and relies little on local inputs.

Most of the linkages to the domestic economy are via the income tax and other revenues to the budget, as in Papua New Guinea, or to the petroleum fund, as in Timor-Leste. The benefits from high oil prices will depend critically on how revenue windfalls are utilized.

High food and fuel prices pose special challenges to low-income countries such as the Pacific islands. The authorities have to strike a balance between protecting the poor from price increases—especially food—and supporting demand to enhance growth.

Ideally, targeted transfer programs—as part of an integrated social safety net—could reach the poor efficiently. In the absence of effective safety nets, a package of measures building on existing programs such as school feeding programs, cash transfers to the most vulnerable populations, reduced education and health fees, and public transport subsidies could be identified.

A more effective approach would include targeted demand and supply responses, combined with donor support. The Pacific islands should continue to allow full pass-through of higher food and fuel prices to domestic prices, while allowing for some time to adjust.

Donor support—preferably grants—would also help limit the harm to real incomes. A more flexible exchange rate regime would also help to cushion inflationary pressures in the commodity-exporting countries. In the islands that have full dollarization or a pegged exchange rate regime, the need for fiscal restraint to facilitate the external adjustment and offset any increase in fuel and food subsidies is clearly heightened. ■

Patrizia Tumbarello

IMF Asia and Pacific Department

Discomfort zone

Inflation pressures are rising in the Pacific islands on the back of strong increases in commodity prices.

(consumer price index, year-on-year percentage change)



Sources: National authorities; and IMF staff estimates.

Current Crisis Highlights Importance of Data

A new head of the IMF's Statistics Department is taking over at a time of increased financial market turmoil around the world.

Adelheid Burgi-Schmelz, who until recently was Director General of the Swiss Federal Statistical Office, is a leader within the international statistical community and has extensive private sector experience.

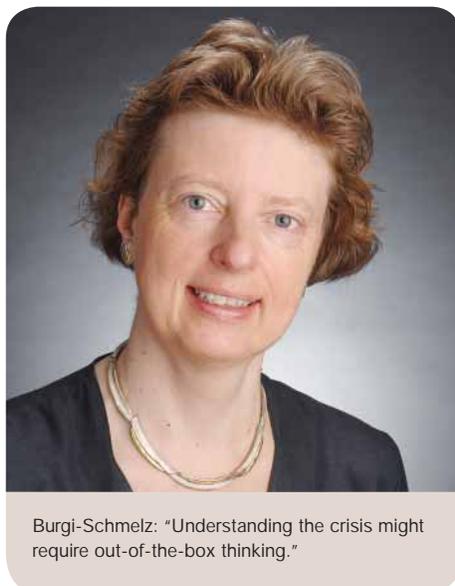
In an interview with the *IMF Survey's* Natalie Ramirez-Djumena, Burgi-Schmelz speaks about the use of statistics in shedding further light on the current financial crisis, the relevance in measuring national wealth, and what she views as her priorities as the new Director of the Statistics Department.

IMF Survey: Your previous assignment was Director General of the Swiss Federal Statistical Office. What prompted you to join the IMF?

Burgi-Schmelz: I enjoy the global perspective and appreciate the sound work the Fund is famous for delivering. Considering the present challenges both for the Fund and for the financial world, I am convinced that I can make a significant contribution based on my experience from heading a national statistical office and from my previous "real economy work" in the telecom industry.

IMF Survey: The current financial crisis has put major strains in financial systems that are of key relevance to the work of the IMF. How should the Statistics Department address some of these areas?

Burgi-Schmelz: The current financial crisis shows the limits of global financial and economic systems as they have evolved from national systems over the past decades. In my opinion, understanding the crisis might require out-of-the-box thinking. Since statistical work traditionally follows conventional data needs, it is



Burgi-Schmelz: "Understanding the crisis might require out-of-the-box thinking."

Courtesy of Adelheid Burgi-Schmelz

not surprising that new needs arise that cannot be necessarily satisfied with well-established statistics, such as government guarantees. In the Statistics Department work is already under way on identifying the main data needs that cut across financial and nonfinancial corporations, government, household, and nonprofit institutions sectors. I also support the Statistics Department's efforts to intensify its close cooperation with other international financial agencies to build on one another's comparative advantages in this field.

IMF Survey: The widely used statistical indicator gross domestic product (GDP)—which measures economic growth—has been criticized for not capturing, for example, the effects on the environment. Is GDP a satisfactory measure of economic progress?

Burgi-Schmelz: In my view, GDP remains a very important statistical indicator. But we have to broaden the scope of statistical observations to include other aspects that are relevant to what could be called the "wealth of nations" in a wider sense.

Wealth and progress rely heavily on economic aspects of well being, but they are not limited to it. Social and environmental phenomena have to be taken into consideration, too. This will eventually lead to several indicators—if not an indicator system—rather than a single indicator.

IMF Survey: Given recent pressures on IMF finances, the Fund has limited the resources earmarked for capacity-building activities. How will this impact the Statistics Department's technical assistance program?

Burgi-Schmelz: As far as I know, the Statistics Department's technical assistance program used to take up a significant portion of the department's activities. Given the important resource reductions, major changes are required. They might include more standardized technical assistance products or train-the-trainer concepts. For such approaches to be developed, further information—for example, on countries with successful technical assistance implementation, on technical assistance demand seen by area departments, and on cost tracking—needs to be put together.

IMF Survey: What's your vision for how the Statistics Department is going to work with IMF area departments? How will it support the Fund's mission and make the institution more effective?

Burgi-Schmelz: It is important for the Statistics Department to have a good understanding of the needs of area departments. At the same time, area departments should be familiar with the "products" of the Statistics Department and how they can be used for the mission of the Fund in general and of the area departments in particular. This kind of coherence is very important to me. It might also lead to a repositioning of the Statistics Department's products to better serve the needs of the Fund. ■

IMF Reviews Georgia's Arrangement

An IMF mission visited Tbilisi in late October to conduct the first review under Georgia's 18-month, \$750 million Stand-By Arrangement (SBA) and confirmed that end-September targets for international reserves, net domestic assets of the central bank, and the overall fiscal deficit were met.

Because of its fundamental strengths, the Georgian economy is well placed to recover from the August 2008 armed conflict, which created the need for an IMF loan. Nonetheless, Georgia is not immune to the impact of the unfolding global financial turmoil. Foreign capital inflows, already affected by the conflict, may be further delayed.

An October 22 donor conference in Brussels resulted in pledges of about \$4.5 billion for the country. This support will help finance much-needed social and reconstruction spending and contribute to the recovery of economic growth.

Unregulated Investment Schemes

The IMF's Caribbean Regional Technical Assistance Center (CARTAC) sponsored a three-day meeting on understanding and combating unregulated investment schemes, in collaboration with the U.S. Securities and Exchange Commission, the U.S. Commodity Futures Trading Commission, the U.S. Agency for International Development, and the Jamaican Financial Services Commission.

The meeting brought together 70 Caribbean participants to discuss pyramid-type schemes. "Pyramid schemes are a growing problem in the Caribbean," said Therese Turner-Jones, CARTAC's Program Coordinator.

IMF Congratulates Barack Obama

IMF Managing Director Dominique Strauss-Kahn extended congratulations to U.S. President-elect Barack Obama following his victory in the November 4 election.

"This is a historic occasion for the United States, and represents the best of the ideals that we in the international community strive to embody," Strauss-Kahn said in a statement. "I look forward to working closely with President-elect Obama and the U.S. Administration in the period ahead in dealing expeditiously and forcefully with the serious challenges facing the U.S. and global economies at the present time."



Alain Bourron/PhotoPOR/Sud Ouest

Kyrgyz Republic Seeks IMF Support

The IMF and the authorities of the Kyrgyz Republic have reached an agreement in principle on an economic program supported by an 18-month arrangement under the Exogenous Shocks Facility. This agreement, which requires the approval of the IMF Executive Board, would provide financial support of at least \$60 million.

The authorities seek to address the adverse consequences of the exogenous shocks that have hit the Kyrgyz economy, including the increase in international food and energy prices and the shortfall in domestic power generation due to low water levels in the Toktogul reservoir. They also aim to manage the effects of the slowdown in regional economic growth and potential spillovers from the international financial crisis.

Cambodia's Growth Eases

Following several years of very strong performance, Cambodia's economy "faces a number of challenging headwinds," an IMF mission team said in a November 7 statement following its annual consultation with the country. Since 2004, Cambodia's economy had been growing at more than 10 percent a year.

But growth has eased over the course of 2008, and the economy has recently begun to feel the effects of global financial stress, said the mission. Garment exports and tourist arrivals are slowing, reflecting a downturn in key trading partners' economies as well as a strain on competitiveness owing to a significant appreciation of both the riel and U.S. dollar combined with high domestic inflation.

These factors are expected to lead to an easing of Cambodia's growth to 6½ percent in 2008, and a further slowing to about 4¾ percent in 2009, the statement said.



Tang Chhin Sothy/AFP Photo

Africa Conference

The Tanzanian government and the IMF are jointly sponsoring a high-level conference in Dar es Salaam on March 10–11 to discuss how Africa can meet the challenge of sustaining and building on its recent economic successes.

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