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On October 5, IMF Managing Director Horst Köhler made a statement on the situation of the world economy and the IMF's response (News Brief No. 01/98). The text of the statement is on the IMF website (www.imf.org).

World Economic Outlook

Report confirms slowdown in global economy, rebound could be evident in first half of 2002

As was widely anticipated, the *World Economic Outlook*, the IMF's biannual survey of global prospects and policies, is projecting a further weakening of the global economy this year. World growth is now expected to be 2.6 percent—sharply lower than the *World Economic Outlook's* projection in May of 3.2 percent and well below last year's 4.7 percent growth rate. However, these projections were completed just before the September 11 terrorist attacks on the United States. At a press briefing on September 26, Kenneth Rogoff, Economic Counsellor and Director of the IMF's Research Department, provided an updated assessment of the economic impact of the attacks, based on the latest information. He noted that even before the September 11 attacks, projections "were already showing marked slowdowns in activity in almost all regions of the world," reflecting a delayed recovery in the U.S. economy, a downturn in Europe, and a continuing slump in Japan. *(Please turn to the following page)*

IMF Economic Counsellor Kenneth Rogoff reports on the World Economic Outlook *at a press briefing. Tamim Bayoumi (left) and David Robinson, both from the IMF Research Department, were on hand to answer questions.*

Press briefing

Köhler expresses optimism about recovery, citing improvement in fundamentals

Uncertainties about the economy are higher in the wake of the terrorist attacks on New York and Washington on September 11, IMF Managing Director Horst Köhler said. He noted, however, that the IMF still expects the U.S. economy and the global economy to recover—perhaps early next year—although the recovery could take longer and be less strong than had been thought some weeks or months ago. Köhler was speaking at a press briefing on September 19 in Washington, during which he answered a number of questions about the prospects for the global economy and for individual member countries.

IMF Managing Director Horst Köhler.

The IMF's cautious optimism is based on the improved fundamentals that were already present in the global economy, the policy response that has taken place, and the scope for further policy adjustments, if necessary, to strengthen the prospects for sustained recovery. For example, Köhler said, there is scope for further monetary and fiscal policy easing in most of the advanced countries because budgets are broadly under control and inflation does not appear to be posing any acute problems. External positions have also improved in most emerging market countries, with most maintaining flexible exchange rates. (See also the report on the *World Economic Outlook* press conference, this page.) Despite the difficult situation in the global economy, he noted that the decisions of central banks around the world—to inject liquidity and cut interest rates—were a powerful demonstration of a policy response that would have a positive impact. International financial markets have continued functioning, further evidence of their increased resilience. Köhler also emphasized his belief that new technologies and *(Continued on page 312)*

IMF report confirms global slowdown

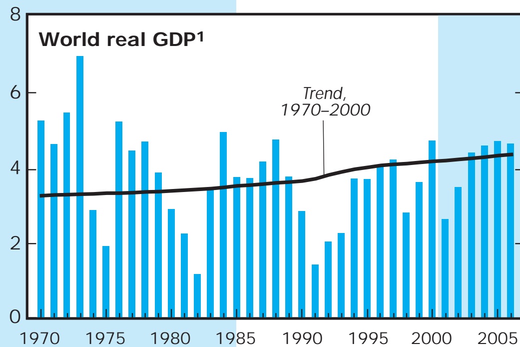
(Continued from front page) Although it is too early to assess the quantitative effects of the attack, the IMF study notes that recent events will clearly have an impact on activity in the short term, adding to the already significant downside risks both in the United States and elsewhere. The effect on projected global growth in 2001 is likely to be moderate, because developments in the third and fourth quarters of the year have a limited impact on the average growth rate for the year as a whole. In 2002, however, Rogoff said, global growth is likely to be "rather lower" than the 3.5 percent presently projected. Despite these gloomy prospects, Rogoff expressed cautious optimism about the global outlook, noting that "there is still a reasonable prospect that a recovery will begin in the first half of next year."

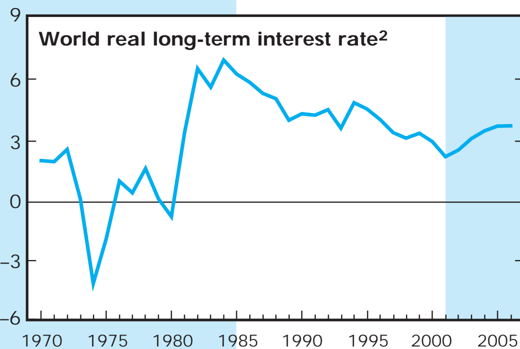
Although the *direct* economic damage of the events of September 11 may turn out to be relatively moderate, Rogoff said, the potential *indirect* effects on consumer sentiment and spending, business confidence, and risk aversion are likely to be significantly more important.

However, while there are clearly substantial uncertainties about unfolding events, one should not overlook that the economic fundamentals in many countries have improved in recent years, and, from an economic perspective, this leaves the world somewhat less vulnerable than it might otherwise be. These improvements, he said, together with the aggressive response by central banks across the globe, should help mitigate the risk of sustained reductions in consumer and business confidence.

Global indicators

annual percent change unless otherwise noted





Note: Shaded areas indicate IMF staff projections. Aggregates are computed on the basis of purchasing power parity weights unless otherwise indicated.

[1]Average growth rates for individual countries, aggregated using purchasing power parity weights; these shift over time in favor of faster growing countries, giving the line an upward trend.

[2]GDP-weighted average of the10-year (or nearest maturity) government bond yields minus inflation rates for the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada. Excluding Italy prior to 1972.

Data: *World Economic Outlook, October 2001*

Projections

The baseline projection for the United States envisages growth of 1.3 percent this year and 2.2 percent in 2002, down from the May 2001 *World Economic Outlook* estimates of 1.5 percent and 2.5 percent, respectively. The fallout from the September 11 attacks will likely cause further weakening of activity in the short term.

The outlook for other industrial countries, according to the IMF study, has been revised down more significantly. In the euro area, growth has been marked down by 0.6 percentage point to 1.8 percent, driven by a sharp weakening in domestic demand growth, particularly in Germany, and a greater than expected impact of the global slowdown. Of particular concern, the *World Economic Outlook* notes, are Japan's prospects, which have become "increasingly somber." Its GDP is now projected to decline by 0.5 percent in 2001, more than 1 percentage point worse than projected earlier, and the economy is now likely experiencing its fourth recession (defined as two quarters of negative real GDP growth) of the past decade.

Prospects for most developing and transition countries have also deteriorated, according to the *World Economic Outlook*, with declines in information technology spending affecting Asia in particular, and deteriorating financing conditions adding to concerns in a number of emerging markets, especially in Latin America.

Risks and prospects

GDP growth is now slowing in almost all regions of the globe, accompanied by a sharp decline in trade growth. In response, the *World Economic Outlook* notes, many countries have eased macroeconomic policies, most recently in mid-September in the aftermath of the terrorist attacks. This easing, along with the gradual abatement of oil prices and of other shocks that contributed to the slowdown, should help support activity and confidence in the period ahead.

Overall, however, the IMF study observes, the current conjuncture of developments is characterized by "unusually large uncertainties and risks," both in advanced and emerging market economies. First, with the broadening of the economic slowdown, there is now no major region providing support to global activity. This has increased the vulnerability of the global economy to shocks and heightened the risk of a self-reinforcing, deeper, and more prolonged downturn. Another risk is that slowing growth will put increasing pressure on financial and corporate sectors in a number of countries, notably Japan. Also, while emerging markets benefit from lower global interest rates, financing conditions remain volatile, partly reflecting continued uncertainties in Argentina and Turkey. Finally, the terrorist attacks on the United States exacerbate all of these risks and add a further one—the possibility of increased volatility in oil prices.

Countering these risks, Rogoff said at the press briefing, there are a number of reasons for cautious optimism. First, there is now a sizable amount of policy stimulus in the pipeline in most major economies. Second, stronger economic fundamentals across the

globe include lower inflation, stronger fiscal positions, greater monetary policy credibility, and, in many emerging markets, more flexible exchange rate regimes and lower external vulnerabilities. Third, the terrorist attacks should not substantially affect underlying productivity in the United States, on which economic prosperity ultimately depends.

Summing up, Rogoff said, the downside risks identified in the *World Economic Outlook* have increased as a result of the terrorist attacks, even if the economic channels are largely the same. The task for policymakers has correspondingly become more challenging, both in advanced and in developing countries. But "the basic requirements remain those set out in the *World Economic Outlook*." In particular:

- The aggressive monetary policy response following the attacks has been appropriate, and there remains room for maneuver, to varying extents, if additional action is needed. In particular, there remains room for a more aggressive monetary easing in Japan. On the fiscal side, the automatic stabilizers should be allowed to operate. Beyond that, it is probably best to wait and see how events develop.
- Given the uncertainties in the United States, other countries—notably in Europe and Japan—will have to rely more on internally generated growth. This makes it even more important to press ahead with structural reforms.
- The weaker global outlook has clearly added to the difficulties facing emerging market countries. With markets increasingly differentiating according to policy performance, the central requirement remains to stay the course of prudent macroeconomic policies and structural reforms.

In addition to the main chapter on prospects and policy challenges, the *World Economic Outlook* also takes an in-depth look at international linkages, the information technology revolution, and international financial integration and developing countries. ■

The text of the *World Economic Outlook*, as well as a transcript of Rogoff's September 26 press briefing, is available on the IMF's website (www.imf.org). Printed copies, which will be available later this month from IMF Publication Services, are $42.00 each (academic rate: $35.00). See below for ordering information.

Recent publications

Books

Macroeconomic Issues and Policies in the Middle East and Africa, edited by Zubair Iqbal ($28.00)
Capacity Building, Governance, and Economic Reform in Africa (combined English and French text), Michel Dessart and Roland Ubogu ($19.00)
IMF Annual Report 2001 (free)

Working Papers ($10.00)

01/93: *Consumption-Based Interest Rates and the Present-Value Model of the Current Account—Evidence from Nigeria*, Olumuyiwa S. Adedeji
01/109: *Short-Term Forecasting: Projecting Italian GDP, One Quarter to Two Years Ahead*, Matteo Iacoviello
01/111: *The Asset Allocation of Emerging Market Mutual Funds*, Piti Disyatat and Rafael G. Gelos
01/114: *Institutional Reform in Transition Economies: How Far Have They Come?* Beatrice Weder
01/115: *Multiple Avenues of Intermediation, Corporate Finance, and Financial Stability,* E. Philip Davis
01/116: *Who Can Explain the Mauritian Miracle: Meade, Romer, Sachs, or Rodrik?* Arvind Subramanian and Devesh Roy
01/117: *Agents' Preferences, the Equity Premium, and the Consumption-Saving Trade-Off: An Application to French Data*, Anne Epaulard and Aude Pommeret
01/118: *Financial Liberalization, Money Demand, and Inflation in Uganda*, Jean-Claude Nachega
01/119: *The Impact of U.S. Economic Growth on the Rest of the World: How Much Does It Matter?* Vivek Arora and Athanasios Vamvakidis
01/120: *Czech Koruna and Polish Zloty: Spot and Currency Option Volatility Patterns*, Armando Morales
01/121: *Is Foreign Debt Portfolio Management Efficient in Emerging Economies?* Luiz R. De Mello Jr. and Khaled Hussein
01/125: *Pension Reform in India*, Robert Gillingham and Daniel Kanda
01/129: *Real Estate Market Developments and Financial Sector Soundness*, Paul Hilbers, Qin Lei, and Lisbeth Zacho
01/130: *The New International Financial Architecture and Africa*, Françoise Le Gall and Saleh M. Nsouli

IMF Staff Country Reports ($15.00)

01/158: Kingdom of the Netherlands—Aruba: Statistical Appendix
01/159: Kingdom of the Netherlands—Aruba: 2001 Article IV Consultation
01/160: Republic of Lithuania: Request for Stand-By Arrangement
01/161: Republic of Slovenia: Financial System Stability Assessment
01/162: Algeria: 2001 Article IV Consultation
01/165: Kiribati: 2001 Article IV Consultation
01/169: Sweden: Selected Issues

Other Publications

What Is the International Monetary Fund? A Guide to the IMF (free)

Publications are available from IMF Publication Services, Box X2001, IMF, Washington, DC 20431 U.S.A.
Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

For information on the IMF on the Internet—including the full texts of the English edition of the *IMF Survey*, the *IMF Survey*'s annual *Supplement on the IMF*, *Finance & Development*, an updated *IMF Publications Catalog*, and daily SDR exchange rates of 45 currencies—please visit the IMF's website (www.imf.org). The full texts of all Working Papers and Policy Discussion Papers are also available on the IMF's website.

Köhler optimistic on world economic recovery

(Continued from front page) the potential for productivity gains had not yet been fully exploited, particularly in Europe. In addition to information technology, the world is on the brink of realizing more potential from biotechnology and communications technology. This is yet another reason, Köhler said, "that I feel we should not exaggerate pessimism."

In response to an observation that the health of the U.S. economy seems to be key to that of the global economy, Köhler pointed out that, for too long, European and Japanese policymakers had "underestimated the spillovers from the slowing in the United States." More than ever, he said, they must know that they cannot rely on the United States, but must use their own means to strengthen growth prospects.

In other regions of the world, Köhler said, there is still room for maneuver. In Europe, for example, he commended the European Central Bank for lowering interest rates but said policymakers could accelerate structural reforms and allow automatic fiscal stabilizers to work fully. In Japan, the government should ease monetary policy more aggressively by buying back government debt and setting a target to eliminate deflation, as well as make a convincing start on structural reforms, tackling, in particular, the nonperforming loans in its banking system. He also stressed that starting a new trade round would be an important step for building confidence: it would demonstrate that the international community has not given up on policy integration as a major vehicle for fighting poverty and achieving sustained growth in the global economy.

Köhler touched on the situations in several other regions. Turning to Latin America, he acknowledged that difficulties had increased for Argentina and Brazil, but said that both countries had taken steps to tackle their problems and were on the right track. Turkey has also implemented ambitious reforms, including restructuring the banking system and reinforcing fiscal discipline. However, high interest rates signal that Turkey's problems have not been solved. On countries like Turkey and Argentina, Köhler said, what is needed is demonstration of the implementation of the right policies, not big new programs, which could even undermine confidence. The IMF stands ready with its advice and its expertise to help countries, "but it's always...the main responsibility of the countries themselves to take the right actions."

Pakistan, under its Stand-By Arrangement with the IMF (see News Brief No. 01/96, September 26 on the IMF's website), has complied with all the program criteria, Köhler said. On that basis, he explained, the IMF anticipated that it would extend concessional financing to Pakistan in connection with a Poverty Reduction and Growth Facility Arrangement, under which Pakistan would discuss debt relief with Paris Club creditors. Discussing whether the IMF had the resources to respond to countries, like Pakistan, that could experience difficulties stemming from the terrorist attacks, Köhler said that it was necessary to have better information about the impact of the attacks before considering further action. He noted that the IMF has been monitoring countries very closely as part of its enhanced vulnerability analysis.

Köhler expressed interest in convening a meeting of the IMF's International Monetary and Financial Committee later this year to discuss the global economy and to review progress to date in fighting poverty and in strengthening the international financial system. ■

The full text of Köhler's press briefing is available on the IMF's website (www.imf.org).

Krueger emphasizes globalization has improved living standards

Anne Krueger

Briefing the press on September 24 in Washington, IMF First Deputy Managing Director Anne Krueger responded to questions about, among other topics, globalization and her view of the progress made in reforming the IMF since Managing Director Horst Köhler took office in May 2000. She also addressed specific questions about Brazil, Europe, Japan, Turkey, and the global economy. Like Köhler (see related article, page 309), she said that what happens to individual countries is largely a function of their own economic policies. She hoped countries would strengthen domestic policies and reforms but indicated that if, in spite of a country's best efforts, there still appeared to be a need for IMF financing, the Fund stood ready to discuss policies and provide assistance.

Discussing globalization and the sentiment against it, Krueger noted that two hundred years ago, poverty and undernourishment were widespread, and life expectancy was low. Thanks to globalization, parts of the world have since broken out of poverty and improved their living standards. More needs to be done for those who have been left behind, Krueger said, but globalization will continue to be a vehicle for enhancing living standards globally and closing the gap between the industrial countries and the rest of the world.

Turning to reforms of the IMF, Krueger said she was mostly in agreement with the changes being made, particularly the streamlining of conditionality and the renewed focus on the IMF's core competencies. As for the emphasis on poverty, she noted that establishing macroeconomic stability and cutting inflation rates enhanced growth and served the poor well.

The full text of Krueger's press briefing is available on the IMF's website (www.imf.org).

IMFSURVEY

IMF view of financial year 2001 highlights increasing openness, continuing reforms

The IMF's recently released *Annual Report 2001* spotlights the organization's intensifying efforts to increase its own openness and that of its member countries. The report, which summarizes the IMF's reforms and operational work in financial year 2001 (May 1, 2000–April 30, 2001), also highlights enhanced surveillance efforts—notably in assessing financial sector soundness and promoting internationally recognized standards and codes of good practice—as well as strong steps taken to rationalize and update its lending practices, streamline its conditionality, and broadly refocus its resources on core macroeconomic responsibilities and the improved functioning of financial markets.

In all of its activities during the year, the IMF sought to ensure that globalization worked for the benefit of all its members. It took significant actions to reduce poverty—notably by substantially reducing debt burdens under the joint IMF–World Bank Heavily Indebted Poor Countries (HIPC) Initiative. Substantial technical assistance to its member countries supported IMF work on financial crisis prevention and management, capacity building in poor countries, and restoration of macroeconomic stability in postcrisis countries.

Highlights

- ***Transparency.*** In addition to making more of its reports and data available to the public, the IMF solicited public input on a number of major initiatives (notably efforts to streamline conditionality) and established the Independent Evaluation Office to provide objective reviews and assessments of its operational work.
- ***Lending and credit.*** The IMF's regular and concessional lending increased slightly in FY 2001 following a sharp decline the previous year. Total IMF credit outstanding declined to SDR 48.6 billion from SDR 50.3 billion in FY 2000. A high level of repayments more than offset the increase in lending.
- ***Surveillance.*** In conjunction with heightened concerns about financial vulnerability, the IMF devoted greater attention to the health of members' financial sectors, capital account developments, and public and external debt. After a successful pilot project, the IMF and the World Bank launched the Financial Sector Assessment Program and collaborated on an international effort to combat money laundering and develop guidelines for public debt management. The IMF also sought to improve the tools used to measure external vulnerability (including early warning signals) and developed a framework for evaluating the adequacy of international reserves. In addition, the IMF created the International Capital Markets Department and the Capital Markets Consultative Group to strengthen and better coordinate its internal and external work in this area.
- ***Lending policies and conditionality.*** The IMF revised its Contingent Credit Lines to make precautionary lending more attractive to potential borrowers; took steps to encourage a more efficient use of IMF financing; and modified its policies to spur borrowing countries to adopt sound policies early and to avoid the prolonged and heavy use of IMF financing. The organization also moved to streamline its conditionality (policy conditions attached to the use of IMF resources). The initiative is designed to improve effectiveness and bolster country "ownership" of IMF-supported adjustment programs while ensuring that the objectives of these programs are met and the revolving nature of IMF finance is safeguarded.

- ***Poverty reduction and debt relief.*** In collaboration with the World Bank, the IMF's concessional lending and debt relief policies contributed to global efforts to reduce poverty. The external debt burden will be reduced by two-thirds in 22 heavily indebted poor countries that have reached the decision point under HIPC. The IMF also provided three-fourths of its technical assistance to low- and lower-middle-income countries. ■

The full text of the IMF's *Annual Report 2001* is available on the organization's website (www.imf.org). Copies are also available, free of charge, from IMF Publication Services. See page 311 for ordering information.

Photo credits: Denio Zara, Padraic Hughes, Pedro Márquez, and Michael Spilotro for the IMF, pages 309 and 312; IMF Institute, page 316; Jeromin Zettelmeyer for the IMF, pages 318 and 319; and Mario de Zamaróczy for the IMF, page 322.

International Monetary Fund Annual Report 2001

UNCTAD report

Foreign direct investment flows soar in 2000, but are likely to decline sharply in this year

Global inflows of foreign direct investment (FDI) soared by 18 percent in 2000 to reach a record $1,300 billion. They are, however, expected to decline sharply by 40 percent to $760 billion in 2001, according to the *World Investment Report 2001* and related material, published on September 18 by the UN Conference on Trade and Development (UNCTAD).

The main impetus behind both the growth in 2000 and the projected drop in 2001 is to be found in cross-border mergers and acquisitions (M&As). These rose by almost 50 percent last year to $1,100 billion but are now declining in line with the overall slowdown of global economic growth.

The report observes that the rapid expansion of FDI makes it "the main force in international economic integration." A total of some 63,000 transnational corporations, with over 800,000 foreign affiliates, drive FDI and increasingly shape trade patterns, accounting for about two-thirds of world trade. At the same time, FDI is unevenly distributed, the report emphasizes. The 30 largest host countries account for some 95 percent of total world FDI inflows and 90 percent of stocks, while 30 home countries—mainly industrial economies—generate around 99 percent of outward FDI flows and stocks.

FDI inflows, by region, 1998–2001

(billion U.S. dollars)

Region	1998	1999	2000	2001[1]
World	693	1,075	1,271	760
Developed countries	483	830	1,005	510
Developing countries [2]	188	222	240	225
Africa[3]	8	9	8	10
Latin America and the Caribbean	83	110	86	80
Asia and the Pacific	96	100	144	125
South, East and South-East Asia	86	96	137	120
Central and Eastern Europe	21	23	25	25
Including countries in the former Yugoslavia	22	25	27	27

[1] Preliminary estimates, made on September 3, 2001, on the basis of 51 countries that accounted for more than 90 percent of FDI inflows in 2000.
[2] Including the countries in the former Yugoslavia.
[3] If South Africa is included, the figures are 8 in 1998, 10 in 1999, 9 in 2000, and 11 in 2001.
Data: UNCTAD, FDI/TNC database

Projected decline in 2001

The anticipated 40 percent decline in world FDI flows in 2001 would be the first drop in FDI since 1991 and the largest over the past three decades, according to an UNCTAD press release accompanying the report. The level of flows in 2001, however, would still be higher than that in 1998 and also higher than the 1996–2000 average (see table, this page).

The projected drop in 2001 is the result of a recent decline in cross-border M&As, with a significant decline in "megadeals" of more than $1 billion, which had characterized M&As in 1999 and 2000. The UNCTAD press release notes that the latest estimates were prepared before the September 11 terrorist attacks on the United States and have no relation to those events.

Given the importance of cross-border M&As between developed countries, FDI flows are expected to decrease significantly in developed countries, falling by 49 percent—from $1,005 billion in 2000 to an estimated $510 billion in 2001. In developing countries, according to UNCTAD, the decline is estimated to be 6 percent, from $240 billion to $225 billion. As a result of the decline in developed countries, the share of developing countries in world FDI inflows may rise to 30 percent. Inflows to Central and Eastern Europe are expected to remain stable at $27 billion in 2001.

Distribution of FDI

The UNCTAD report states that, as in previous years, nearly all of the 10 largest recipients and sources of FDI in 2000 were developed countries (see charts, page 315). The only exceptions were China and Hong Kong SAR. The developed countries accounted for more than three-fourths of global FDI totals in 2000, with over $1,000 billion in inflows, a 21 percent increase over 1999. While flows to developing countries also rose, to $240 billion, their share of global inflows has fallen to 19 percent, the lowest since 1991. Flows to the least developed countries also rose somewhat, but since they constitute only 0.3 percent of world inflows, they remain marginal.

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
September 17	2.92	2.92	3.43
September 24	2.61	2.61	3.07
October 1	2.67	2.67	3.14

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2001).

General information on IMF finances, including rates, may be accessed at www.imf.org/external/fin.htm.

Data: IMF Treasurer's Department

• The UNCTAD report observes that FDI flows in both the developed world and globally are dominated by what it terms the triad of the European Union, the United States, and Japan, which together account for 71 percent of inward flows and 82 percent of outward flows, principally because of cross-border M&As. The United Kingdom and France have now replaced the United States as the principal outward investors (see chart). The United States is still the leading recipient of FDI, however, although its inflows and outflows dropped by 5 percent and 2 percent respectively in 2000.

• Flows of FDI to Central and Eastern Europe rose by 7 percent in 2000 to $27 billion, or 2 percent of global inflows. FDI was concentrated on Russia, Poland, and the Czech Republic and was dominated largely by transactions related to privatization, with the bulk of investments continuing to come from Western Europe.

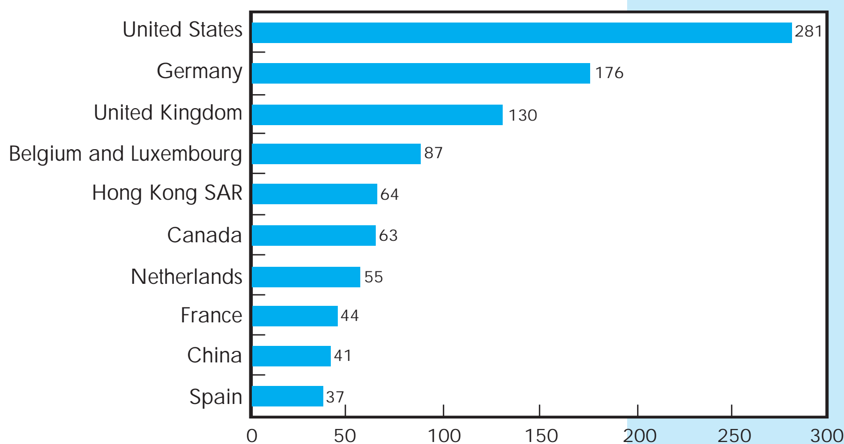
• FDI flows to and from the developing countries of Asia were at record levels in 2000 as the region recovered from the crisis of the late 1990s. Inflows to the region rose 44 percent to $143 billion, while outflows increased 140 percent to $85 billion. The overwhelming majority of the inflows were to Hong Kong SAR, rising 160 percent to $64.4 billion, and China, $40.8 billion. The report notes that one of the reasons Hong Kong SAR overtook China as the single largest recipient of inflows in Asia was that FDI flows entered Hong Kong for the purpose of being invested in China. The report notes that other large recipients of FDI in Asia were Korea, $10.2 billion; Singapore, $6.4 billion; and Malaysia, $5.5 billion.

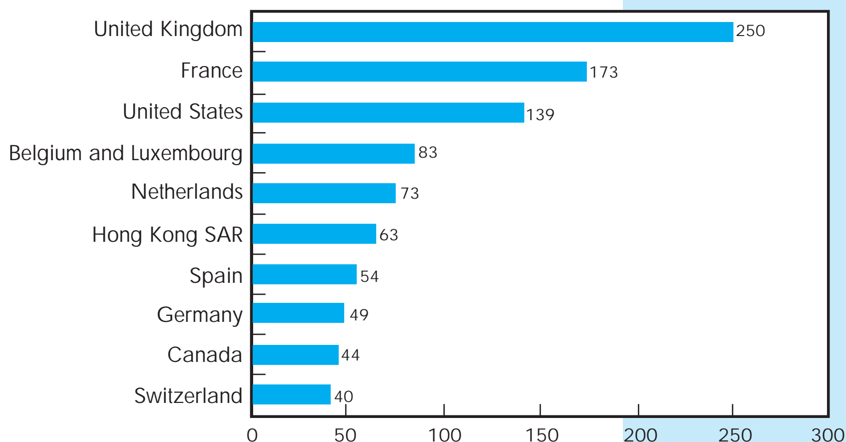
• Latin America and the Caribbean, where FDI flows had tripled during the second half of the 1990s, registered a 22 percent decline to $86 billion in 2000. The report attributes this decline to a correction from 1999, when inflows were affected by some major cross-border acquisitions. Brazil, with $34 billion, and Mexico, with $13 billion, were the major recipients of FDI in 2000.

• FDI inflows to Africa declined 13 percent to $9.1 billion, bringing the continent's share of global inflows down to less than 1 percent in 2000, largely owing to slowdowns in South Africa, Angola, and Morocco. The sub-Saharan African countries as a group also saw declines. This decline of FDI flows to Africa contrasts sharply with a rise of $2.2 billion in 1999, the report notes, and is the first major drop since the mid-1990s.

Backward linkages

A major theme of the UNCTAD report is how to promote "backward linkages" between foreign affiliates and domestic firms. The report sees these linkages as providing the strongest channel for diffusing skills, knowledge, and technology. From the standpoint of foreign affiliates, the report states, the local procurement that results from such linkages can lower production costs and allow more specialization and flexibility. From the standpoint of domestic suppliers, the





Data: UNCTAD, *World Investment Report 2001*

direct effect of linkages is generally a rise in the suppliers' output and employment. Linkages also transmit knowledge and skills, promoting efficiency, productivity growth, and increased market diversification. The report provides specific examples of productive backward linkages in a number of countries, including China, India, Malaysia, and Singapore. ■

The *World Investment Report 2001: Promoting Linkages* is available on the UNCTAD website (www.unctad.org/wir). Printed copies may be obtained for $49 each ($19 in developing countries and economies in transition) from United Nations Publications, Sales Section, Palais des Nations, CU-1211 Geneva 10, Switzerland, or from United Nations Publications, Two UN Plaza, New York, NY 10017, USA.

Dakar forum

African countries share experiences, challenges in galvanizing efforts to reduce poverty

What challenges does the poverty reduction strategy paper (PRSP) initiative present to African countries, and how are they dealing with these challenges? The Second Africa Forum on Poverty Reduction Strategies, held in Dakar, Senegal, September 10–13, moved beyond design questions—the focus of last year's forum in Yamoussoukro, Côte d'Ivoire—to address issues of implementation.

Organized by the IMF Institute and the World Bank Institute, the forum gathered 270 participants from 31 countries representing governments, parliaments, civil society, and the private sector. Also attending were 140 participants from donor agencies and multilateral and regional institutions. Discussions centered on four broad themes: ownership, governance, and accountability; economic policies for pro-poor growth; measuring and monitoring poverty reduction; and relations with development partners. A key goal of the forum was for participants to learn from one another. In contrast to previous conferences on the PRSP initiative, African country participants took center stage—sharing their experiences, while representatives of development and financial institutions listened. The lessons learned will provide critical input in the forthcoming comprehensive review by IMF and World Bank staff of the PRSP approach.

Overview

In the opening session, chaired by Soumana Sakho, President of the African Capacity Building Foundation, IMF Institute Deputy Director Saleh Nsouli and Cheickh Soumaré, Minister Delegate in charge of the budget in Senegal, outlined the main issues in implementing poverty reduction strategies. Sakho emphasized the crucial role of capacity building in the design and implementation of such strategies. Nsouli, speaking on behalf of the organizing institutions, underscored the challenges of poverty, the key steps that characterize effective development strategies, and the main themes of the forum. Soumaré, as host, welcomed participants to Senegal and provided a telling account of the efforts that Senegal—one of the first countries to prepare an interim PRSP—has made to accelerate economic growth and reduce poverty.

In introducing President Abdoulaye Wade of Senegal to the forum, Nsouli noted that Wade had originated the Omega Economic Plan for Africa. That plan has now been integrated into the New African Initiative, which African heads of state adopted earlier this year. The New African Initiative (see box, page 317) is firmly anchored in the fundamental principles of African ownership, leadership, and accountability to eliminate homegrown obstacles to sustained growth, Wade said. The initiative recognizes the PRSP process as a core vehicle for integrating continent-wide priorities into national poverty reduction programs and for coordinating international support.

At the Dakar forum are (left to right) Abdoulaye Diop, Minister of Finance for Senegal; President Abdoulaye Wade of Senegal; and Saleh Nsouli, Deputy Director of the IMF Institute.

Ownership and accountability

Delegations provided evidence of a strong sense of ownership of the PRSP process in their countries. Broad participation has become part of the strategy setting. Participants also saw improving governance as an essential step in the effective design and implementation of poverty reduction strategies. And there was broad agreement on the need for mechanisms to provide accountability and on the importance of delineating the functions of the executive, legislative, and judicial branches.

The media also have a crucial role to play, participants agreed, in disseminating information and facilitating genuine debate—provided that national conditions permitted access to information and freedom of expression. Although the role of parliaments varied widely across countries, discussants recognized that parliamentary committees responsible for poverty reduction and finance must be kept well informed to strengthen their work and to increase their technical capacity. Local governments, which are closest to grassroots communities, need to be engaged in the design, implementation, and monitoring of strategies. Civil society groups, nongovernmental organizations, and local research institutes favorably viewed their own involvement in the process, noting that they can play a vital role in holding governments and elected officials accountable at the local and national levels.

Pro-poor policies

Participants shared the view that pro-poor growth was a key ingredient in reducing poverty over time and required sound fiscal, monetary, and exchange rate

policies, along with structural reform. The sessions on pro-poor policies focused on three key sectors for poverty reduction: education, health, and infrastructure. Discussants emphasized that education and health care services often failed to reach the poor and that efficiency, rather than spending, had to increase. In this respect, officials needed a better understanding of the impact and efficiency of education and health care expenditures in reducing poverty. Poverty reduction would also require improved infrastructure services in energy, telecommunications, transportation, and water and sanitation. And it will also be critical for governments to achieve a better balance between urban and rural infrastructure spending, as well as greater involvement of local governments in decision making.

In addition, participants considered it essential to take into account the regional dimensions of growth and poverty to increase the effectiveness of domestic policies. Reflecting President Wade's call for a New African Initiative, participants pointed to the creation of an African regional market, the adoption of common policies to improve institutional and human capacities, the coordination of economic policies, and the buildup of infrastructure as some areas for cooperation.

Monitoring

Country delegations reported substantial, albeit difficult, progress in establishing systems and building the capacity to analyze and monitor the impact of poverty reduction strategies, particularly with regard to gender and governance. Successful monitoring systems, they said, should have the ability to quickly produce information on actions taken and on progress on key lead indicators of poverty reduction. Traditional poverty monitoring, dependent upon household surveys and participatory assessments, produced good data on impacts, but with a time lag and without immediate policy relevance. In addition, participants underscored the importance of integrating data collection on poverty and analysis—particularly the social impact analysis of macroeconomic and structural reforms—in the PRSP process.

Changing role of development partners

Nationally owned and broadly endorsed poverty reduction strategies provide an opportunity to change the culture and practice of development assistance in Africa. Participants acknowledged that once consensus was reached on national priorities and performance targets, donor practices would have to shift to empower governments to take action. Country delegations insisted that donors harmonize their policies and procedures and make them more transparent. But they also recognized that the countries themselves needed to articulate their policies more clearly, take the lead on donor coordination, and hold themselves accountable for use of resources and for achieving their strategy goals.

Within discussions of these broad issues, several subthemes emerged. Participants believed conditionality should be made less intrusive and more focused on outcomes than on policy intentions. They also stressed the need for greater predictability in medium-term financing plans and commitments. For their part, donors indicated that they are moving to shift from project to sector assistance. But to do so, they stressed, clear political commitment and domestic accountability mechanisms must be in place, particularly with respect to public expenditure management.

Issues of capacity building and utilization proved to be a recurring theme throughout the proceedings. Participants viewed a country's capacity to develop its own strategies and implement its own policies as central to the success of poverty reduction strategies. A lack of capacity and an inability to use existing capacity effectively remain important constraints. But several countries insisted that the remedy for these constraints lies in building their own capacity over time rather than in relying on conventional technical assistance.

Ultimately, the forum helped participating countries and donors share experiences and move toward a common understanding of what has been achieved and what challenges remain. Candor, openness, and constructiveness characterized the discussions. At closing, several PRSP country groups took the initiative to set up a system of electronic exchange of documents and ideas to sustain the "spirit of Dakar." ■

Roland Daumont
IMF Institute

New African Initiative

The New African Initiative focuses on putting in place the preconditions for promoting investment, growth, and reduced poverty in Africa through a regional coordinated effort. In a September 11 meeting with IMF Institute Deputy Director Saleh Nsouli, President Abdoulaye Wade of Senegal detailed the ongoing work on the initiative. Wade explained that the initiative recognizes the importance of peace, democracy, and good governance and seeks to develop regional infrastructure, enhance human capital formation through education, and improve health care. It also focuses on accelerating growth in the agricultural sector, which is the mainstay of many African economies.

The initiative envisions a key role for the private sector and seeks to promote regional integration, Wade said. It also aims to enhance Africa's partnership with bilateral and multilateral donors, and with private sector investors. The initiative views the poverty reduction strategy paper process as an important element in implementing national efforts to reduce poverty and in coordinating international support. To help implement the initiative, a continent-wide organizational structure is envisaged, and the details of this are being worked out.

Bangkok conference

"Perfect" monetary and exchange rate strategies for East Asia may prove difficult to devise

What are the prospects for East Asian monetary integration? A high-level conference on September 5–6 at Chulalongkorn University, Bangkok, provided a venue for two dozen distinguished speakers and discussants to examine the range of policy options. The conference, organized in cooperation with the universities of Paris-Dauphine and Mannheim and commemorating the thirtieth anniversary of Chulalongkorn's Faculty of Economics, drew approximately one hundred participants from academic, business, and policymaking communities as well as a large number of Chulalongkorn students.

The conference included lively sessions on specific country issues, such as macroeconomic policies in

From left to right, Ricardo Hausmann, Michael Hutchison, Takatoshi Ito, Srinivasa Madhur, Ronald McKinnon, and other conference participants listen to Masahiro Kawai's presentation.

Thailand after the crisis and the future of multiple monetary systems in China in the face of increasing economic integration between Hong Kong SAR and the Chinese mainland, explored in a paper by Shu-ki Tsang of Hong Kong Baptist University. But alternative monetary and exchange rate regimes for East Asia provided the gathering with its central theme. The debate also addressed related issues, such as capital controls and international "last resort" lending.

Policy proposals

Notwithstanding the role of quasi-fixed exchange rates in the run-up to the Asian crisis and the apparent smooth functioning of Asian inflation targeting regimes, such as Thailand's (discussed in a paper by Chayodom Sabhasri, June Charoenseang, and Pornkamol Manakit of Chulalongkorn University), participants were generally skeptical of the long-term desirability of floating exchange rates for East Asia. This skepticism appeared to be chiefly motivated by two considerations: the desirability of limiting exchange rate volatility from the perspective of regional economic integration, and the potentially destabilizing effect of exchange rate swings in emerging economies with short-term debt denominated in foreign currency.

Beyond this theme, however, little consensus emerged on which exchange rate regime might constitute the best alternative for the region. Discussion largely centered on three main proposals:

- ***Soft peg to a basket of currencies.*** A soft peg, argued Takatoshi Ito of Hitotsubashi University, could limit exchange rate volatility while maintaining a degree of flexibility, thus avoiding the types of misalignments that had preceded the Asian crisis (particularly in the case of the Thai baht). Ito noted that a soft peg could be achieved by allowing some flexibility within a band and by choosing basket weights that were approximately in line with trade importance. This would imply a much higher weight for the Japanese yen than in Thailand's precrisis basket peg, and thus make the peg less vulnerable to swings in the bilateral U.S. dollar–yen exchange rate.
- ***East Asian dollar standard.*** Ronald McKinnon of Stanford University proposed a system of long-term parities that would tie East Asian currencies—including the Japanese yen—to the U.S. dollar. While temporary suspensions would be acceptable at times of intense exchange market pressure, governments would commit to return to original parities after such crisis episodes (although on a flexible timetable). This would fix long-run expectations and thus reduce exchange rate overshooting in the face of speculative pressure, as many East Asian currencies famously experienced in the second half of 1997.

Maintaining long-term parities to the U.S. dollar would require considerable fiscal discipline, he said, but this was something most Asian authorities were quite capable of. The advantages of such a standard, McKinnon emphasized, were a clear nominal anchor—including against expectations of deflation in Japan—and the reduction or elimination of financial instability caused by the combination of flexible exchange rates and foreign currency–denominated liabilities. Moreover, a "good peg" could be expected to lower interest rate differentials and might thereby reduce incentives to borrow short term in U.S. dollars, gradually reducing systemic vulnerability over time.

- ***East Asian currency union.*** Robert Mundell of Columbia University, Srinivasa Madhur of the Asian Development Bank, and Ricardo Hausmann of Harvard University each proposed variations of an East Asian currency union. Mundell and Madhur envisaged a process of monetary integration along European

Robert Mundell (center) states the case for East Asian monetary integration as Srinivasa Madhur and Ronald McKinnon look on.

lines, requiring a combination of exchange market intervention agreements and a coordination of macroeconomic policies during an interim period, and eventually leading to a common currency. The principal advantage would be closer regional economic and financial integration.

Hausmann, on the other hand, was primarily concerned with the risks that foreign currency borrowing—the "original sin" of emerging market economies—implied for financial stability. Dollarization or "yenization" would, he indicated, eliminate these risks, lower real interest rates, encourage domestic savings, promote financial deepening, and provide a fully credible monetary anchor. However, a multilateral arrangement—in other words, a currency union with either the yen or the dollar at its core—would be preferable to the unilateral adoption of the dollar or the yen, because it would provide some seigniorage-sharing and a lender of last resort function that would benefit all members of the system.

All three proposals generated lively exchanges. Some participants criticized Ito's and McKinnon's proposals on the grounds that these monetary systems remained vulnerable to speculative attacks—a concern that would also apply to an arrangement similar to the European exchange rate mechanism. In McKinnon's proposal, temporary flexibility, disciplined macro policies, and commitment to a return to long-run fixed parities might give the system some resilience. But if equilibrium exchange rates shifted for reasons other than macroeconomic policies—for example, as a result of the discovery of large implicit liabilities, or major real or external shocks—a return to the original parities might be painful and perhaps not credible.

Finally, currency unions built around the yen or the U.S. dollar and an East Asian dollar standard that excluded Japan could create competitiveness problems for Southeast Asia in the event of large swings in the yen-dollar exchange rate. For this reason, both Mundell and Hausmann stressed that their proposals would work best if exchange rate volatility among the dollar, the yen, and the euro were limited.

Other instruments

One conclusion that can be drawn from the discussion is that defining a "perfect" exchange rate arrangement for East Asia might be difficult because too much is being demanded from it: providing a nominal anchor, promoting regional trade and economic integration, maintaining competitiveness, and safeguarding the financial system. To really address these multiple objectives, it might be necessary to invoke additional policy instruments.

Conference participants dwelled on two such potential instruments: capital controls, the subject of a paper by Masahiro Kawai, Deputy Vice-Minister for International Affairs in Japan's Ministry of Finance, and Shinji Takagi of Osaka University; and an international lender of last resort, discussed by Jeromin Zettelmeyer of the IMF. According to Kawai, capital controls are rarely successful over an extended period, but might have a useful role to play in specific circumstances—in particular, as a way of imposing a standstill in a financial panic that arises despite fundamentally sound domestic policies. An example, he said, might be the brief imposition of controls on short-term outflows in Malaysia after the Russian crisis. The Malaysian authorities used capital controls to create breathing space for domestic financial and corporate restructuring and other needed reforms while maintaining a sound macroeconomic framework.

After the conference, Hausmann, Zettelmeyer, and Hutchison pose with Chulalongkorn University students.

Zettelmeyer argued that maintaining actual or even potential exchange rate flexibility—in other words, any exchange rate arrangement short of full dollarization—might require an international lender of last resort to help domestic financial safety nets deal with the risks associated with foreign-denominated debt. However, neither strategy was without problems, as the authors themselves and subsequent discussants pointed out. Imposition of capital controls, even if only in the context of a panic, might be interpreted as a signal of government willingness to restrict investor rights, and thus could have a damaging effect on the country's credibility and on inflows of foreign direct

investment. And the backing of domestic financial safety nets by an international guarantee might increase both country and investor moral hazard, unless the guarantee could be carefully tailored to the quality of the financial safety net and to domestic financial sector policies. ■

Jeromin Zettelmeyer
IMF Research Department

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IMFSURVEY

Trade liberalization can yield major benefits, but are new initiatives likely to be taken up?

The extraordinary growth of the global economy since World War II has been driven, at least in part, by trade liberalization. Eight rounds of multilateral negotiations, including the Uruguay Round concluded in 1994, have significantly reduced international trade barriers. Regional trade arrangements, such as the European Union (EU) and the North American Free Trade Agreement (NAFTA), have also reduced trade constraints. But should the failure to launch a new global trade round in Seattle in 1999 be seen as a signal of dimming prospects for further trade liberalization initiatives? What, specifically, is the likelihood of reducing still-high EU trade barriers and creating a Free Trade Area of the Americas (FTAA)?

Two new studies by the Institute of International Economics (IIE)—*Measuring the Costs of Protection in Europe*, by Patrick Messerlin, a visiting fellow at the IIE and professor at the Institut d'Etudes Politiques de Paris; and *Prospects for Free Trade in the Americas*, by Jeffrey Schott, a senior fellow at the IIE—argue that further liberalization holds the promise of significant benefits. The findings of the two studies, and an address by Robert Zoellick, the U.S. Special Trade Representative, provided the basis for a September 24 discussion of trade issues at the IIE.

Fortress Europe?

Despite 50 years of trade liberalization, large chunks of the European economy remain highly protected, according to Messerlin. Rolling back these barriers would be a boon for European consumers, who currently foot the bill for this protectionism—a sum estimated to be equivalent to 5–7 percent of GDP or Spain's total GDP. Put another way, Messerlin indicated, Europe is paying €200,000 for every job it protects through trade barriers.

To gauge the real level of protection in the European Community (EC), Messerlin combined tariff barriers and (the tariff equivalent of) certain nontariff barriers, such as quantitative restrictions and antidumping measures, and weighed individual tariffs by each sector's economic importance rather than taking a simple average of sectoral tariffs. Viewed in this way, Europe's level of protection is actually higher than generally assumed, his study found. Although protection has declined fairly modestly from 15 percent at the start of the 1990s, it still stood at about 12 percent at the decade's end. And on average, agriculture is far more highly protected than industry (see chart, this page).

What then are the prospects for further lowering EU trade barriers? In the past, many in Europe viewed protectionist trade policy as the price they willingly paid to achieve political objectives, such as deep integration. But with political objectives being met to a considerable degree, Messerlin was hopeful European trade policy would have greater scope to concentrate on economic considerations.

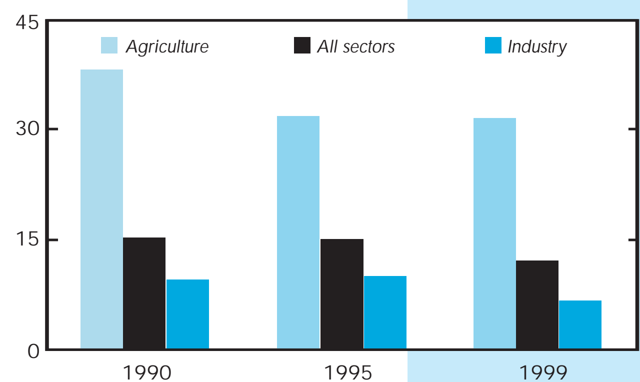
After NAFTA, what?

The FTAA, if realized, would constitute the largest free trade area in the world. In his study, Schott analyzed the problems in crafting a free trade agreement among the 34 democratic countries in the Western Hemisphere. Linking some of the richest and the poorest, and some of the largest and the smallest, countries in the world is a "daunting task," he said. The U.S. economy is 10 times larger than Brazil's—the second biggest economy in the hemisphere—and almost 100 times larger than the combined total of all of the countries of Central America and the Caribbean.

What benefits could an FTAA offer the hemisphere? Schott projected that U.S. trade with Latin America would grow sharply if the high common external tariff and other domestic regulatory restrictions of the Mercosur (Argentina, Brazil, Paraguay, and Uruguay) were eliminated. For example, U.S.-Brazil trade would probably triple. Tangible progress toward an FTAA would also complement efforts by the IMF and other international financial institutions to strengthen the economies of the Mercosur, particularly Argentina's and Brazil's.

European Community protection in the 1990s

percent



Data: Patrick Messerlin, *Measuring the Costs of Protection in Europe*

But is continued progress toward the FTAA likely? Schott observed that, despite many financial crises, Latin American and Caribbean countries have tended to stick to a path of economic reforms that includes continued trade liberalization. Current economic problems in the region could delay further trade liberalization, he said, but are not likely to reverse it. Still, the "main prize" for many potential members of FTAA will be access to the U.S. market, so it is essential, according to Schott, that the United States eliminate trade barriers in areas such as agriculture, steel, and apparel.

But will the United States lead?

Zoellick stated emphatically that the United States would press vigorously for the creation of the FTAA and the launch of a new global trade round in November. "We will not be intimidated," Zoellick insisted, "by those who have taken to the streets to blame trade—and America—for the world's ills. The global trading system has demonstrated—from Seoul to Santiago—that it is a pathway out of poverty and despair."

Zoellick made a strong case for greater trade liberalization, pointing to its role in helping boost economic growth abroad. Liberalization also conferred long-term benefits on the United States, he observed, citing, in particular, gains made by the country's small businesses, high-tech community, and farmers and ranchers.

Trade agreements are particularly important to small businesses that lack the resources needed to deal with intricate trade restrictions. Small businesses do not have "lawyers to call on to figure out complex foreign procedures," he noted. Also, exports are becoming increasingly important to small businesses, and vice versa. Small businesses account for nearly 40 percent of U.S. exports to Central and South America and play a key role in the U.S. economy. Exporting firms have greater productivity than nonexporting firms and pay, on average, 13–18 percent higher wages.

Technology is the largest U.S. manufacturing sector in terms of employment, sales, and exports. According to Zoellick, high-tech exports accounted for nearly 30 percent of U.S. merchandise exports last year. An open trading system should be a priority for U.S. farmers, too, because "96 percent of their customer base lives abroad." Trade agreements have already made a difference for U.S. farmers; since the passage of NAFTA, U.S. agricultural exports to Mexico have doubled.

"The eyes of the world are now on America," Zoellick concluded. "It is the moment to affirm our commitment to trade and openness." ■

Prakash Loungani
IMF External Relations Department

Micro-island economy

Kiribati takes action to improve growth and raise living standards

Every village in Kiribati has a "manieba"—or traditional community meeting hall—where people meet to socialize and take decisions regarding community matters.

The Republic of Kiribati, a lower-middle-income micro-island state in the central Pacific, confronts daunting physical and economic challenges. Economic policies are rooted in communally oriented values and involve an extensive role for the state and a gradualist approach to structural reform. With prudent economic management, the country has succeeded in maintaining macroeconomic stability and building up large external assets over the past decade. However, slow growth has failed to raise real per capita income. To raise living standards on a sustainable basis, the country will need to foster a dynamic private sector that can serve as the main engine of growth.

Background

Kiribati, with a population of only 85,000, is spread over an area roughly equal to that of Europe, but most of it is ocean (see map). Its land area measures 810 square kilometers, while its exclusive maritime economic zone spreads over 3.6 million square kilometers—roughly the size of India's land mass. This sea-to-land ratio is one of the highest in the world. Kiribati's archipelago of 33 islands stretches 4,000 kilometers from east to west and 2,000 kilometers from north to south. The archipelago's small and low-lying atolls leave it vulnerable to environmental changes, notably a rise in the sea level.

Kiribati's remoteness and dispersion have significant economic and administrative implications. With the nearest large markets 4,000 kilometers away (in Hawaii and Australia), the country is far from major centers of commerce and finance. The development of even a small domestic market is constrained by widely dispersed communities and infrequent internal transport services—both of which hamper competition.

The country's productive base is very limited. An arid climate and poor soil offer little potential for agricultural development, except copra. Marine resources and copra are the mainstay of the economy—about 80 percent of households make their living through either fishing or copra cutting. While Kiribati shares some of the structural characteristics of other small islands, its government sector accounts for an unusually large share of the economy. Even when GNP, rather than GDP, is used as the basis for comparison, the relative size of Kiribati's government spending is almost twice that of comparable small island economies (see table, page 324). Physical attributes and the size of government in the economy complicate the appropriate pacing and sequencing of structural reforms.

Fishing license fees and external grants have financed a large share of public spending and of the country's persistent trade deficits (averaging 60 percent of GDP during the last decade). They have also allowed Kiribati to accumulate sizable official external reserves. However, these inflows have been unstable, because they depend on erratic fishing conditions and the goodwill of donors. External reserves are held in an overseas trust fund, the Revenue Equalization Reserve Fund (RERF—see chart, page 323), managed by two international brokerage firms, under the government's supervision. The real per capita value of the fund has risen markedly, and thus Kiribati's reserves at end-2000 were comfortable—equivalent to seven years of imports or nine times GDP.

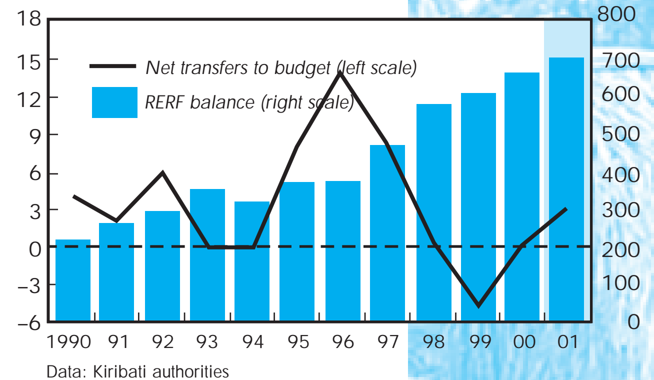
Recent developments, near-term outlook

Over the past decade, economic expansion has kept pace with population growth but has not been able to improve living standards. Growth faces major constraints—some arising from Kiribati's physical disadvantages and some stemming from policy choices, including a large and moderately effective public sector, barriers to investment, and distortionary price controls. Between 1998 and 2000, real GDP grew modestly at 1/4 of 1 percent a year, but real per capita income shrank concurrently. This outcome was partly the result of external factors beyond the government's control, including adverse climatic conditions in the wake of *La Niña*, which reduced fishing yields; a plunge in world copra prices; and a drought that hurt copra production. However, the expansion of the public sector and the slow pace of structural reform also hampered the country's ability to absorb adverse shocks. Inflation remained subdued in 1999–2000, owing to the weakened economic activity and the easing of transportation problems at the main port.

Kiribati's external position deteriorated in 1999–2000. Although exports of new marine products (bêche-de-mer and seaweed) rose, traditional fish exports fell and imports surged to meet the needs of several large domestically financed construction projects. Over the same period, the revenue drawn from fishing license fees and external grants contracted sharply. The country's external current account surplus plummeted, with the overall balance surplus halved between 1998 and 2000, even as the depreciation of the Australian dollar (Kiribati's legal tender) slightly improved external competitiveness. External public debt remained low and on concessional terms.

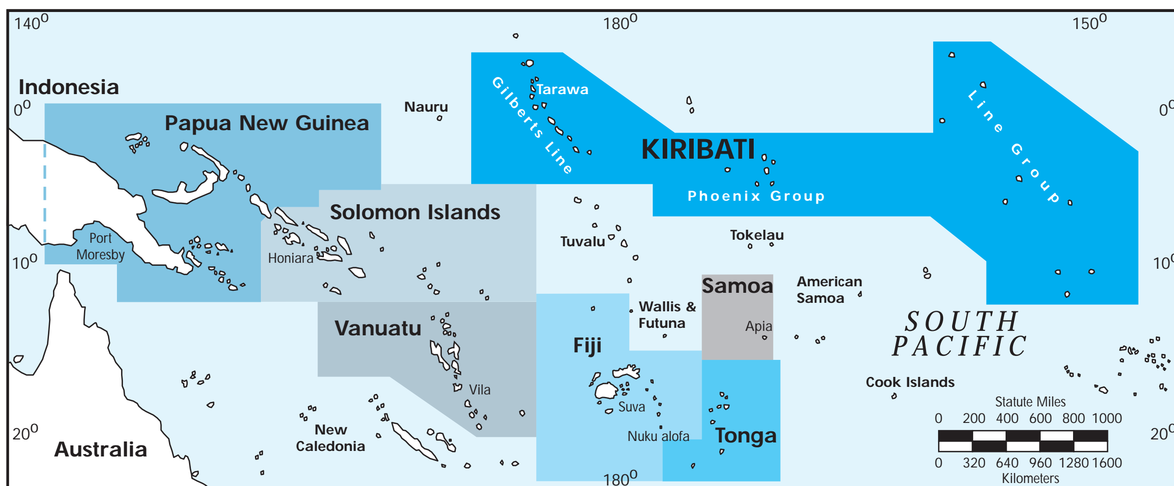
Revenue Equalization Reserve Fund

(million Australian dollars)



Predictably, Kiribati's fiscal position also weakened over the period. Total revenue and grants slumped, and development expenditure declined in line with lower external assistance. However, current government expenditure rose slightly because of increased support to public enterprises and copra producers and additional purchases of goods and services. Reflecting these developments, the overall budget balance swung from a surplus of 19 percent of GDP in 1998 to a deficit of 7 percent of GDP in 2000. The government financed the deficits by drawing down its bank deposits, without using the RERF.

While the outlook for 2001 is slow growth and low inflation, the prospects for the medium to long term are favorable if the right policy mix is implemented. Economic growth is projected to remain modest in 2001, at 1 1/2 percent. The continuation of unfavorable fishing conditions is expected to be offset by increased government spending, higher public investment associated with the commencement of several foreign-financed projects, the coming on-stream of a new wharf



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in the main port, and improvements in copra production. The external and fiscal positions are projected to deteriorate further in 2001, and the significantly larger budget deficit is expected to exhaust government deposits and prompt the first drawing from the RERF since 1997. The overall balance of payments is anticipated to show a deficit for the first time in seven years.

Challenges ahead

Kiribati's economic policies reflect the country's community-based development approach, which favors social cohesion over individual self-reliance and the "rough and tumble" of the market economy. This policy stance involves dependence on the state for investment, employment, and service delivery, and extensive participation of the public in decision making. This strategy has produced a stable macroeconomic environment and the buildup of sizable external assets, but it has failed to deliver high growth and improved living standards. While a comfortable level of official reserves can shelter Kiribati temporarily from external shocks, this buffer should not dull the authorities' sense of urgency about the need for reform.

The deterioration in the budgetary and external positions during 1999–2000 underscores the need for the early implementation of fiscal consolidation while promoting human resource development. To achieve sustainable medium-term growth, timely implementation of fiscal and structural reforms is critical. The authorities' three-year National Development Strategy of October 2000 provides an adequate framework for private sector–led growth with macroeconomic stability. Reducing current expenditure—to offset declining external grants—and increasing its efficiency are key to regaining a sustainable fiscal position. Civil service reform and a reduction in subsidies and net lending to state-owned enterprises and copra cutters are especially important. A curbing of such outlays would allow for tax reductions, which in turn would unfetter the private sector. It would also accommodate additional expenditure on education, health, and environmental protection. However, increasing the efficiency of social expenditure is as critical as bigger outlays are for promoting human resource development.

Public enterprise reform and privatization should be at the top of the reform agenda. Unprofitable state-owned enterprises place a burden on the budget, compete unfairly with the private sector, and lead to a misallocation of scarce resources. State-owned enterprises need either to face hard budget constraints or to be privatized, and the authorities should refrain from new commercial ventures that would expand the already dominant role of the public sector. Sale of part of the large government-owned housing stock is a good area for starting public sector retrenchment.

A key to boosting private sector activity and credit will be removing barriers to foreign investment. Given the scarcity of domestic capital and technological know-how, lowering such barriers is essential to facilitating the entry of foreign investment. Innovative solutions to ease the restriction on foreign ownership of land would need to be explored, because this restriction deters investment and hampers credit. To enhance economic efficiency, high tariffs should be progressively replaced by a broad-based simple indirect domestic tax, and price and margin controls should be gradually reduced.

For the longer term, however, the Kiribati archipelago and its vast economic zone offer growth potential through tourism and enhanced fishing and deep-sea mining, provided sufficient investment becomes available. In spite of its physical limitations, Kiribati's strong democratic institutions, relatively stable economy, and promising potential can help put the country on the path of sustainable development, provided that fiscal and structural reforms are implemented in a forceful and timely manner. ■

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Selected economic indicators of small island economies, 1990–2000
(averages)

	Kiribati	Pacific[1]	Caribbean[2]
National accounts		(units as indicated)	
Nominal GNP (million U.S. dollars)	74.1	415.9	934.0
Consumer price index (percent change)	3.2	4.7	2.6
Government finance		(percent of GNP)	
Revenue	59.1	39.8	20.5
Tax revenue	13.8	17.1	15.4
Nontax revenue	22.9	7.0	3.9
Grants	22.5	15.6	1.3
Expenditure	61.5	40.9	17.5
External sector			
Current account balance	3.8	–2.6	–11.7
Exports of goods	7.2	16.7	28.4
Imports of goods	–44.9	–16.8	–51.6
Service receipts	5.8	20.6	40.8
Service payments	–2.1	–19.4	–24.8
Gross international reserves	383.1	20.5	11.3

Note: Not all data available for all islands every year.
[1]Federated States of Micronesia, Fiji, Republic of the Marshall Islands, Samoa, Solomon Islands, Tonga, and Vanuatu.
[2]Antigua and Barbuda, The Bahamas, Barbados, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

Data: Kiribati authorities; and IMF staff estimates

The IMF's Executive Board concluded the 2001 Article IV consultation with Kiribati on June 25, 2001. The report prepared by the IMF staff on that occasion is posted on the Internet at www.imf.org, under "Kiribati."