

IMF Sees Global Imbalances Narrowing, but More to Be Done

Global economic imbalances appear to have peaked in 2006–07 and are now projected to narrow faster than earlier forecast, but more remains to be done to correct a worrying disequilibrium in the world economy, according to IMF analysis.

With slower growth and a weaker dollar, the U.S. current account deficit has narrowed faster than previously projected, while surplus nations have made some progress in implementing policy plans made under an IMF-sponsored process to reduce the imbalances.

But as recent events in global financial markets have shown, market disruptions can occur abruptly and in unexpected ways. Thus, the stakes remain high to help smoothly unwind still-large global imbalances. “The key challenge for policymakers is to implement the measures that are needed to sustain the global expansion while reducing potentially disruptive imbalances,” said John Lipsky, IMF First Deputy Managing Director.

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Rob Crandall/Newscom

A slowing economy in the United States has helped narrow the U.S. current account deficit faster than previously projected.

Africa Growing Rapidly, but Faces Risks

The economic expansion looks set to continue in sub-Saharan Africa, although the slowing of the global economy could threaten the outlook in some countries.

Policymakers face the challenge of preserving hard-won macroeconomic stability

while determining their next steps on the basis of inflation risks, their external position, and the state of public finances.

Sub-Saharan Africa grew at a healthy pace in 2007, and the region is now enjoying its highest growth rates in decades (see chart, page 36). Real GDP expanded by about 6½ percent, fueled by growing oil production and rising domestic investment and productivity. Solid global demand for commodities, greater flows of capital to Africa, and debt relief have helped lift growth.

Strengthened macroeconomic policies and years of structural reforms have begun to bear fruit. Moreover, armed conflicts and political instability have become less frequent. As a result, not only have investment and growth increased, but income volatility has fallen to near 30-year lows. Real per

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Baltics: Too Much, Too Fast?

Growth in the Baltic countries has been exceptionally high. Lately, however, the economic headlines have been dominated by unwelcome news. Will the skeptics, who have long contended that these countries' rapid convergence has been too much, too fast, be proved right?

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IMF Managing Director Strauss-Kahn visits a school in Ouagadougou, Burkina Faso, in February.

IMF Photo



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IMF Sees Global Imbalances Narrowing

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IMF-backed framework

Through a new process of multilateral consultations, launched in June 2006, the IMF has brought together key players in the global economy—China, the euro area, Japan, Saudi Arabia, and the United States—to work to reduce the imbalances in an orderly and growth-friendly manner.

The goal was to avoid an abrupt unraveling of the imbalances caused by the large current account deficit in the United States and big surpluses in some Asian and oil-producing countries. The strategy adopted by the IMF aimed to encourage “steps to boost national saving in the United States, including fiscal consolidation; further progress on growth-enhancing reforms in Europe; further structural reforms, including fiscal consolidation, in Japan; reforms to boost domestic demand in emerging Asia, together with greater exchange rate flexibility in a number of surplus countries; and increased spending consistent with absorptive capacity and macroeconomic stability in oil-producing countries.”

After almost a year of consultations, the participants’ policy plans consistent with these aims were outlined in a statement released in April 2007, and the IMF committed itself to monitoring progress with implementation.

Changing circumstances

Since then the global economy has changed dramatically. Market turmoil—triggered by the U.S. subprime mortgage crisis—has shaken confidence in money and credit markets worldwide. Against concerns about a “credit crunch” and a possible U.S. recession, policy attention in the United States has shifted to aggressive monetary policy easing and fiscal stimulus to support the economy.

Financial market disruptions have also directly affected Europe, and sizable financial losses related to U.S. complex financial products have hit many European banks. Slower U.S. growth, financial dislocations, and tighter lending conditions more generally have raised concerns about a broader global economic slowdown.

Smaller U.S. deficit

With a slowing economy and a weaker dollar, the United States’ current account deficit has narrowed faster than expected (to about 5½ percent of GDP in 2007). Moreover, current projections for the deficit are markedly lower compared with projections when the consultations were under way (see Chart 1, page 35).

The U.S. net foreign asset position, meanwhile, has remained broadly stable, continuing to reflect valuation gains and return differentials in favor of U.S. foreign investment. With a better starting point and smaller flow deficits, the trajectory for U.S. net external assets has also substantially improved since last July. Overall, global imbalances appear to have peaked last year and are now projected by the IMF to narrow faster than at the time of the consultations (see Chart 2, page 35).

Still needed?

So has the consultation and IMF-monitoring process been overtaken by recent events?

IMF analysis suggests that, if anything, events have made joint action to curb the imbalances more relevant, and just as important as when the process began. Indeed, the dual objectives of the consultations—to help facilitate an orderly unwinding of imbalances while ensuring the unwinding is carried out in a manner supportive of global growth—have gained new significance in light of recent financial turmoil and possibly slower global growth.

- Specifically, in a period of more fragile market confidence and still-large imbalances, risks of a disorderly adjustment remain a clear concern. Moreover, sustained large foreign losses on holdings of U.S. external assets, as well as reduced confidence in the asset quality of complex financial products (such as mortgage-backed securities and collateralized debt obligations), suggest that foreign financing could be less forthcoming in the future.

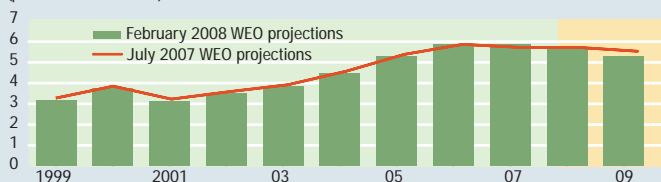
- An asymmetric pattern of currency movements against the U.S. dollar—which has fallen noticeably less against the currencies of some key surplus

Chart 1

Narrowing imbalance¹

Total current account imbalances in the global economy are falling compared with earlier projections.

(percent of world GDP)



Source: IMF, World Economic Outlook (WEO) database.

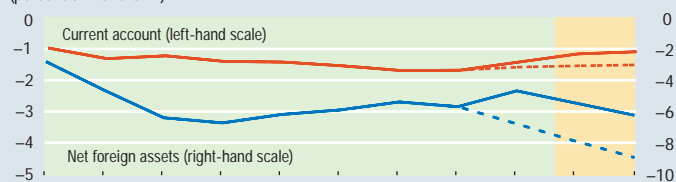
¹The chart shows the global sum of current account imbalances by adding up deficits and surpluses in absolute value terms.

Chart 2

Improving U.S. position

Aided by a weaker dollar, the U.S. current account deficit is projected to narrow further, helping lead to a smaller buildup in foreign indebtedness.

(percent of world GDP)



Source: IMF, World Economic Outlook (WEO) database.

Note: Solid line = February 2008 WEO projections; dotted line = July 2007 WEO projections.

countries—continues to underscore the need for broader-based adjustment. Continued asymmetric adjustment, on the other hand, risks fueling protectionist sentiment, particularly if global growth slows.

- Given the unfolding U.S. slowdown, falling house prices, and tighter credit conditions, one might expect to see some normalization in U.S. household saving from its low levels. But the prospects for softer U.S. domestic demand going forward would need to be balanced by stronger domestic demand elsewhere to avoid a deeper slowdown in global growth.

- Volatile oil prices—touching new highs amid tight market conditions—could slow a narrowing of global imbalances, given still-strong demand from emerging markets and ongoing concerns over supply. Oil price spikes could add to the imbalance problem by leading to wider deficits for importers such as the United States and larger surpluses for oil exporters such as Saudi Arabia.

Recent policy progress . . .

The IMF has been monitoring progress with the policy plans of the five participants and finds there have been welcome gains on several fronts since the consultations.

- **China** has made some progress with respect to rebalancing growth toward domestic demand (a focal point of the upcoming fiscal budget) and taken incremental steps toward greater currency flexibility;

- in **Saudi Arabia**, the authorities have ramped up spending on needed social and economic infrastructure;

- in the **euro area**, member states have taken measures to accelerate financial integration and to better align incentives in labor markets;

- **Japan** has made some progress in reforming product markets and in fiscal consolidation; and

- in the **United States**, alongside a narrowing current account deficit, the major advance for policies has been the continued decline in the federal budget deficit through FY2007, ahead of earlier projections, although the deficit is expected to widen temporarily in FY2008–09 because of the impact of the cyclical downturn and the recently approved stimulus package.

. . . but more to do

Overall, the progress to date has been encouraging, but more remains to be done. Moreover, in light of recent developments, the policy plans in some key areas could be advanced, but flexibility is needed to take account of the fast-changing global context:

- In **China**, a faster rate of renminbi appreciation would allow for more broad-based exchange rate adjustment and would create much-needed space for monetary policy tightening to keep inflation pressures at bay. In addition, advancing fiscal plans to support domestic consumption would help rebalance demand and support the global economy in the event of a sharper slowdown.

- In **Saudi Arabia**, rising inflation pressures suggest that spending priorities in key areas such as infrastructure should be maintained to help relieve supply bottlenecks.

- In the **euro area**, large losses suffered by European banks stemming from the U.S. subprime crisis have drawn attention to the need not only to deepen integration but also to strengthen financial stability arrangements. Effective product market reforms are needed to improve the business

climate and sustain growth. Also, labor market reforms (including improving mobility) are needed to boost productivity and labor utilization.

- In **Japan**, with limited policy space to address a possible economic slowdown, structural reform measures remain central to enhance growth prospects and strengthen domestic demand. The priorities are enhancing labor flexibility and participation and boosting productivity through deregulation.

- And, finally, in the **United States**, a slowdown in activity is challenging the steady progress made in reducing the federal deficit. But longer-term pressures on public finances from an aging population and entitlements underscore the importance of adhering to the authorities' medium-term fiscal consolidation objectives. Thus, while timely fiscal stimulus is justified by the cyclical situation, it should be kept strictly temporary and targeted to effectively insure against a deeper downturn without jeopardizing medium-term budgetary goals.

Thus, overall, the plans outlined through the consultation process continue to provide a relevant road map for policies that both help serve national interests and contribute to reducing broader risks to the global economy, which are a collective concern. From a global perspective, against the background of ongoing financial turmoil and a clouded outlook for the global economy, tangible further progress on these plans by all participants would provide much-needed reassurance at a time of heightened market uncertainty. ■

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Africa Overview

(continued from page 33)

capita income is improving, although fragile countries continue to lag behind. Despite double-digit food price inflation in several countries in 2007, inflation on average has been held to the 6–9 percent range. Some countries, including some of the continent's leading reformers that no longer need IMF financial assistance, are, nevertheless, committing to sound policies through the IMF's Policy Support Instrument.

Sub-Saharan Africa is also witnessing an increase in financial flows from emerging creditors, particularly China, which are stepping up assistance to the region largely in the form of project assistance and export credits.

Financial market turbulence

The global financial market turbulence has, to date, had a limited impact on sub-Saharan Africa. However, countries with more globally integrated financial markets, such as South Africa, experienced some increase in sovereign spreads and volatility in their foreign exchange and stock markets.

In South Africa, an additional factor at play may have been the realization that bottlenecks in energy supply could constrain future growth. But, by and large, tighter credit conditions have not materialized.

Prospects for 2008

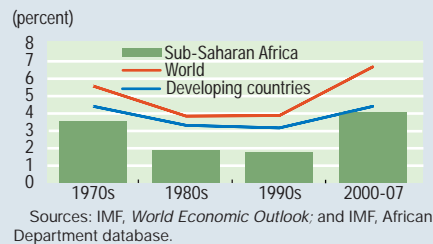
Global economic growth is expected to slow to 4.1 percent in 2008, down from 4.9 percent in 2007, with the slowdown in advanced economies offset somewhat by growth in emerging markets and developing countries. GDP growth for sub-Saharan Africa is projected at 6½ percent, with growth in oil exporters expected to accelerate to slightly less than 10 percent and that in oil importers to taper off at 5 percent. Inflation is expected to remain below 8 percent for the region, assuming macroeconomic policies hold firm. Unless policies change, Zimbabwe is expected to continue facing hyperinflation.

Despite sound fundamentals, the region faces risks. Inflationary pressures arise mainly from oil prices, which are expected to increase by more than 20 percent this year compared with the average price in 2007. If oil prices were to rise to \$100 a barrel in 2008, rather than the \$75 projected in the fall *World Economic Outlook*, GDP growth would be reduced by 0.2–1.0 percent in the region, depending on countries' production structure and energy intensity.

The behavior of other non-oil commodity prices will also be crucial to the growth outcome. If high oil prices are accompanied by a stronger slowdown in major commodity importers, sub-Saharan Africa's exports would be hit hard. It is estimated that, for every 1 percent decline in global GDP growth, the region's GDP

Better performance

Growth in sub-Saharan Africa is strongest in decades.



growth will decline by about ½ percentage point. If turbulence in global financial markets leads to a reversal of portfolio flows, this would also hurt growth in a few countries.

The region also faces internal risks. Conflicts still ravage the Darfur region of Sudan and the Horn of Africa, and the situation remains fragile in the Democratic Republic of Congo. Postelection violence in Kenya is likely to reduce growth there, and neighboring countries could also be affected—for example, through interrup-

tions to transit routes. The unrest in Chad also has implications for neighboring countries.

Vulnerability varies

Many countries are less exposed to shifts in global economic conditions than they were in the 1990s. Smaller current account and fiscal deficits, lower inflation, lower debt levels, increased foreign reserves, and strengthened policy frameworks have all helped make the region more resilient to external shocks. But while many countries have become more resilient, vulnerability varies significantly, and the region would still be affected by a pronounced global slowdown and a deterioration in its terms of trade.

In countries with a flexible exchange rate regime, a forward-looking easing of monetary policy could help mitigate the output response to a negative demand shock. To the extent that the slowdown is temporary, countries with comfortable foreign reserves could use their reserves to smooth shocks. In some countries, the policy response may entail a more depreciated exchange rate to rebalance growth. A permanent shock, however, would require a real exchange rate adjustment.

Countries with a sustainable fiscal position may have room for countercyclical fiscal policy and could let their automatic stabilizers operate. But countries without this room may have to offset at least part of the effect of automatic stabilizers. The degree of fiscal easing should take into account the level of public debt; to the extent that discretionary action is taken, it should be temporary.

In several countries, especially oil exporters, the challenge will be to maintain macroeconomic stability in the face of strong foreign exchange inflows. Countries should cast spending and saving decisions in a medium-term framework that takes into account long-term fiscal sustainability. A strengthened public financial management system and institutional reforms in budgeting and project implementation would help ensure that expenditures are growth promoting and poverty reducing. ■

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Debt Relief Brings Benefits to Africa

Debt relief under two international initiatives has helped reduce significantly the debt burden of heavily indebted poor countries in Africa and freed up additional resources for poverty-reducing and social expenditures.

Thirty-three African countries are eligible for debt relief of an estimated \$80 billion (in end-2006 present value terms) under the two initiatives. Some \$42 billion is being delivered to the 19 countries that have already reached the final stage of the process.



Ultrasound at a clinic in Malawi, where debt relief has freed up money for social spending.

What are the two initiatives?

The Heavily Indebted Poor Countries (HIPC) Initiative was launched in 1996 by the IMF and the World Bank to ensure that no poor country faces a debt burden it cannot manage. The initiative aims to reduce the external debts of the most heavily indebted poor countries to levels they can service. It entails coordinated action by the international community, including multilateral organizations, governments, and private creditors. In 1999, the initiative was modified to provide faster and broader debt relief and to strengthen the links among debt relief, poverty reduction, and social policies.

In 2005, the HIPC Initiative was supplemented by the Multilateral Debt Relief Initiative (MDRI) to help accelerate countries' progress toward the UN Millennium Development Goals (MDGs).

The MDRI grants countries 100 percent relief on eligible debts owed to three multilateral institutions—the IMF, the International Development Association of the World Bank, and the African Development Fund—if they complete the HIPC Initiative process. In 2007, the Inter-American Development Bank also decided to provide debt relief to the five HIPCs in the Western Hemisphere on terms similar to those under the MDRI.

Thirty-three African countries have been found to be eligible, or potentially eligible, for assistance under the HIPC Initiative and the MDRI. Nineteen countries have already established a good track record of policy performance and have reached the final stage of the process. At that point, lenders are expected to provide the full amount of debt relief they committed to at the “decision point,” when countries become eligible for interim debt relief under the HIPC Initiative.

Seven countries have reached the decision point. Seven other countries have been identified as potentially eligible for HIPC Initiative assistance, but have not yet reached their decision points. Liberia could reach its decision point by early 2008, as progress continues in mobilizing the bilateral contributions necessary to finance arrears clearance and debt relief.

How African countries have benefited

The international community has committed significant resources for debt relief for the heavily indebted poor countries in Africa. Debt relief under the HIPC Initiative and the MDRI is projected to reduce by more than 90 percent the debt stocks of the 26 African countries that have reached the decision point.

Debt service paid by these countries declined by about 3 percentage points of

GDP between 1999 and 2006; their poverty-reducing expenditures increased by about the same magnitude.

Before the HIPC Initiative, eligible African countries were, on average, spending slightly more on debt service than on health and education combined. Now they have markedly increased their spending on health, education, and other social services, and, on average, such spending is more than five times the amount of debt-service payments.

With fewer armed conflicts, less political instability, strengthened macroeconomic fundamentals, and lower debt levels following debt relief, low-income African countries have become more attractive to a broader universe of investors.

Challenges facing African HIPCs

Many of the countries that have not yet reached their completion point are having difficulty doing so. Those that have not yet reached their decision point are facing such obstacles as internal conflict (for example, in Comoros, Somalia, and Sudan), substantial arrears to multilateral institutions (Liberia, Somalia, and Sudan), governance issues, and, more generally, difficulties in formulating viable macroeconomic and poverty-reduction programs.

Some countries that have received interim debt relief are grappling with maintaining macroeconomic stability, preparing Poverty Reduction Strategy Papers, and implementing reforms that will enable them to meet the criteria for the completion point.

Long-term debt sustainability remains a concern for most of the African countries that have received debt relief. To mitigate debt-related vulnerabilities, they need to increase domestic revenue mobilization, diversify their production and export bases, and strengthen public institutions. ■

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Nigeria Needs Sustained Reforms to Build on Success

Nigeria's current economic situation is the strongest in its recent economic history.

Growth is high, inflation is in single digits, and external and fiscal positions are strong (see table, page 39). The recapitalized banking sector and newly active financial markets are supporting private activity. These gains reflect Nigeria's implementation of a homegrown reform program. The IMF supported this reform program through a two-year Policy Support Instrument, which was concluded successfully late last year (see box, p. 39).

According to the IMF's annual assessment of the economy, released on February 15, prospects for growth in 2008 are good. In the oil sector, a rebound in production is anticipated; however, developments in the Niger Delta need to be watched.

The non-oil sector, particularly in the areas of services and agriculture, has been growing strongly. Growth in the non-oil sector is on course to reach about 9 percent this year, as long as weather conditions continue to support agriculture. Single-digit inflation targets are within reach, helped by a strong naira. An increase in food prices, driven by unfavorable weather conditions, is the main risk to inflation.

However, challenges remain, particularly in three key areas—budgets and oil revenues, the financial sector, and private sector growth.

Managing oil revenues and oil savings

The success of recent budget policy in bringing about high growth and lower inflation also resulted in mounting oil savings. The presence of these savings has resulted in pressures, particularly by state governments, to spend more. Everybody agrees with the goals: a stronger public infrastructure is needed, especially for power, to support a growing private sector; and there is a tremendous need to reduce poverty. But what is the best budget policy and best use of oil savings to deliver these goals?

Nigerians know better than anyone that the answer to this question is not simply to spend. Hundreds of billions of dollars have accrued from the oil sector in recent decades, but unfortunately there is little to show for this revenue in terms of lower levels of poverty. In these earlier episodes, spending of oil receipts resulted in a short-term boom in growth, but this phase was followed by low or even negative growth and massive accumulation of debt. In other words, Nigeria saw a harmful pattern of boom and bust that locked it onto a low-growth path.

In 2008, a carefully balanced policy stance is essential. Spending should not be determined by whether oil prices are high or low. The various tiers of government must spend in line with the economy's needs and its ability to absorb those resources. The alternative is economic instability, which increases the suffering of the poor and



Workers on an oil rig in Nigeria, where prudent management of oil savings and revenues is key to unleashing the country's potential and reducing poverty.

makes the private sector uncompetitive. In sum, the success of the oil-price-based fiscal rule in containing spending to levels consistent with macroeconomic stability in recent years was central to the turnaround in Nigeria's economic performance. Without a comparable policy anchor in the future, the country's gains are at risk.

Supervising the financial sector

The success of the reform efforts, dramatic reductions in external debt, and high oil prices are leading Nigeria along the path followed by emerging markets elsewhere in the world, giving Nigeria's financial sector a new lease on life. This is good news, but it must be managed well to get the best results.

Accounting for about one-third of sub-Saharan Africa's GDP, excluding South Africa, Nigeria is attracting great interest from global financial markets. It is integrating rapidly into these markets, including through a fivefold increase in government securi-

ties trading and a fourfold increase in stock market capitalization since 2005. The growth dividend is already evident in the form of increased bank lending across a range of sectors. At the same time, the challenges for monetary policy and of preserving financial stability will only intensify. The central bank needs to redouble its efforts to keep pace with the dramatic changes in the sector and to ensure that its supervisory capacity is commensurate with growth and activities in the banking sector.

Private sector growth is critical

The private sector must ultimately be the driver of growth, employment creation, and poverty reduction. Measures such as liberalization of the communications sector and privatization have paid off. But much more needs to be done—particularly in addressing the infrastructure gap that is the main impediment to growth. Limited power generation and weak distribution, along with a severe lack of transportation, raise the cost of business. By some estimates, the cost of power to the private sector is six or seven times the price paid by international competitors.

The government's medium-term fiscal strategy allows for adequate spending to make meaningful progress in addressing the infrastructure gap. Of course, attention must be paid to the quality of spending and to ensuring that projects are completed. Identifying the right role for the public and private sectors, prioritizing outlays, and strengthening public financial management are priorities.

Boom times

Nigeria's strong growth is projected to continue.

	Act.		Est.	Proj.	
	2005	2006	2007	2008	2009
Real GDP growth (percent)	6.5	6.0	6.3	9.0	8.3
Consumer price inflation, annual average (percent)	17.8	8.3	5.4	7.3	8.5
Overall fiscal balance (percent of GDP)	9.4	7.7	0.4	6.2	4.8
Non-oil primary fiscal balance (percent of non-oil GDP)	-27.2	-28.3	-27.1	-25.0	-25.0
Current account balance (percent of GDP)	7.1	9.4	0.8	4.7	2.4

Sources: Nigerian authorities; and IMF staff.

The success of the reform program to date shows that the authorities' macroeconomic policy priorities have been centered on tackling the right bottlenecks and grasping available opportunities. Looking forward, the authorities recognize that macroeconomic stability is essential to translate the higher growth into a widespread increase in living standards. For this reason, the prudent management of oil savings and revenues is the key to unleashing Nigeria's potential and to reducing poverty. ■

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IMF's Policy Support Instrument Underpins Nigeria's Gains

With Africa enjoying its strongest economic performance in decades, a growing number of countries across the continent are seeking a different form of engagement with the IMF, reflecting less need for financing and more demand for institution-building and growth-promoting policies.

In response, the IMF in 2005 introduced the Policy Support Instrument (PSI). The PSI is a nonfinancial instrument—that is, no IMF resources are disbursed—but it is structured to resemble closely the IMF's traditional financial facilities. A PSI provides endorsement of a member's policies by the IMF Executive Board and is reviewed twice a year against a number of benchmarks and assessment criteria.

A PSI represents a commitment to sound policies. Signaling such a commitment can be valuable to external audiences (such as donors and investors) to indicate the quality of the policy framework, but also to domestic audiences (such as politicians and markets).

Since 2005, six countries have received support under the PSI: Cape Verde, Mozambique,

Nigeria, Senegal, Tanzania, and Uganda. In all cases, these countries have a track record of successful policy implementation, strong growth, and no immediate need for IMF financing. At the same time, these countries wished the IMF to remain closely engaged in designing and supporting their domestic reform programs. In all cases, the PSI is based on a well-articulated national strategy—for example, the Nigerian Economic Empowerment and Development Strategy (NEEDS) program.

Nigeria's two-year PSI-supported program, approved in October 2005, had as its key objectives to consolidate macroeconomic stabilization—notably by reducing double-digit inflation—and achieve a comprehensive debt restructuring, lower the debt burden on the economy, and free up resources for priority spending. The PSI's structural reforms aimed to improve macroeconomic management, reinforce public institutions, and redefine the government's role in supporting private sector-led growth.

By the end of the program, macroeconomic performance and sustainability in Nigeria had improved. Non-oil sector growth averaged 8½ percent and inflation fell to 6 percent, exceeding expectations on both counts. The external and fiscal positions strengthened significantly with the reduction of Paris and London Club debt and the accumulation of public savings and international reserves. Debt-service savings were directed to poverty spending. The improved policies and good macroeconomic performance increased confidence, thereby creating a virtuous circle.

Buoyant financial market sentiment about Nigeria is reflected in a sovereign rating of BB– and in the success of several Nigerian banks in raising capital on international markets. But while a majority of households saw their economic situation improve or stay the same, poverty remains high, and progress toward the Millennium Development Goals needs to accelerate. ■

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IMF African Department

Burkina Faso: Weathering Its Cotton Crisis

In Burkina Faso, sub-Saharan Africa's largest cotton producer, cotton production has grown 19 percent a year over the past 10 years, boosting GDP growth. But the cotton sector has been hurt by lower world prices and the appreciation of the euro (to which the region's CFA franc is pegged) against the dollar. In addition, because an inflexible pricing mechanism prevented the timely pass-through of lower world cotton prices to producers, the ginning companies, which sell at world prices, incurred sizable financial losses (see chart).

Although initiatives to address the problems have begun, more must be done to make the cotton sector more competitive. The sector's viability—in Burkina Faso, as well as in other West African countries—is under pressure from distortions in global cotton trade caused by producer subsidies and the surge in low-cost output from other developing countries. Perhaps more important, however, are the low efficiency of ginning companies, low yields, and generally slow productivity growth. The financial difficulties of Burkina Faso's cotton sector are affecting the general economy.

Cotton's economic contribution

Cotton is a major pillar of Burkina Faso's economy.

Although it represents only 5–8 percent of GDP, it accounts for 50–60 percent of export earnings and is the main source of foreign exchange. The country's share of world cotton exports has tripled over the past 10 years—unprecedented for an African agricultural product. What makes it more remarkable is that this occurred despite a slump in world prices.

The sale of cottonseed is the main or only source of cash revenue for farmers and is critical in the fight against poverty. Cotton provides about 700,000 jobs to about 17 percent of the population. In cotton-growing zones, poverty has been reduced by a quarter.

Taking remedial steps

Steps have been taken to address the crisis. The government recapitalized the largest ginning company in 2007 at a cost of more than 1 percent of GDP, increasing its share from 35 percent to more than 60 percent. It is now working with stakeholders and donors to reduce its role in the sector.

Efforts to boost productivity and make cotton more competitive are crucial. They will require institutional and policy reforms to disseminate advanced techniques and promote use of higher-yielding cottonseeds. One step toward insuring the sector's viability has been the adoption of a market-based producer price-setting mechanism, which was implemented for the 2007/08 harvest. The new mechanism aligns domestic producer prices with world market prices and thus makes producers share the risk.

The sector's future

The new pricing mechanism brought the producer floor price down from CFAF 165 per kilogram in 2006/07 to CFAF 145 per kilogram for 2007/08. If current world prices prevail over the next few months, the ginning companies should break even for the fiscal year, and farmers might earn a small bonus. Cotton output for 2007/08 is expected to fall by more than 25 percent relative to 2006/07 because of bad weather, but should rebound in 2008/09.

Trials in cultivating high-yield seeds show a productivity gain of 19–30 percent and a gain in income of about \$70 per hectare, on average. The challenge now is to get these seeds to producers. Raising

yields will also require a clearer idea of who will pay—and how they will pay—for the cost of research and extension services, knowledge of best cultivation practices, and the ability to design and enforce incentives that may lead farmers to follow technical recommendations.

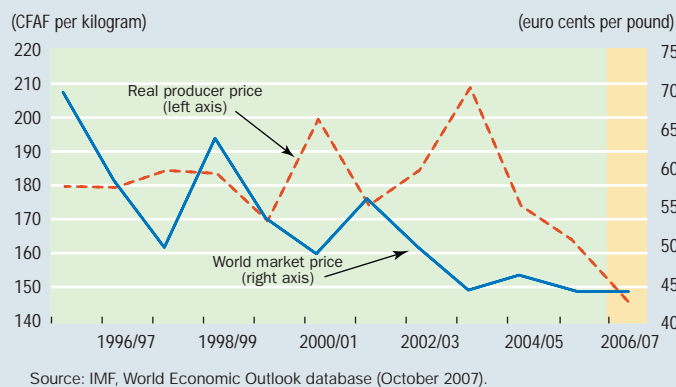
Market-based hedging strategies should be used to limit financial risks. Despite some practical problems, such strategies are possible not only for Burkina Faso but for West Africa as a whole. Currently, recourse to hedging instruments and futures markets is limited in West Africa, but the use of forward sales and exchange rate hedging is possible. The increasing volume of cotton exports from countries other than the United States offers hope for the successful development of world cotton futures contracts.

The government's role in the cotton sector should be reduced over time. And, over the medium term, consideration could be given to rebalancing the relative weights of different cotton companies. ■

*Charles Amo Yartey
IMF African Department*

Cotton losses

Domestic producer prices in the past few years have been higher than world market prices, contributing to the difficulties of Burkina Faso's ginning companies.



IMF Helps Ghana Learn from Others on Inflation Targeting

In May 2007, Ghana formally adopted an inflation-targeting framework for its monetary policy, announcing price stability as the central bank’s primary objective. Only the second country in sub-Saharan Africa to adopt such a regime (after South Africa), Ghana has few regional models to follow, so the authorities have decided to draw on the experiences of a wide cross section of other countries.

“We’ve had bilateral assistance on inflation targeting from the Bank of England and others, but we thought it was time to see how other countries have been doing it,” said Maxwell Opoku-Afari, Advisor to the Governor of the Bank of Ghana, during a recent visit to the IMF. A four-person delegation studied the inflation-targeting models used in Brazil, Turkey, South Africa, Chile, and other countries.

Turning point

At the beginning of the decade, Ghana was grappling with high inflation, large fiscal and external account deficits, and high external and domestic debt. In 1998–99, the country registered a poverty rate of about 58 percent.

The turning point, according to Opoku-Afari, came in 2002, when the authorities introduced a new monetary and fiscal policy framework. The Bank of Ghana Act 2002 gave operational independence to the central bank, established an implicit inflation-targeting framework, and created the Monetary Policy Committee to oversee the new policy.

Under Ghana’s inflation-targeting regime, the monetary and fiscal authorities have made a joint institutional commitment to price stability as the primary goal of monetary policy, to which all other goals are subordinated. The numerical target

range for inflation is announced in the context of the annual budget, and the Bank of Ghana communicates on a regular basis with the public and the markets about its goals and decisions. The current medium-term target for inflation is about 5 percent.

Because this monetary policy strategy is highly transparent, the central bank faces a greater degree of accountability for reaching its inflation targets than it otherwise would. Because the central bank and



IMF Photo

Maxwell Opoku-Afari, Advisor to the Governor of the Bank of Ghana, visited the IMF to get comparative information on inflation targeting.

Ghana’s Ministry of Finance jointly agree to the target, the accountability of the latter also increases.

“The anchor of our new macroeconomic framework was a reduction in domestic debt,” Opoku-Afari said. “As domestic debt decreased from about 31 percent of GDP in 2001 to 13.5 percent in 2006, we also saw inflation come down from about 62 percent in 2001 to around 12.7 percent today.” Ghana’s five-year success with “implicit” inflation targeting—when a country establishes inflation targets but does not announce them as its primary monetary policy objective—encouraged the government to formally adopt the policy in 2007.

Cross-country comparisons

Opoku-Afari said that his team’s week-long visit yielded valuable lessons. “One lesson that has come out strongly for most of the countries is the role of fiscal policy in trying to break the single-digit [inflation] barrier,” he said. Brazil and Chile represent particularly important case studies in inflation targeting, he said, because they have fiscal responsibility laws similar to the one Ghana has announced it will introduce.

Studying South Africa’s well-established inflation-targeting system and Nigeria’s experience is also useful, Opoku-Afari said. Although Nigeria has not yet formally adopted inflation targeting, the authorities have looked at an IMF-developed model. He noted that, with Ghana’s discovery of oil last summer, some aspects of Nigeria’s experience as an oil exporter will, in time, become relevant.

“Frontier” emerging market

Most of the economies whose experiences Ghana is studying are emerging market countries. “Ghana is no longer a typical low-income country,” noted Piroska M. Nagy, the IMF mission chief for

the country. “It’s not yet an emerging market, but it’s in transition. It’s at the frontier.”

Ghana’s economy has been growing at an average of more than 6 percent a year and, with lower inflation, better fiscal discipline, and slightly higher growth—of about 7.5–8 percent a year—Ghana could achieve middle-income status by 2015.

But high growth is not to be taken for granted. To spur growth, and in the absence of a major scaling up of aid, the Ghanaian government issued a \$750 million sovereign bond in late 2007 to bring in resources for investment in energy and transport infrastructure. ■

Maureen Burke
IMF External Relations Department

Iraq Makes Progress on Economic Front

Although Iraq continues to experience perilous conditions, the IMF said its economy has improved over the past two years, and a new arrangement with the IMF will help the war-shattered economy move toward sustainable growth.

Iraq made significant progress under an IMF Stand-By Arrangement approved in December 2005. On December 19, 2007, the IMF's Executive Board approved a new Stand-By Arrangement for Iraq. The decision to continue supporting Iraq's economy recognizes the significant progress the country made under the first program. In light of Iraq's strong international reserves position, the authorities will treat the new arrangement as precautionary, which means that they do not intend to draw these resources.

But the IMF noted that much remains to be done to put Iraq on a path to sustainable growth. The main objectives of the new program, which will run through March 2009, are to maintain macroeconomic stability, facilitate higher investment and output in the oil sector, and advance structural reforms and institution building.

Progress under first program

Inflation, which spiked at 65 percent at end-2006, was sharply reduced with a policy package that included exchange rate appreciation, monetary tightening, and fiscal discipline. These policies, together with measures to reduce fuel shortages that resulted in declining black market fuel prices, limited the increase in consumer prices to less than 5 percent during 2007. Core inflation, which excludes fuel and transportation prices, fell to about 12 percent from 32 percent in 2006.

Because of security conditions, however, the implementation of the public investment program fell short of budget plans, and oil output and economic activity in general did not expand as much as was hoped. Before oil exports through the



Karim Sahib/AFP

Worker at the Dura oil refinery, on the outskirts of Baghdad, filling a barrel. A key government objective is to facilitate higher investment and output in the oil sector.

northern pipeline to Turkey resumed in the last quarter of 2007, oil production hovered around 2 million barrels per day (mbpd) (see Chart 1).

The shortfall in oil production was offset by higher world market prices (see Chart 2). Iraq's international reserves position has continued to strengthen, allowing the country to repay in advance the full amount outstanding from a 2004 loan under the IMF's Emergency Post-Conflict Assistance, which preceded the first Stand-By Arrangement.

Aside from improving macroeconomic stability, Iraq also made progress on structural reforms. The authorities significantly increased the initially very low domestic official fuel prices to levels that are in line with those in the region's other oil-exporting countries. Direct subsidies on fuel products, which amounted to almost 13 percent of GDP in 2004, were eliminated in 2007, except for a small subsidy on kerosene. This has released much-needed resources for reconstruction

and reduced the incentives for smuggling fuel products out of the country. Other achievements include amending the new pension law to make the pension system fiscally sustainable and modernizing the payments system.

Aiming for stability

Maintaining macroeconomic stability remains a key objective of the authorities' program for 2008. The Central Bank of Iraq will gear its monetary and exchange rate policies toward achieving this objective. Fiscal policy will help contain inflation by keeping current spending, notably the wage and pension bill, in check to limit pressure on Iraq's small non-oil economy. The envisaged increase in government investment, in view of its high import content, should have only a limited impact on inflation.

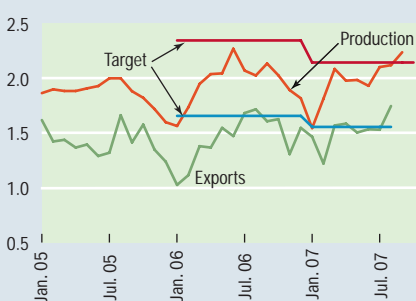
In light of Iraq's large reconstruction needs, the government has prepared an ambitious investment program for 2008. It is taking steps to speed up projects that

Chart 1

Crude oil up

Iraq's production and exports of crude oil increased in 2007.

(million barrels per day)



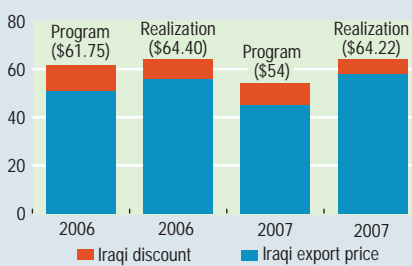
Sources: Iraqi authorities; and Platts (<http://www.platts.com>).

Chart 2

Exports benefit

Iraq benefited from higher world prices and a lower discount for its oil.

(million dollars)



Sources: Central Bank of Iraq; and IMF staff calculations.

Note: *World Economic Outlook* crude oil price is in parentheses. Realization for 2007 is through August.

Chart 3

Banking limited

Iraq's deposit base and loan portfolio are smaller than in other countries in the region.

(percent of GDP, 2006)



Sources: IMF, *International Financial Statistics* and staff calculations; Iraqi authorities.

could not be undertaken in previous years, in particular to rebuild infrastructure and improve the provision of electricity, water and sanitation, education, and health care. Provided that further security improvements allow execution of the public investment program and a return to a more normal functioning of the economy, economic activity outside the oil sector should pick up.

which all oil revenues are channeled, from the International Advisory and Monitoring Board, which has performed this role since December 2003.

Under the new program, restructuring Iraq's banking sector will be a major challenge. The sector is dominated by state-owned commercial banks, which account for 90 percent of the banking sector's

Bank technical assistance. Other structural reforms include modernizing public financial management and strengthening the accounting and reporting framework of the Central Bank of Iraq.

Outlook hinges on security

Iraq's medium-term outlook is favorable, provided security continues to improve. The sustainability of its external debt situation would, however, still require the third and final tranche of Paris Club debt rescheduling (worth 20 percent in net present value terms) planned for end-2008 and further progress in reaching debt reduction agreements with Iraq's other creditors. Disbursement of the last Paris Club tranche is contingent on good performance under the new Stand-By Arrangement.

Although much remains to be done, Iraq has registered a number of successes. Significant progress was made in stabilizing the macroeconomic environment and in advancing the structural reform agenda. The 2008 program will focus on similar objectives to capitalize on the momentum achieved by the first program and, in particular, to help the economy begin growing again. Continued progress, however, will depend on the success of efforts to stabilize the security situation and strengthen political consensus. ■

Raising oil production will be crucial to provide the resources needed for reconstruction over the medium term.

The authorities' program will also focus on the oil sector and the need for higher investment to raise output and for greater transparency. Raising oil production will be crucial to provide the resources needed for reconstruction over the medium term. Projects to increase production and export capacity in the south and better protect the northern export pipeline are either under way or planned. With continued exports through the north, oil production is projected to increase to 2.2 mbpd in 2008, helping to boost economic growth overall to about 7 percent.

Following the installation of a metering system in the Basra export terminal, metering systems in other ports and oil installations are also being put in place. During 2008, an all-Iraqi Committee of Financial Experts will prepare to take over the audit oversight role of the Development Fund for Iraq, through

total assets (70 percent for Rafidain and Rasheed banks alone). The banks lack expertise in commercial banking and market finance. There is very little extension of credit to the private sector, and the banks' asset composition is heavily tilted toward government securities.

Compared with other banks in the region, Iraqi banks' deposit base and loan portfolio are small. Most banks lack the expertise to assess risks and, thus, few offer loans with maturities of more than one year. As a result, financial intermediation is weak (see Chart 3). Banks' total loan portfolio at end-2006 was only \$2.2 billion (4 percent of GDP), mostly in the form of overdrafts. Total deposits stood at \$12.9 billion (26 percent of GDP).

Under the program, financial and operational audits of the two largest banks will be undertaken and a restructuring program adopted, with IMF and World

Erik De Vrijer, Udo Kock, and David Grigorian
IMF Middle East and Central Asia Department

Egypt: Reforms Trigger Economic Growth

Growth in Egypt has picked up steadily since 2004 (see chart), making it one of the Middle East's fastest-growing economies. Egypt launched bold reforms in 2004 that, along with a favorable external environment, have triggered an impressive acceleration of growth, to 7 percent in 2006/07.

In its most recent review of Egypt's economy, the IMF says the expansion has broadened from energy, construction, and telecommunications to agriculture and manufacturing. According to the IMF, the Egyptian economy will continue to grow at 7–8 percent if ongoing improvements in the business environment succeed in raising investment to more than 25 percent of GDP.

Between end-2004 and end-March 2007, 2.4 million jobs were created. As a result, unemployment—chronically high in this emerging market economy—has dropped from 10.5 percent to 9 percent. Exports and imports also rose sharply, along with workers' remittances, Suez Canal receipts, and tourism revenues.

Better business climate

The reforms have started to tackle critical impediments to private business and investment.

In 2004, the establishment of a well-functioning foreign exchange market lifted formal and informal restrictions on access to foreign exchange that had long hampered business in Egypt. The weighted average import tariff was cut to about 6.9 percent by 2007, accelerating integration with the global economy. Personal and corporate income tax rates have been slashed, and tax administration is being modernized. Business regulations have been streamlined to speed up customs clearance and facilitate registration of new businesses and property. A wide range of productive assets have been privatized, and more than half of the banking system is now in private hands. Finally, governance and finan-

cial soundness of state banks and banking supervision have been strengthened.

Structural reforms were complemented by prudent macro-economic policies. Monetary policy, underpinned by greater exchange rate flexibility, has become more effective in targeting and containing core inflation. The fiscal deficit for 2006/07 was reduced to about 7.7 percent of GDP from an average of 9 percent in recent years. The decline is due to the tax reforms, fuel price adjustments, wage restraint, and windfall receipts from a telecom license sale.

In a global environment flush with cash, investors took notice. Large capital inflows, mostly foreign direct investment, reinforced the growth impact of the reforms. Egypt's balance of payments has recorded a surplus since 2004/05, bringing official reserves to the equivalent of more than six months of imports and eight times short-term debt.

Tasks ahead

With Egypt's labor force growing rapidly, job creation will be essential and will require sustained higher investment. Structural reforms need to continue to tackle inadequate infrastructure, red tape, poor public service delivery, and the scarcity of skilled labor.

Reducing the budget deficit is key to raising national saving to finance higher investments. It is also key to supporting monetary policy in containing inflation and speculative inflows and to reducing the net public debt. The government has embarked on a program that aims to reduce the deficit gradually to 3 percent of GDP by 2010/11, which would put public debt on a firmly declining path.

The authorities have also started to tackle the underpricing of energy. They hiked diesel prices in mid-2004; further adjusted retail prices in mid-2006; and, in late 2007, launched a three-year program to phase out most industrial energy subsidies.

But prices for most energy products are still far below global prices. This distortion could attract investment into sectors where Egypt does not have a long-run comparative advantage. It also encourages levels of energy consumption with high environmental costs and uses up public funds that could be spent more productively, such as on education or infrastructure.

The favorable external environment and Egypt's continued strong growth provide an opportunity for early action in these areas. Early action would also contribute to a strong and swift investor response. At the same time, the authorities should continue to strengthen social safety nets and help the poorest segments of society benefit from opportunities offered by a growing economy. ■

On the move

Egypt's per capita growth has picked up since 2004.



Source: IMF, World Economic Outlook database (October 2007).

Klaus Enders

IMF Middle East and Central Asia Department

Intraregional Trade Key to Asia's Export Boom

As almost any shopper in the industrial countries knows, Asian exports are booming, with growth built increasingly around rapid expansion in intraregional trade that has China playing a central role.

Despite the current slowdown in the world economy, the IMF projects Asian growth to moderate only slightly, with developing Asia growing by a projected 8.6 percent in 2008. China's growth is forecast to slow to 10 percent from an estimated 11.4 percent in 2007.

The export boom reflects an ongoing geographical dispersion of production, with assembly operations migrating to lower-wage economies, and more developed Asian economies specializing in production of high-value-added components and capital goods.

The resulting increase in vertical intra-industry trade, fostered by foreign direct investment, has created a sophisticated production network in emerging Asia, facilitating the "catch-up" process of developing Asian countries through technology transfer.

Growing share of world trade

The export-oriented growth strategies of emerging Asian economies have been reflected in a steady increase of their share in world trade. Emerging Asia's share in world trade flows reached 34 percent in 2006, up sharply from 21 percent in 1990. Moreover, the rise in emerging Asia's trade accounted for roughly 40 percent of the total increase in world trade over the period.

The importance of exports to the region has reached an unprecedented level. Although the share of exports in GDP was already high for emerging Asia in 1990, it increased further over the past decade, reaching almost 50 percent in 2006. This is attributed in part to the small, open, newly industrializing economies, especially Hong Kong SAR and Singapore, whose exports-to-GDP ratios are 109 and 184 percent, respectively. However, high and rising exposures of other economies in emerging Asia, including China, suggest that this trend is key to understanding economic developments in the region.



Engineers set up a turbine rotor in China, where exports are growing in sophistication.

Peter Bowater/Newscom

Asia's growing share of world trade has resulted largely from increased regional trade integration. While trade flows in the rest of the world roughly tripled between 1990 and 2006, interregional trade involving emerging Asia rose by five times, and intraregional trade within emerging Asia increased by eight and a half times. As a result, trade between the economies in emerging Asia has risen steadily from about 30 percent of total exports by the region in 1990 to more than 40 percent in 2006. China has become Asia's export hub, dramatically raising its profile as a destination for intraregional exports and the source of exports from Asia to the rest of the world.

Intra-industry trade is also booming. This trend in emerging Asia tracks developments in the more advanced economies, but the motivation in Asia is quite different. There, intra-industry trade is primarily a reflection of greater vertical specialization that exploits differences in comparative advantage to build a production network targeting foreign markets. In contrast, intra-industry trade in the developed economy groups (the North American Free Trade Agreement and the European Union) appears to stem primarily from demand for product variety in their large domestic markets. This difference can be seen clearly in Asia's increasing intermediate goods trade.

Implications

What are the implications of growing interdependence among economies in emerging Asia?

- **Decoupling from the global economy is unlikely.** Developed economies outside Asia remain the chief destination of emerging Asia's final good exports. Indeed, the exposure of Asian economies to interregional exports has increased over the past 15 years.

- **The impact of exchange rate fluctuations on Asian final good exports may be limited.** Exchange rate changes will be mitigated by a countervailing movement of import prices that represent a sizable portion of production costs.

- **Policies are needed to enhance complementarities.** Structural reforms in the leading countries to encourage smooth upgrading of their technological competitiveness are important.

- **Free trade arrangements can help.** Market access to third countries, especially in Europe and North America, appears to be crucial for further trade expansion and, hence, for industrial development. ■

Paul Gruenwald and Masahiro Hori
IMF Asia and Pacific Department

For more information, please see Chapter 4 of *Asia and Pacific Regional Economic Outlook*, October 2007.

The Baltic Party Need Not End in a Bust

Growth in the Baltic countries (Estonia, Latvia, and Lithuania) has been exceptionally high.

Indeed, their performance over the past decade and a half is almost unprecedented in post-World War II history. Year after year, GDP has grown much faster in these countries than in their emerging market peers, let alone in Europe (see Chart 1). Membership in the European Union (EU) provided an extra boost, with per capita incomes increasing by up to 50 percent since 2004.

Lately, however, the economic headlines have been dominated by unwelcome news, from negative industrial output growth in Estonia to double-digit inflation in Latvia. Credit from foreign parent banks, which until recently fueled growth in the real estate sector, has slowed markedly. On January 31, the rating agency Fitch followed its earlier move on Lithuania and downgraded the outlook for Estonia and Latvia, citing “heightened downside risks.”

Avoiding boom-bust

Will the skeptics, who have long contended that these countries’ rapid convergence has been too much, too fast, be proved right after all? Now that cheap global financing is drying up, will the imbalances built up during the boom—large current account deficits (see Chart 2), heavy private sector

debt burdens, and overheated real estate markets—end in a bust? Academics and policymakers at a high-level seminar, jointly organized by the Estonian Central Bank (Eesti Pank-EP) and the IMF on February 1–2 in Brussels, debated the policies needed to avoid the experience of other countries that went from boom to bust—and what makes the Baltic case so different. With the right policies in place, they argued, a soft landing is feasible.

To be sure, nobody questions that the risks of a hard landing are real. Some observers point to the case of Portugal. It, too, experienced a rapid acceleration of economic convergence after joining the EU. But starting in 2001, this boom gave way to a long period of subpar growth and high current account deficits that persist today, as big wage increases exceed productivity growth and the country has lost competitiveness. Other observers draw parallels to the 1998 Asian crisis, where a rapid expansion of foreign-funded credit preceded a painful sudden stop and a collapse of fixed exchange rate regimes.

Although some of these tales may sound alarmingly familiar, none of the comparisons quite sticks. Having joined the EU only four years ago, the Baltic countries’ capital, labor, and product markets are already deeply integrated with those of

their European neighbors (see Chart 3, page 47), especially the Nordic countries. This provides protection against sudden stops, but also limits policy options.

What makes the Baltics different?

Three fundamental factors distinguish the Baltics from the usual pathology of emerging market countries caught in a boom-bust cycle.

- **Capital markets are very open.**

Financial deepening has not only proceeded extremely fast, but it has also been accompanied by a very high degree of international integration: Baltic banks are de facto owned and operated by Nordic banks and domestic credit is largely financed from there. Because these parent banks have a strong stake in the Baltics’ economic future, a sudden Asian-style halt of financing is unlikely. By the same token, however, these close ties put the fate of the Baltic banks, and their ability to weather the global financial turmoil, into the hands of just a few Nordic banks.

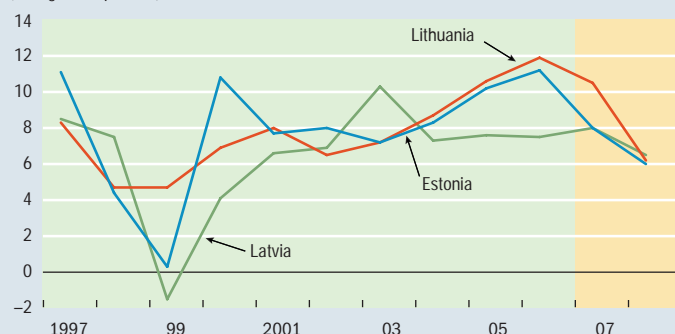
- **Labor is highly mobile.** The opening up of the British and Irish labor markets—where wages are considerably higher—has encouraged Baltic workers to seek employment abroad. So although low unionization and a traditionally high degree of labor market flexibility suggest that the Baltics

Chart 1

Party time

The Baltic countries have achieved very strong growth rates.

(GDP growth, percent)



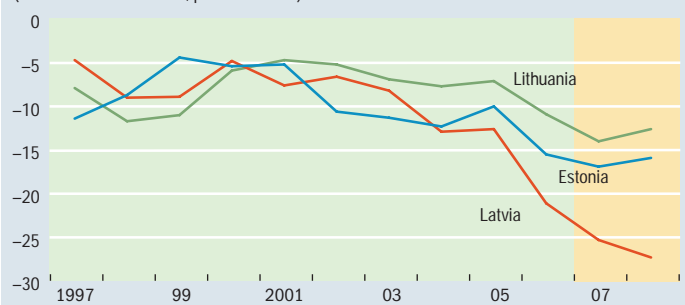
Source: IMF, World Economic Outlook database (October 2007).

Chart 2

Worrying trends

A surge in domestic demand, financed by foreign credit, has fueled expanding current account deficits.

(current account balance, percent of GDP)



Source: IMF, World Economic Outlook database (October 2007).



Street market in Tallinn, Estonia, one of the Baltic states looking for a soft landing.

could do better than Portugal in keeping wage growth in check, the scope for doing so is limited by the threat that workers would leave. This is fundamentally different from the textbook case, where labor endowments are usually assumed to be immobile.

- **Governments have a strong commitment to maintaining fixed exchange rate regimes.** This has provided a crucial anchor of stability in both good and trying times, such as the Russian crisis. Abandoning these pegs, even in the face of mounting external pressures, would likely create more problems than it solves, given that many households and enterprises have borrowed in euros.

Policymakers from the Baltic countries, the European Central Bank, and the European Commission also firmly rejected suggestions to periodically revalue the exchange rate (Paul de Grauwe, University of Leuven) or to unilaterally introduce the euro (Willem Buiter, London School of

Economics). Ruling out monetary and exchange rate policies does, however, put an even heavier burden on remaining policy levers.

How can a soft landing be achieved?

The EP-IMF seminar identified four elements of a comprehensive policy package to avoid a boom-bust cycle and achieve a soft landing.

- First, **fiscal policy should not seek to offset a contraction in demand**, even if the Baltic economies enter a period of slow growth. Drawing on Portugal's experience, Olivier Blanchard (Massachusetts Institute of Technology) argued that a fiscal stimulus would be a false solution. More public spending would drive up prices and wages and undermine competitiveness. After all, the heart of the problem is insufficient external, not internal, demand. From that standpoint, it would

be better to rely on incomes policy if that was thought to be effective.

- Second, **facilitate the switch of production and investment from nontradables to tradables.** This means, for example, removing tax distortions that favor investment in real estate and improving the business climate for export-oriented sectors such as manufacturing or tourism. Structural reforms would also increase productivity growth, in line with the goals of the Lisbon agenda.

- Third, **wages should be flexible and free** to increase or decrease as warranted by companies' competitiveness and productivity conditions. Inward migration into the Baltics can help. Jakob von Weizsäcker (Bruegel) argued that temporary workers from neighboring Commonwealth of Independent States countries can replace those natives who, because of their EU citizenship, can legally work in other member countries. As Tito Boeri (Bocconi University) pointed out, such issues are best addressed through a coordinated EU-wide approach.

- Fourth, **financial supervision should be strengthened.** As credit growth is decelerating, the focus is now shifting from discouraging excessive lending to ensuring that financial institutions are well prepared for an economic downturn. Like migration, this is a formidable task requiring close cross-border cooperation within the EU, in this case between national financial supervisors.

"Change the optic from promoting growth at all costs to consolidating the recent gains and ensuring that external debt is serviced" is how Michael Deppler (IMF) summarized the proposed policy package. The global credit crunch may in fact prove to be a blessing in disguise because it dampens access to cheap financing and, more fundamentally, serves as a reminder that no boom lasts forever.

Participants at the IMF-EP seminar asked governments and citizens in the Baltics to take this lesson to heart and to lower their expectations, whether with respect to income growth, large-scale public investment projects, or speedy adoption of the euro. Modesty and prudence are the best insurance against falling into the Portuguese slow-growth trap—or experiencing a sudden Asian-style output contraction. ■

Christoph B. Rosenberg

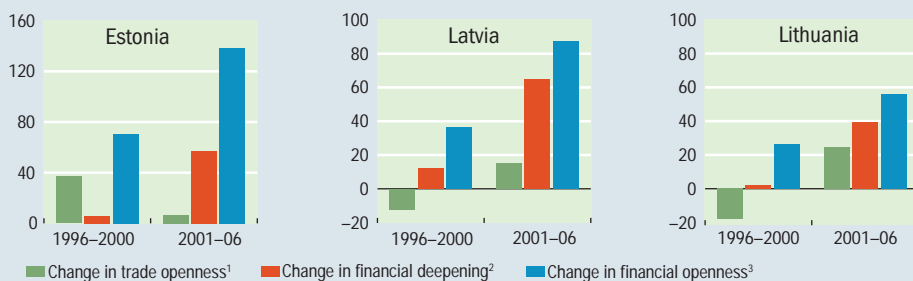
IMF Senior Regional Representative
Central Europe and the Baltics

Chart 3

Better integrated

Foreign trade and financial development have accelerated, especially since EU membership.

(percent of GDP)



Sources: IMF, *World Economic Outlook*; *International Financial Statistics*; country authorities; and IMF staff calculations.

¹Trade openness = total trade (imports plus exports) in percent of GDP.

²Financial deepening = credit to private sector in percent of GDP.

³Financial openness = the sum of total external assets and total external liabilities in percent of GDP.

NEWS BRIEFS

G-7 Backs IMF Reform

Group of Seven (G-7) finance ministers and central bank governors expressed support last month for the IMF's proposal to refocus its operations on core priorities and to cut spending by \$100 million over three years, saying that they are prepared to assist the IMF in taking measures to augment its income.

Since then, the United States has reiterated its commitment to helping the IMF devise a viable model for financing its operations. The institution's medium-term financing gap, which has emerged because of the recent decline in IMF lending, is projected to be around \$400 million a year if new sources of income are not found.

"The United States will help ensure that the IMF has adequate resources to fulfill its vital global mission by seeking authority from Congress for a limited sale of IMF gold," said U.S. Treasury Under Secretary David H. McCormick, speaking at the Peterson Institute for International Economics in Washington on February 25.

"We believe an endowment, financed through a limited gold sale, combined with continued budget discipline, will provide the basis for sound and sustainable IMF finances," McCormick said. A committee formed last year to study the IMF's long-term financing options had proposed the creation of such an endowment, but IMF member country approval must be obtained before new financing measures are implemented.

Both McCormick and the G-7 stressed that the IMF should continue to strengthen its exchange rate surveillance and pursue the reform of its governance structure.



IMF, Trade Union Group to Meet

Representatives of the International Trade Union Confederation (ITUC) will return to Washington in March 2008 to discuss with the IMF the global economic outlook and the growing influence of collective investment instruments, such as hedge funds.

The meeting is part of a longstanding dialogue between the international labor union movement and the Bretton Woods institutions. "Trade unions often give us insights that help us refine our policy advice to countries," said Richard Harmsen of the IMF's Policy Development and Review Department.

The IMF's work touches on many areas of significance for trade unions. The IMF's main role is to promote macroeconomic stability and sustainable growth, including promoting high levels of employment in its member countries. The IMF also monitors labor market characteristics and developments because these factors can have a significant impact on a country's macroeconomic performance. When labor markets are more flexible and competitive, the economy will generally react better to shocks. And when labor unit costs are too high, the country may suffer a loss of competitiveness, because higher labor costs often result in higher prices.

The ITUC has called for greater involvement of local unions in the elaboration of poverty reduction strategies in low-income countries. More recently, the ITUC has advocated greater regulation, transparency, and accountability of hedge funds, sovereign wealth funds, and private equity.

Study on Securities Market Regulation

In many countries, a combination of factors has undermined the capacity of securities market regulators to regulate effectively, a recent IMF study shows. These include insufficient legal authority, as well as a lack of resources, skills, and political will. This weak capacity is more acute in areas that are technically complex, such as valuation of assets, risk management practices, and internal controls.

Although gaps in securities market regulation are a worldwide phenomenon, they are greater in low-income countries than elsewhere, the study finds.

Algeria's Reforms Pay Off

Algeria's market-oriented economic reforms over recent years have started to bear fruit, the IMF noted on February 11 after its annual health check of the economy. The country is registering higher growth—4.6 percent in 2007, up from 2 percent in 2006—low inflation, and strong fiscal and external positions. The IMF Board noted that Algeria's main challenges are to ensure sustained high productivity and nonhydrocarbon growth and to lower unemployment. Unemployment declined in 2007 but remains high, particularly among youth.

Afghanistan Gets \$17.9 Million

The IMF's Executive Board approved a disbursement to Afghanistan of \$17.9 million under its three-year Poverty Reduction and Growth Facility arrangement of 2006. IMF Deputy Managing Director Murilo Portugal noted in a statement that, despite the difficult security environment, the country continues to show satisfactory performance under the IMF-backed program, but that structural reforms will need to be accelerated.

Portugal said that the Afghan authorities have launched a joint appeal with the World Food Program to distribute wheat to areas affected by shortages. "Cash transfers should be targeted to vulnerable households—sourced from the existing budget envelope—to mitigate the effect on the poor of rising wheat prices," he said.

