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Lessons from sovereign debt crises

IMF exchange rate advice in the spotlight

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A new report by the IMF's Independent Evaluation Office, assessing the usefulness of the Fund's exchange rate advice to member countries, has put the IMF's role in exchange rate surveillance, a core function of the institution, in the spotlight. The report called for "a major refocus of efforts" to remedy what it referred to as an "effectiveness gap" in the IMF's advice. IMF Managing Director Rodrigo de Rato said the Fund is already making changes to its framework for exchange rate surveillance.



China Newsphoto

Rapid changes in global financial system spell new risks

page 135

With unprecedented capital flows across borders and new asset classes and investors, the world's financial system needs to be alert to new risks on the horizon, particularly as investors put money in unfamiliar areas, according to the IMF's recent *Global Financial Stability Report*. A key policy challenge is encouraging effective cross-border coordination between home country and host country regulators.



Keith Levitt Photography

Belgium: making the future as good as the present

page 136

Belgium's economy is in a robust expansion, performing better than the euro area average and well above its long-term trend. Sound public policies, including a declining public debt burden and labor market reforms, underpin the growth. But the population is aging quickly, with significant repercussions for public finances, and global competition is increasing. That means that Belgium must accelerate the pace of both fiscal and labor market reforms to ensure a continuing healthy economy.



Francis Lenoir/Reuters

Bright outlook for Middle East and Central Asia

page 140

All groups of countries in the Middle East and Central Asia—oil exporters, emerging markets, and low-income countries—are growing strongly, says the IMF's May 2007 economic outlook for the region, which is expected to achieve GDP growth of more than 6 percent, on average, this year. There are risks to the outlook, including the possibility of slower world growth and a sustained rise in financial market volatility, although the countries in the region are becoming more resilient to potential shocks.



Fays/Paresspax

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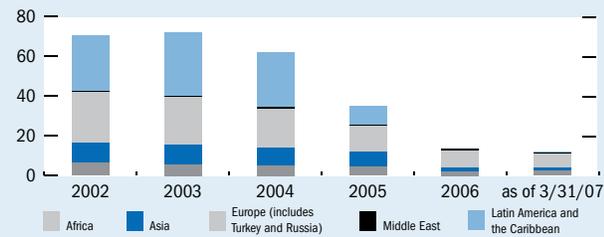
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IMF financial data

Total IMF credit and loans outstanding, by region

(billion SDRs, end of period)



Largest outstanding loans

Nonconcessional		Concessional	
Turkey	5.24	Pakistan	0.92
Ukraine	0.46	Congo, Dem. Rep. of	0.55
Dominican Rep.	0.33	Bangladesh	0.32
Iraq	0.30	Georgia	0.16
Sudan	0.26	Yemen, Rep. of	0.14

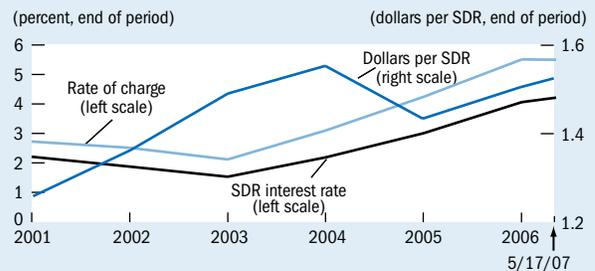
Available IMF resources

(one-year forward commitment capacity, billion SDRs)



Related rates

SDR interest rate, rate of charge on IMF nonconcessional loans outstanding, and dollars per SDR.



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

serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies.

Independent Evaluation Office report Report questions IMF exchange rate advice

The IMF's Independent Evaluation Office (IEO) called on May 17 for "a major refocus of efforts" to remedy what it referred to as an "effectiveness gap" in the Fund's advice on exchange rate policy, a core IMF function. In a report that analyzed the IMF's work on exchange rate policy during 1999–2005, the IEO acknowledged that the quality of the Fund's advice to its member countries had improved in some ways during those years, citing "many examples of good analysis and dedicated staff teams." But in too many cases, the report went on to say, "there was a lack of effective engagement on exchange rate issues."

The IMF's Executive Directors welcomed the report and, in discussing it, broadly endorsed the IEO's conclusion that the Fund was not as effective as it needed to be in its exchange rate advice during 1999–2005. The Board also agreed that the Fund should aim to enhance the effectiveness of its analysis, advice, and dialogue with member countries, and that it should seek to address any perception of asymmetry in its exchange rate surveillance. In his remarks, IMF Managing Director Rodrigo de Rato said that many initiatives were already under way to make exchange rate surveillance more effective. He also pointed out that IMF staff and management disagreed with some of the report's conclusions (see page 132).

To gather evidence for its analysis, the IEO reviewed the last two country reports for each of the IMF's members through 2005, as well as related background material. These reports are produced every year for most countries and contain the Fund's advice to policymakers on a range of economic issues, including exchange rate policy. IEO staff also examined in detail the IMF's exchange rate advice to a group of 30 economies. To complement its desk reviews, the IEO conducted interviews with country authorities and IMF officials and carried out two surveys, seeking views from central banks or finance ministries in all member countries and from senior IMF staff involved in country work.

The IEO set out to answer three main questions: Is the role of the IMF clearly defined and understood? How good is the quality of the IMF's advice and its underlying analysis? And how effective is the Fund in its policy dialogue with country authorities? It concluded that "the IMF was simply not as effective as it needs to be in both its analysis and advice and in its dialogue with member countries." It attributed the shortcomings to a number of factors, including



A bank teller counts currency in Jiangsu Province, China, one of 30 countries studied in the IEO report.

The rules of the game for exchange rate surveillance are unclear both for the IMF and for member countries.

—Independent Evaluation Office

- a lack of understanding on the part of governments of the role of the IMF in exchange rate surveillance and a failure by some member countries to commit to their obligations as members of the IMF (for instance, in terms of providing relevant data);
 - a perception among some member countries that the IMF is not evenhanded in its treatment of countries (implying that advanced countries were given "kid-glove treatment" by IMF staff);
 - a lack of depth in the IMF's analysis and advice relating specifically to exchange rate regime choice, combined with a lack of attention to implementation issues;
- a lack of depth in analyzing policy issues spanning several countries (including spillover effects), resulting in a lack of attention to policy interdependencies and the possibility of coordinated policy responses;
 - a failure by IMF management and the Executive Board to provide adequate direction and incentives for high-quality analysis and advice on exchange rate issues; and
 - the absence of an effective dialogue between the IMF and many—though certainly not all—of its member countries.

The role of the IMF

Its Articles of Agreement mandate the IMF to "exercise firm surveillance over the exchange rate policies of members." Further guidance on what that means in practice was provided in the so-called 1977 Decision on Surveillance over Exchange Rate Policies and a series of Executive Board decisions on exchange rate issues, which suggested that IMF staff look at such issues as a country's choice of exchange rate regime (whether the exchange rate is fixed, pegged, or floating); the level of the exchange rate (the currency's value compared

with that of other currencies); the use of intervention policies to target a particular exchange rate level; and the overall consistency of exchange rate policy with other economic policies. According to the IEO, however, “the rules of the game for exchange rate surveillance are unclear both for the IMF and for member countries.” Moreover, it argued, operational guidance for staff was not as clear as it should be.

As evidence, the IEO cited responses from its survey of central banks and finance ministries, which suggested different expectations of what the IMF is supposed to do and what it is in fact doing. On the positive side, two-thirds of the respondents felt that the IMF had appropriately played the role of confidential advisor and as intellectual partner in discussions about exchange rate policy. And about half considered that the IMF had it about right in helping build a consensus for policy changes. In all these roles, however, policymakers from large emerging market countries—a key constituency for the IMF—were more likely than policymakers from other countries to express a sense of missed opportunity in their dialogue with the Fund.

Roughly two-thirds of the respondents said that the IMF was getting it about right in its roles as provider of credibility and as contingency lender. But fewer than half thought the IMF was getting the balance right in its roles as a broker for international policy coordination and ruthless truth teller to the international community, with respondents from advanced economies call-

ing on the institution to be more proactive. Some 40 percent of IMF staff also thought the Fund could play a more active role in terms of international policy coordination.

Quality of the IMF's analysis and advice

How about the quality of the IMF's advice and its supporting analysis? Overall, the IEO's survey revealed that policymakers were almost evenly split between those who thought that the IMF's advice had improved and those who saw it as unchanged between 1999 and 2005. The most critical group was, once again, the large emerging market countries, whereas the most positive responses came from small emerging market and developing countries.

One big challenge for the Fund's exchange rate analysis is a lack of relevant and high-quality data pertaining to exchange rate management. IMF staff members who participated in the survey cited data deficiencies as impairing their ability to conduct exchange rate analysis for 37 percent of the countries they worked on. And in almost one-fourth of cases, country officials had been unwilling to provide relevant data pertaining, for instance, to intervention in foreign exchange markets. The IEO also noted that some of the largest holders of foreign exchange reserves do not disclose the currency composition of their reserves.

Data problems notwithstanding, the IEO said that its findings indicated a gap between the existing quality of advice and the kind of analysis that many government officials in advanced

The response

IMF weighs advice on exchange rate work

The IMF has already begun to make changes to its framework for exchange rate surveillance that are in line with several of the recommendations in the latest report from the IMF's Independent Evaluation Office (IEO) on exchange rate policy advice, according to IMF Managing Director Rodrigo de Rato.

These initiatives include strengthening analytical tools for exchange rate analysis, better integrating financial sector analysis into IMF surveillance, and tackling issues of global importance through multilateral consultations involving the major players in the global economy, de Rato said. The IMF is also seeking to clarify the parameters of its surveillance mandate through an update of the so-called 1977 Decision on Surveillance over Exchange Rate Policies.

While de Rato welcomed the report as a timely contribution to the debate about how to improve the IMF's work on exchange rates, he also noted that it had certain limitations. “The IEO report contains a great deal of valuable information,” he said. “However, because the report does not address the specific initiatives in this area that have been launched since 2005, its applicability is somewhat diminished. Moreover, the report's conclusions are not fully supported by the evidence.”

Mark Allen, head of the IMF's Policy Development and Review Department, said he was not surprised the IEO had identified areas in which the Fund's exchange rate analysis could be strengthened. “Exchange rate surveillance is a major challenge. There are no widely agreed economic theories to analyze many exchange rate issues. And many of the issues are political in nature as well as market-sensitive.” But like the Managing Director, IMF staff noted that the report disregarded much of its own positive evidence on the quality of the Fund's work, ignored progress made during the period under review, and was sometimes premised on unrealistic expectations about the IMF's ability to influence its members.

In its discussion of the findings on May 9, the IMF Executive Board welcomed the IEO report, noting that the evaluation would be “an important input into ensuring that the Fund remains responsive to the rapidly evolving world economy.” Executive Directors stressed “the shared responsibility of the Board, management, and staff—as well as national authorities—in carrying forward these objectives.”

De Rato said the IMF would make specific proposals to the Executive Board on how to follow up on the IEO's recommendations over the next few months. ■

What the IMF should do to sharpen its advice

In its report, the IEO argued that a concerted effort by IMF staff, management, the Executive Board, and member countries would be required to make the IMF more effective in its exchange rate policy advice. The IEO listed a number of recommendations that it encouraged the IMF's management and its Executive Board to consider:

1. Clarify the rules of the game for exchange rate surveillance, for both the IMF and its member countries.
2. Develop practical policy guidance on key analytical issues, for instance on the use and limitations of intervention in foreign exchange markets, building on the findings of an Executive Board policy review of the stability of the international monetary system.
3. Ensure a more effective policy dialogue with member countries by developing a more strategic approach to these discussions and by adjusting organizational incentives for IMF staff.

4. Resolve inconsistencies and ambiguities in the way the IMF classifies exchange rate regimes.
5. Back up the IMF's advice on the choice of exchange rate regimes with more explicit analytical work.
6. Ensure that the IMF is always at the forefront of new approaches and methodologies for assessing exchange rate levels.
7. Take steps to find out what lies behind the apparently serious problems of data provision.
8. Develop guidelines for improving the analysis of spillover effects in country analysis.
9. Ensure proper focus on key issues in exchange rate analysis by clarifying responsibilities and considering changes to the structure of IMF country teams.
10. Clarify the confidentiality and accountability rules that apply to discussions of sensitive exchange rate-related policy action.
11. Focus on opportunities for concerted multilateral policy action.

and emerging market economies would like to see. "While some officials stressed that the quality of the analysis was excellent and clearly valued, others (and not just those who may have disagreed with the advice given) were quite blunt in saying that it fell short of what would have been appropriate and helpful."

The IEO did not find any clear-cut cases of uneven treatment in its sample of 30 countries—despite what it referred to as widespread perceptions that the IMF goes easy on large, advanced countries. But it said that the Fund could have done more to counter existing perceptions of a lack of evenhandedness.

Impact of the IMF's advice

When the IEO asked central banks and finance ministries about the impact of the IMF's advice in shaping important deci-

sions on exchange rate policy, 43 percent said they regarded the advice as "instrumental," whereas 38 percent saw it as marginal. Policymakers from advanced economies were the most likely to characterize the impact as limited, and in the large emerging market economies, only a minority viewed the IMF's role as instrumental. In contrast, a majority of the respondents from small emerging market and developing countries said the IMF's advice had been instrumental in their decision making.

How about the quality of their interactions with IMF staff? Close to three-fourths of policymakers said they viewed their meetings with Fund officials as an opportunity for a two-way dialogue. IMF staff was willing to discuss exchange rate questions with candor, most of the respondents said, while remaining respectful of national points of view. But the IEO noted that "while there were very few obviously negative experiences, the bigger issue appeared to be the tepid enthusiasm expressed privately in several countries." It saw this as a warning sign "that the IMF is seen by some as providing limited value added . . . and that it needs to find a way to reenergize its contribution to members' ongoing policy discussions."

The IEO urged the IMF to take action to remedy the "effectiveness gap in its main line of business" as quickly as possible (see box above). Unless the shortcomings were addressed, and as the number of countries looking elsewhere for policy advice continued to grow, "there could be serious implications for the ability of the IMF to discharge its responsibilities in the future." ■

Camilla Andersen
IMF Survey Magazine

Getting it right

Exchange rates affect many aspects of a country's economy and its relations with the rest of the world. For this reason, exchange rate issues occupy a central place in the IMF's analysis and advice to its 185 member countries—a process known as surveillance.

IMF staff considers its 2006 Article IV consultation with China an example of good practice in exchange rate surveillance. The report contains extensive coverage of key exchange rate issues, including the exchange rate regime, the level of the exchange rate, and the implications of China's exchange rate policies for other countries. The report highlights both the authorities' views and those of IMF staff.

Other examples of what IMF staff considers to be good exchange rate surveillance can be found in country reports and selected issues papers for the Economic and Monetary Community of Central Africa (CEMAC), Chile, Colombia, Hungary, New Zealand, Russia, South Africa, and Spain.

More information is available at www.imf.org/imfsurvey.

The full text of *IEO Evaluation of IMF Exchange Rate Policy Advice, 1999–2005* is available at www.ieo-imf.org/eval and the full staff response, at www.imf.org/external/np/sec/pr/2007/pr07101.htm.

Effects of globalization

Financial institutions need regulation that keeps up with change

The expansion of financial institutions across borders has accelerated significantly in the past decade in both banking and other areas of finance. But regulation and supervision have not always kept pace. In banking, where there are more data to examine, the globalization of institutions has brought benefits to financial stability but may have changed the nature of the remaining risks. For individual financial institutions, geographic diversification has meant less volatile income and asset values, reduced exposure to domestic markets, and improved access to foreign markets. There are also broader financial sector development and efficiency benefits for many countries—especially emerging markets, which have benefited from knowledge and technology transfer. An open question, however, is what would happen to global and national financial stability if severe adverse events occurred, given banks’ increased cross-border expansion. The April 2007 *Global Financial Stability Report* examined the potential risks and implications for regulators.

Although global banking systems have weathered a number of shocks in recent years, they have, fortunately, not been tested by more extreme shocks that threaten to spill across borders, institutions, and markets. A relatively small number of large institutions are playing a leading role in local and international financial markets, which could increase the spillover effect of any large shocks. This is not only a global issue involving the largest institutions; it is also an important regional and national issue and one that touches even smaller banks that operate internationally. Some indicators suggest that increased institutional globalization could hasten ripple effects across borders, reflecting either increased exposure to common shocks or institutional spillovers from ownership, trading, or other linkages. For example, implied market expectations of loss rates are higher for internationally diversified large banks as a group than they are for all large banks, including less diversified banks, as a group. Unlike measures that look at financial institutions individually, those that look at groups of banks allow for correlations between the institutions’ expected losses.

Strengthening supervision

The nub of the issue for policymakers is the mismatch between the scope of institutions’ activities, and the legal, regulatory, and supervisory frameworks. This mismatch can be particularly problematic when foreign banks’ activities are large and important for a host country. The problem is only partially resolved if a foreign bank operates as a locally incorporated subsidiary rather than as a branch. Although such an arrangement gives host authorities greater supervisory control over local operations, it may not guarantee access to relevant information or the ability to respond promptly and effectively in a crisis. One key policy challenge



A key policy challenge is encouraging effective cross-border coordination between home country and host country regulators.

is ensuring effective cross-border coordination between home country and host country regulators in the ongoing supervision of cross-border banks and in crisis management arrangements. Surveillance of financial system risks thus needs to cover globalized banks’ systemic issues as well as the regional issues that arise when such banks are involved in several host countries.

Various challenges for cross-border supervisory and crisis management cooperation arise from legal, political, and cost constraints. In many countries, there are wide differences in legal powers and objectives, relative expertise and resources, risk preferences, and deposit protection and insolvency frameworks. Similar constraints will likely make it difficult to predetermine the division of any loss or burden sharing between the authorities in the home and host countries if a cross-border institution fails. Still, although these constraints are important considerations, significant work is under way to improve collaboration in both crisis prevention and crisis management, especially in major financial hubs and in Europe. This reflects the importance of the most significant global institutions. Such work needs to continue and be undertaken more broadly.

The options that may be appropriate for collaborative processes in different circumstances range from ad hoc discussions on issues of mutual interest to shared reliance on the performance of tasks and the delegation of authority. Improved mutual understanding and confidence building are cornerstones of future success. Ongoing joint crisis-simulation exercises will further increase awareness and the commitment of both supervisors and national authorities. The continuing evolution and application of international supervisory and other standards, and the convergence of good practices, should help make national arrangements and policies more transparent and easier to understand—within and between countries. ■

Jorge Chan-Lau and Mark Swinburne
IMF Monetary and Capital Markets Department

The changing contours of international financial markets

As a result of the globalization of today's world financial markets, global capital flows are increasing rapidly, and asset classes and investor types are becoming more diverse. Many of these developments have been driven by a broadening investor base, financial liberalization, and technological innovations, enabling investors to diversify into new markets and new instruments, according to the IMF's most recent *Global Financial Stability Report*.

The diversity of assets, source countries, and investor types suggests that this form of globalization should support financial stability by distributing risk more widely. Long time horizons and lower leverage of institutional investors such as pension funds imply a greater capacity to ride out market volatility. That said, the speed at which these changes are taking place and the sheer size of capital flows may temporarily distort prices in financial markets and create pockets of vulnerability. Indeed, cross-border capital flows have tripled over the past decade, to \$6.4 trillion in 2005.

New frontiers of risks

In some emerging market countries, increased demand has outpaced the availability of domestic financial assets, leading to a sharp increase in asset prices, rapid credit growth, and currency appreciation. Also, some investors have been venturing down the "credit ladder," investing in riskier areas where they have little experience. With the growing role of leveraged investors such as hedge funds, asset prices have greater potential to overshoot during good times, increasing

the probability of downside risks when financial conditions worsen.

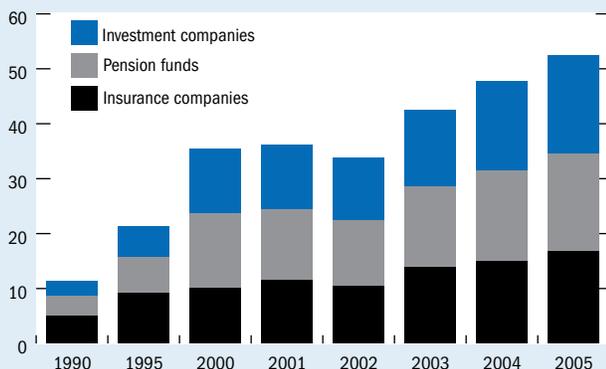
Implementing structural policies to capitalize on the globalization of the investor base while fostering financial stability is the key challenge for many countries. The focus of prudential regulation and supervision needs to shift toward international risks conveyed through financial market instruments. Countries can reduce vulnerabilities by developing sound markets and instruments and by providing an environment that enables market participants to share and transfer risks to those most able and willing to bear them. In addition, mechanisms to manage considerable gaps in global financial information flows can make oversight more effective.

Changes in demography, accounting, and regulatory frameworks and windfall gains accruing to commodity producers have led to increased asset accumulation and changes in asset allocations. Assets under management by mature market institutional investors have more than doubled over the past decade, amounting to about \$53 trillion in 2005 (see chart). Institutional investors in the United States account for about half of this amount, with continental Europe accounting for one-fourth, followed by Japan and the United Kingdom. Within conventional investment management, pension fund assets managed by institutional investors have expanded significantly. There has also been an increasing reliance on hedge funds as a vehicle to achieve higher returns, with pension fund assets being invested in hedge funds.

Growing asset base

Assets managed by institutional investors, such as banks, insurance companies, retirement funds, hedge funds, and mutual funds, in mature markets have been growing rapidly.

(trillion dollars)



Sources: International Financial Services, London; OECD; and IMF staff estimates.

New sources of capital

Emerging market countries have become net exporters of capital and an important investor class in mature markets over the past five years. Their outflows mirror the U.S. external financing gap. This notable shift, which casts a spotlight on global payments imbalances, is driven primarily by the official sector in emerging markets, particularly central banks and sovereign wealth funds. Gross official reserves have more than doubled since 2002, reaching nearly \$5 trillion in September 2006. Governments of countries producing commodities have become large investors in financial instruments, particularly in bonds and equities, through sovereign wealth funds. Market estimates indicate that these funds manage more than \$1.4 trillion. ■

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Belgium's challenge: making the good times last

Belgium's economy is enjoying a robust expansion. Output growth has outpaced the euro area average since 2002 and reached 3 percent in 2006, its fastest pace since the start of the decade and well above its long-term trend. Sound economic policies have underpinned growth. Public finances have been in balance since the beginning of the decade, bringing about an unprecedented decline in the public debt burden (see Chart 1, top panel). Labor market reforms have helped more people find jobs. Nonetheless, the aging of the population and globalization make it increasingly evident that policies need to be strengthened further. With a new government taking office later this year, and a favorable macroeconomic environment, this is a good time to shift the pace of reforms into a higher gear.

Belgium's population is projected to age quickly, with significant repercussions for public finances. By 2050, one out of four citizens will be older than 65, compared with one in six today. As a result, the total age-related annual public bill will increase by almost 6 percentage points of GDP. At the same time, demographic change will contribute to a gradual drop in employment (only temporarily offset by a rise in female participation), depressing output growth over the long run. By mid-century, every worker would have to contribute 8,100 euros (in today's euros) more annually to fund pensions and health care.

For a small open economy such as Belgium's, globalization provides clear growth opportunities. Larger export markets and cheaper inputs could boost workforce productivity—already among the highest in the world—with hourly labor productivity surpassing that of the United States by about 10 percent. This strong performance reflects the efficiency of the manufacturing sectors and the specialization in capital-intensive industries, such as chemicals, pharmaceuticals, and oil refining. But Belgium's competitiveness has eroded and productivity growth has slowed, bringing up the challenge of maintaining its high living standards.

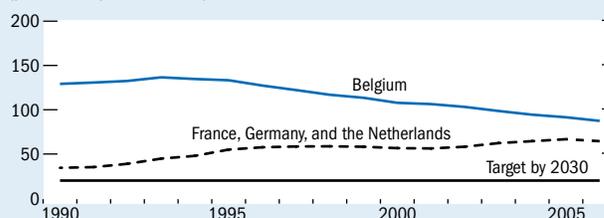
It is equally important to ensure that globalization benefits are widely enjoyed. Here, the picture is somewhat unsettling. Employment in Belgium is among the lowest in the industrial world (see Chart 2). This reflects a combination of structural problems. Labor costs, the highest among Organization for Economic Cooperation and Development (OECD) countries, have priced low-skilled workers out of jobs and encouraged capital- rather than labor-intensive production. Only about 40 percent of low-skilled workers are employed, and their unemployment rates are among the highest in the European Union. Similarly, high labor costs and taxes have discouraged labor supply: a Belgian worker puts in half a day less a week than a peer in another OECD economy. Out-of-work benefits are generous and give little incen-

Chart 1

Getting the budget right

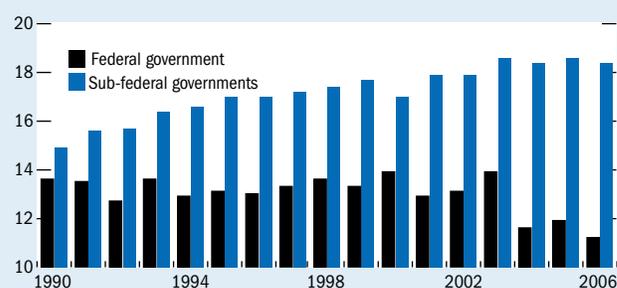
There has been an unprecedented decline in public debt, but further reduction is needed to cope with the costs of an aging population.

(public debt, percent of GDP)



The federal government faces shrinking revenues, whereas revenues are growing in sub-federal governments.

(total net revenue, percent of GDP)



Sources: Belgian authorities, Eurostat, and IMF staff.

tive to participate in the labor market. Activation measures, such as enforcement of job search requirements, have been spotty, and labor shortages in some regions and sectors underscore fundamental skill mismatches and limited labor mobility.

The current strategy could use a hand

To deal with the rising costs of aging, the government is pursuing a multipronged strategy of building up fiscal surpluses and implementing growth- and productivity-enhancing reforms. So far, the government's economic policies have met with success, and the principles of the strategy remain valid, but full implementation cannot be delayed further and policies need to be strengthened:

- **Fiscal consolidation.** Achieving fiscal balance for seven years running has established credibility, but interest savings associated with the declining public debt burden have been spent and used for tax reductions. Recognizing that this is no longer an option, the government now aims to build surpluses gradually to 1½ percent of GDP by 2013. As significant as this prefunding may be, it will fail to fully achieve the objectives of intergenerational equity; increases in social security contributions would be required later on. A somewhat more ambitious objective and,

more important, a meaningful medium-term plan to reduce expenditures will be essential.

- **Higher employment rates.** Natural increases in female labor force participation and the impact of recent reforms will raise employment rates, though not enough to ensure an employment rate high enough to be consistent with the fiscal strategy. That means additional reforms of labor market institutions remain crucial, in particular in the context of mounting competitive pressures.

- **Increased productivity growth.** Further removing obstacles to competition in the services sector, including retail and financial services, would allow the economy to reap the benefits of new technologies and accelerate productivity growth.

- **Further entitlement reform.** Small but fair changes to pension requirements would help ensure against cost overruns and enhance the credibility and sustainability of the system; these should include fully phasing out early retirement, establishing complete actuarial fairness of the pension system, and tying contribution periods to life expectancy.

In addition, achieving fiscal sustainability will require addressing emerging fiscal imbalances across levels of government (see Chart 1, bottom panel). With population aging, it is increasingly evident that those imbalances between spending pressures and

revenue growth across levels of government will widen. The federal entities face escalating aging-related spending but a decline in their relative share of revenues, mainly because of a policy of cutting social security contributions. In contrast, the sub-federal governments are experiencing an increase in revenues as a result of prior decentralization agreements, with no pressing incentive to save. A revision of fiscal federalism arrangements should start now because it will take time for its effects to accrue. Its objective should be a more balanced sharing of the fiscal burden from population aging across levels of government while securing accountability and stronger coordination among government entities of both budgetary and other economic policies.

Labor markets: the key and the Achilles' heel

Labor market reforms of the recently enacted Generation Pact represent a breakthrough in awareness of the need to improve incentives to work and to make work pay, but they will not significantly lift employment rates above demographic trends. As a result, a balanced package of labor market and fiscal reforms (mindful of the implications for public finances) is essential to boost both labor demand and supply. The tax wedge on labor should be further reduced and the generosity of out-of-work benefits reviewed. Eligibility for unemployment benefits will have to be tightened, its duration limited, and efforts to improve training and education enhanced. Finally, to raise their effectiveness, active labor market policies, such as job search assistance, training, and monitoring, will need to be streamlined, systematically evaluated, and coordinated across regions.

More wage flexibility would be a boon in the context of global competitive pressures. Although the central wage-bargaining framework has allowed for wage moderation, it has not favored wage differentiation across sectors, enterprises, and regions and has focused more on job preservation than on job creation. Broadening the use of practices in wage agreements to better reflect regional, sectoral, and firm-specific conditions would be helpful. But a fundamental rethinking of the wage-bargaining system seems worthwhile. In the end, the trade-off is between endless wage moderation—sometimes bought with taxpayers' money—to keep waning industries alive and dynamic entry into new sectors with more promising overall wage prospects.

Belgium's capacity to maintain relatively high standards of living will also depend on its ability to promote its human capital and the development and adoption of new technologies. On-the-job and lifelong training keeps the labor force competitive, and raising the quality and efficiency of education should nurture a high-skilled labor force, key to continuing to attract foreign investment. In the same vein, ongoing initiatives with respect to research and development deserve to be pursued enthusiastically. ■

Rodolfo Luzio

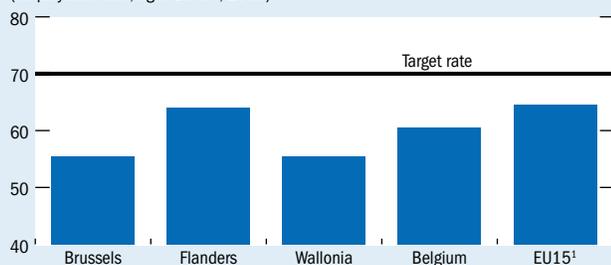
IMF European Department

Chart 2

More workers needed

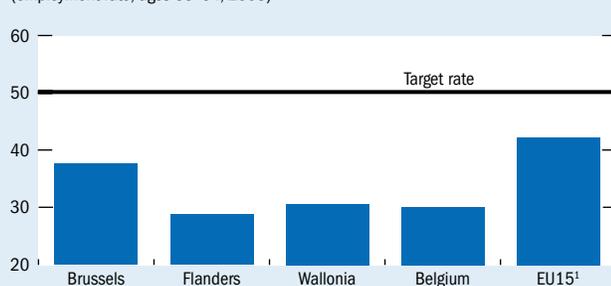
To generate the revenues needed to reduce debt, the employment rate must rise.

(employment rate, ages 15–64, 2005)



...especially among older workers, many of whom take early retirement.

(employment rate, ages 55–64, 2005)



Sources: Belgian authorities, Eurostat, and IMF staff.

¹EU15=Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom.

Africa's oil exporters: balancing saving and spending

Oil prices have been near record highs for more than two years, and oil-producing countries have seen exports and revenues skyrocket. In Africa, high prices have often been accompanied by higher production, as more remote oil fields become economically viable. Government coffers have swelled. This revenue bonanza offers African countries enormous opportunities to tackle difficult and long-standing problems and make decisive progress in reducing poverty. But history has shown how difficult it can be to use natural resource wealth effectively and productively.

Previous oil booms have often fueled waste and corruption rather than growth and poverty reduction. This time, many oil exporters have used windfall revenue to reduce debt and accumulate reserves, while spending increases have been relatively prudent. Spending pressures, however, are mounting and the challenge facing African countries is how to ensure an optimal balance between saving and spending that benefits both current and future generations.

The recent regional economic outlook for sub-Saharan Africa (SSA) and a new IMF Working Paper address some of the major macroeconomic challenges that high oil revenues present for fiscal policymaking in the region. Oil booms present very particular policy problems, raising expectations that suddenly abundant oil revenues will be used to address pressing social needs and fragile public infrastructures. But there are considerable macroeconomic threats—in both the long and the short term—to scaling up government expenditure



Oil workers in Nigeria, one of Africa's oil-exporting countries that is enjoying higher exports and revenues.

too quickly. To avoid a repetition of past boom-bust cycles, oil producers need to take into account long-term fiscal sustainability, short-term macroeconomic pressures, and institutional absorptive capacity.

Long-term fiscal sustainability: defining the fiscal space

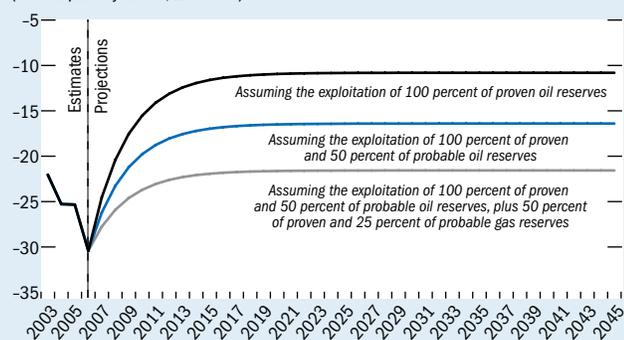
Abundant oil revenues create an illusion that binding budget constraints do not exist. If oil reserves were limitless, governments could simply consume all oil revenues directly. But oil resources are being gradually depleted, and some day in the not too distant future oil revenues will run out. To prepare for that time, governments must run surpluses during periods of oil production and invest those surpluses in alternative sources of wealth, such as financial assets or productive public investments. These alternative sources of wealth will generate a return that could indefinitely make up the difference between a reasonable government spending level and non-oil revenues after oil reserves are depleted.

For policymakers, then, it is important to define a clear benchmark to distinguish sound and forward-looking policies from those designed to address only immediate demands. To this end, the IMF Working Paper “Old Curses, New Approaches? Fiscal Benchmarks for Oil-Producing Countries in Sub-Saharan Africa” uses a formal model to estimate the fiscal paths that SSA oil-producing countries should follow to allow non-oil public spending to remain constant as a percentage of non-oil GDP for the foreseeable future. While oil revenues are present, that benchmark produces surpluses that can be invested; after oil resources are depleted, the benchmark spending level can be sustained with the help of the income from investments made when balances were in surplus.

When the oil runs out in sub-Saharan Africa

Countries will be able to sustain non-oil deficits indefinitely by investing surplus oil revenues until they are exhausted.¹

(non-oil primary deficit, 2003–45)²



Source: IMF Working Paper No. 07/107.

¹Assumes financial rate of return on investments of 3.2 percent.

²Non-oil spending less non-oil income as a percentage of GDP.

As a group, the SSA oil-producing countries—Angola, Cameroon, Chad, Republic of Congo, Côte d'Ivoire, Equatorial Guinea, Gabon, and Nigeria—ran a non-oil primary (excluding interest payments) deficit of 27 percent of non-oil GDP during 2004–06. The model simulations show that even if oil prices remain at their current highs, the oil producers, in the aggregate, will not be able to maintain forever that level of public expenditure (see chart). The benchmark estimates of a permanently sustainable non-oil deficit range from 11 percent, in the most conservative assumption that only today's proven oil reserves are exploited, to 22 percent, assuming the additional exploitation of half of "probable" oil reserves and one-half of all proven and one-fourth of probable gas reserves.

The fiscal positions of individual SSA oil producers fluctuate considerably around the aggregate simulation, showing that—under baseline assumptions—the current fiscal positions of all major oil producers cannot be maintained. However, these policy benchmarks are not immutable. Any estimate of a fiscal deficit that could be financed ad infinitum is fraught with uncertainty with respect to variables that are outside a government's control (oil reserves, oil prices) or are partially the result of policies being implemented (financial rate of return, productivity of public investments). Proactive policies aimed at increasing the rates of return on financial, infrastructure, and social investments would help expand the overall sustainable fiscal envelope.

Identifying the economy's absorptive capacity

Raising public spending sharply over a short period of time could pose significant inflationary risks and lead to a rapid appreciation of the real exchange rate, damaging the international competitiveness of the non-oil economy (so-called Dutch disease). However, the magnitude of these effects depends on many factors, including the degree to which the spending increase can be externalized or can be absorbed through a supply response. To mitigate inflationary pressures and overcome the erosion of international competitiveness, the central bank could sell foreign exchange (if operating within a flexible exchange rate regime) and mop up a substantial portion of the injected liquidity. At the same time, the government could consider measures to improve the medium-term supply response (by improving the business environment) and reinforce fiscal institutions to ensure that public sector investments alleviate bottlenecks to private sector activity.

Weak public management

By four measures of performance, governments of oil-producing countries in sub-Saharan Africa trail not only oil producers in other regions but non-oil-producers in sub-Saharan Africa.¹

	Quality of budget and financial management	Efficiency of revenue mobilization	Quality of public administration	Transparency, accountability, and corruption in the public sector
Oil-producing countries in sub-Saharan Africa	2.9	3.2	2.5	2.4
Oil-producing countries in other regions	3.3	3.5	3.0	2.9
Non-oil-producing countries in sub-Saharan Africa	3.1	3.4	2.9	2.8

Source: World Bank, IDA Reference Allocation Index, 2005.

¹Scale: 1=lowest, 6=highest.

Reinforcing administrative capacity

Oil-rich countries face particular challenges in public financial management to ensure that additional spending does not overwhelm institutional capacity and budgetary control mechanisms, which tend to be underdeveloped. Many of the oil exporters have already taken some steps to strengthen budget planning and budget preparation to ensure that fiscal policies achieve stated goals. To this end, the governments of several SSA oil-producing countries are seeking to prioritize expenditures within medium-term expenditure frameworks. Similarly, effective public spending requires the strict execution of approved budgets—while ensuring that spending is of high quality. To achieve this, regular reporting in revenue administration and expenditure management promotes transparency and accountability and improves internal policy decision making. By adopting the Extractive Industries Transparency Initiative, which calls for verification and publication of company payments and government revenues from oil, gas, and mining, SSA oil-producing countries have made considerable progress toward oil transparency. Still, considerable challenges remain (see table).

Historical experience, international comparison, and economic analysis hold ample lessons for sub-Saharan Africa on how to avoid the pitfalls of previous oil booms and seize the exceptional opportunity offered by the currently high oil prices. The challenge will lie in resisting the short-term spending pressures and providing an institutional and policy environment that will ensure long-term sustainable growth and tangible poverty reduction. ■

Jan-Peter Olters
IMF African Department

Copies of *Regional Economic Outlook: Sub-Saharan Africa*, April 2007, are available for \$31.00, and copies of IMF Working Paper No. 07/107, "Old Curses, New Approaches? Fiscal Benchmarks for Oil-Producing Countries in Sub-Saharan Africa," by Jan-Peter Olters, for \$18.00 from IMF Publication Services. Please see page 144 for ordering details. The full texts of both are also available on the IMF's website (www.imf.org).

Outlook for Middle East and Central Asia

Fast-growing region needs to use savings efficiently

At a May 14 press briefing announcing the release of the May 2007 *Regional Economic Outlook: Middle East and Central Asia*, Mohsin Khan, Director of the IMF department responsible for that region, noted that all country groupings—oil exporters, emerging markets, and low-income countries—have been performing well.

Robust global growth, a favorable international financial environment, continued high prices for oil and other commodities, and sound policies in many countries are underpinning this strong growth. Real GDP growth is expected to remain strong at more than 6 percent on average, with double-digit growth projected in the Caucasus and Central Asian countries (see table).

However, the strong foreign exchange inflows—export receipts, foreign direct investment, and remittances—and rapid demand growth, combined with accommodative monetary policies, are fueling inflation, which is expected to increase to 9 percent this year from 7½ percent last year. The report says the rise is particularly notable in some oil-exporting countries, where the higher inflation is beginning to translate into more appreciated real effective exchange rates, as would be expected in response to increased oil prices.

The oil factor

The Middle East and Central Asia countries have benefited more from the high price of oil than other regions because they hold almost three-fourths of the world's proven oil reserves and account for one-third of world oil production. Rising prices of other commodities have also benefited the region, which accounts for one-fifth of the world's gas production and boasts the largest aluminum smelter site in the world (United Arab Emirates). In addition, the region is well endowed with cotton (Uzbekistan), copper (Armenia and Georgia), and uranium (Armenia and Uzbekistan). In 2006, it had a combined GDP of \$1.8 trillion, with oil contributing one-third of that amount. At the end of 2006, its international reserves amounted to \$625 billion, compared with China's \$1.1 trillion and Russia's \$285 billion.

With oil prices expected to average about \$61 a barrel in 2007, compared with more than \$64 a barrel last year, export receipts and government revenue from oil and gas will be lower this year. As a result, the external current account surplus will decline, but only one-fourth of the projected fall will be because of lower oil prices. The remainder reflects sharply rising imports as social and infrastructure investment plans are implemented. As external and fiscal positions are expected

to remain strong, the oil-exporting countries in the region should be able to undertake their investment plans while continuing to set aside resources for the future.

Sustaining strong growth

But there are risks to the generally very positive outlook, Khan continued. "Potentially adverse global developments include the possibility of slower world growth, perhaps triggered by a sharper-than-expected slowdown in the United States or a sustained rise in financial market volatility," he said. At the regional level, Khan noted that escalating conflicts are a perennial threat.

On a positive note, as the countries in this region increase their international reserves (see chart) and reduce their debt, they are becoming more resilient to potential shocks. Khan said that the region's key policy challenge is to sustain or even accelerate growth to make significant inroads into reducing

Impressive growth

GDP growth in the region will average more than 6 percent in 2007, with some countries hitting double digits.

(annual change, in percent)	Average 1998-2002	2006	Proj. 2007
Middle East and Central Asia	3.9	6.5	6.4
Oil exporters	3.7	6.2	6.3
Algeria	3.6	2.7	4.5
Azerbaijan	7.7	31.0	29.2
Bahrain	4.8	7.7	6.9
Iran	4.2	5.3	5.0
Iraq	...	3.0	10.4
Kazakhstan	6.8	10.6	9.0
Kuwait	8.2	5.0	3.5
Libya	2.2	5.6	7.9
Oman	3.6	5.9	6.0
Qatar	7.1	8.8	8.0
Saudi Arabia	1.5	4.6	4.8
Syria	2.4	3.0	3.3
Turkmenistan	15.6	9.0	10.0
United Arab Emirates	4.0	9.7	8.2
Low-income countries	4.9	9.4	8.6
Afghanistan	28.6	8.0	12.2
Armenia	7.9	13.4	9.0
Djibouti	1.6	4.5	5.1
Georgia	3.6	9.0	9.4
Kyrgyz Republic	3.3	2.7	6.5
Mauritania	3.1	11.7	1.9
Sudan	5.5	12.2	11.1
Tajikistan	7.3	7.0	7.5
Uzbekistan	4.1	7.2	7.7
Yemen	4.3	3.8	2.6
Emerging markets	4.0	6.4	6.0
Egypt	5.1	6.8	6.7
Jordan	4.3	6.0	6.0
Lebanon	2.3	0.0	1.0
Morocco	3.6	7.3	3.5
Pakistan	3.1	6.2	6.5
Tunisia	4.4	5.3	6.0

Sources: Country authorities and IMF staff estimates and projections.

poverty and unemployment. “Strong growth has not yet generated sufficient jobs for the rapidly expanding labor force, and poverty rates have not yet declined much, even in the rapidly growing low-income countries,” he said. To reduce poverty, the region’s governments should improve the distribution of income, which would also generate support for reform and help sustain the growth momentum.

Diverse challenges

Within the region, different groups of countries face somewhat different challenges.

Oil-exporting countries. The region’s 14 oil exporters can expect GDP growth to remain slightly higher than 6 percent in 2007 despite lower projections for oil prices. For these countries, sound management of oil revenue will be a top priority. In most countries, investment spending has picked up: investments to increase oil production and refining capacity will alleviate the tightness in the supply of refined petroleum products, and investments in both oil and non-oil sectors will increase imports, thereby contributing to the orderly resolution of global imbalances.

In some countries, supply bottlenecks and signs of overheating have emerged. In these cases, the authorities will need to take account of their economies’ absorptive capacity in judging the speed at which large projects should be implemented, in order to ensure that high growth can be sustained in a stable macroeconomic environment.

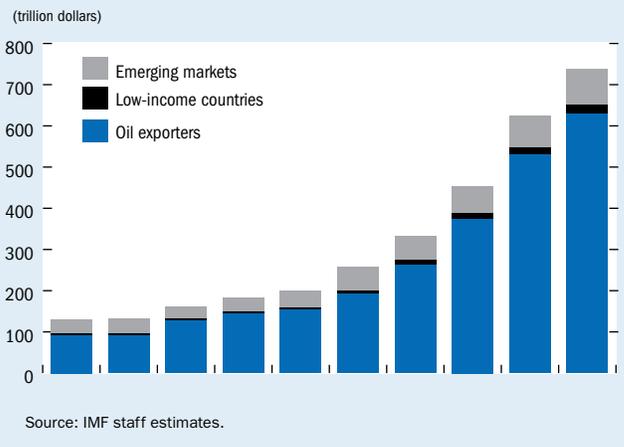
Another issue for some oil exporters is the need to diversify their economies in the face of the anticipated declines in oil production. This calls for an increased role for the private sector. Various reforms will be required to facilitate this process, including improving the business environment, lifting price controls, developing their financial sectors, further opening key activities to private and foreign participation, and strengthening their overall legal and regulatory frameworks.

Emerging market countries. Five of the six countries in this group—Egypt, Jordan, Morocco, Pakistan, and Tunisia—are likely to continue to grow vigorously in 2007, whereas Lebanon can expect subdued growth because of ongoing political tensions following its conflict with Israel last summer. Inflation is not expected to increase, but large fiscal deficits are keeping government debt high in several countries. In all countries in the subgroup, fiscal consolidation will be the key to sustaining a stable macroeconomic environment, and governments will need to adopt fiscal reforms to broaden the tax base, reduce exemptions, improve tax administration, and reduce subsidies.

Low-income countries. Growth in these countries should continue to be strong, particularly in Afghanistan (because

Soaring reserves

High oil revenues are allowing the region to accumulate reserves and become more resilient to potential shocks.



of a rebound in agriculture and activity in construction and services), Armenia (because of buoyancy in construction and services and recovery in exports), Georgia (from strong growth in services and manufacturing), and Sudan (because of increased oil production). And strong external demand should allow Uzbekistan to perform well.

The governments of low-income countries face the challenge of managing the macroeconomic impact of large-scale foreign-financed investments. Because of their progress in cementing macroeconomic stability, reducing debt, and improving policies in general, these countries are attracting increased financing, which, in turn, will allow them to invest more in infrastructure and human capital, reduce unemployment, and enhance prospects for higher potential output.

However, these governments must also balance these benefits against the need to ensure medium-term debt sustainability. To mitigate risks, they must manage debt well, keep spending in line with their economies’ absorptive capacity, and improve financial management to avoid waste.

All countries in the region would also benefit from a further broadening and deepening of the region’s financial markets. In particular, there is a need to strengthen banking system soundness, monitor market risks, and increase the depth and liquidity of capital markets to reduce asset market volatility and use the region’s large savings efficiently. ■

Elisa Diehl
IMF Survey Magazine

Copies of *Regional Economic Outlook: Middle East and Central Asia*, May 2007, are available for \$31.00 each from IMF Publication Services. Please see page 144 for ordering details. The full text is also available on the IMF’s website (www.imf.org).

Caucasus and Central Asia

Capital inflows: a mixed blessing?

Like many emerging market and developing countries around the world, nine countries in the Caucasus and Central Asia are on the receiving end of large inflows of foreign exchange and are grappling with some of the same issues of how to control inflation and manage the exchange rate. An April 25 seminar in Almaty, Kazakhstan, organized by the IMF's Middle East and Central Asia Department and co-sponsored by the National Bank of Kazakhstan, focused on policy options that would maximize the benefits of the inflows to the countries while maintaining external competitiveness and keeping inflation under control.

The nine countries—Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkmenistan, and Uzbekistan—are benefiting from large inflows of foreign exchange into their economies (see chart) in the form of buoyant export receipts, remittances, foreign direct investment, and external borrowing by banks. The inflows are driven in part by high energy prices and a favorable situation in global financial markets. They have contributed to exceptionally fast economic growth in the region, averaging more than 10 percent a year for the past four years. They have also led to abundant liquidity, rising inflation, and pressures for exchange rate appreciation, which have complicated the conduct of monetary and exchange rate policies.

The potential for problems

Policymakers in these countries are thus grappling with two potentially serious challenges. First, they are struggling to prevent exchange rate appreciation from undermining their external competitiveness and efforts to diversify their exports while keeping inflation under control. Second, they are trying to ensure that the developing financial sectors in their economies are able to effectively intermediate the massive inflows while minimizing the risks of future financial sector problems.

The one-day seminar, attended by representatives of the central banks and governments of the nine countries,

provided a forum in which the participants could discuss the strategies for managing strong foreign exchange inflows. It was opened by Kazakhstan's Prime Minister, Karim Massimov, and was co-chaired by Anvar Saidenov, Chairman of the National Bank of Kazakhstan, and Mohsin S. Khan, Director of the IMF's Middle East and Central Asia Department.

Following the opening remarks, David Owen (IMF) described how policymakers in the region have responded to these inflows and the resulting macroeconomic consequences. He noted that all countries have used the inflows

to significantly strengthen their official reserves and that most countries—except Armenia and, to a lesser extent, Kazakhstan—had resisted changes in the nominal exchange rate. As a result, broad money growth exceeded 30 percent in all countries in 2006. Also, all countries except Azerbaijan and Georgia have moderately tightened their fiscal stance in the face of these inflows.

The result has been an acceleration in inflation, which now averages more than 10 percent for the region and has contributed to a real exchange rate appreciation in virtually all the countries. Still,



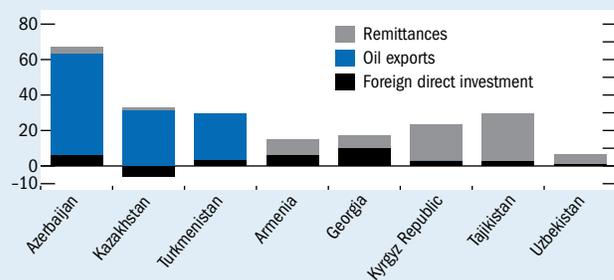
Mohsin S. Khan, Director of the IMF's Middle East and Central Asia Department (left), and Karim Massimov, Prime Minister of Kazakhstan.

than 10 percent for the region and has contributed to a real exchange rate appreciation in virtually all the countries. Still,

Rising inflows

Policymakers in the Caucasus and Central Asia need to focus on managing the large amounts of capital flowing into their countries.

(average of 2005 and 2006, percent of GDP)



Source: IMF staff estimates.

non-oil export growth was strong in all nine countries in 2006, exceeding 10 percent in many of them. Overall growth has thus continued to be strong across the region, except in the Kyrgyz Republic. Interestingly, the countries that saw the greatest real appreciation saw the strongest growth.

Lessons from outside

Following Owen's presentation, John Wakeman-Linn (IMF) reviewed how countries outside the Caucasus and Central Asian region have managed similar inflows. He drew six lessons for policymakers.

- First, because monetary policy cannot influence the real exchange rate beyond the short term, monetary authorities should focus primarily on maintaining inflation at moderate levels.
- Second, fiscal tightening—that is, spending cuts and higher taxes—is the only way to avoid real appreciation in the face of these inflows, but it may be politically difficult.
- Third, with real exchange rates likely to appreciate over the medium term, structural reforms designed to improve the business environment and encourage the use of inflows to finance investment rather than consumption will be essential to protect competitiveness.
- Fourth, capital controls designed to limit inflows are unlikely to be successful, at least beyond the short term.
- Fifth, central banks should seek to hold a substantial level of foreign reserves as a cushion against a possible future reversal of inflows while ensuring that any accumulation of reserves is consistent with their inflation objective.
- Sixth, to minimize the risks of a financial crisis in the event that the flows were to reverse, countries should strengthen prudential and other financial market regulations and, particularly if they face significant short-term inflows, seek to gradually make their exchange rates more flexible.

Two case studies from the Caucasus and Central Asian region were then discussed in detail. Aasim Husain (IMF) reviewed Kazakhstan's experience in managing rapidly rising oil export receipts, foreign direct investment, and bank loans. He noted that Kazakhstan had seen roughly \$140 billion in

inflows in the three years from 2004 through 2006. Although Kazakhstan saved a large share of these inflows in its oil fund, its central bank reserves increased sharply as well. A part of this increase was sterilized, and fiscal policy was tightened modestly, but money growth still increased to almost 80 percent in 2006. Saidenov highlighted the challenges facing



Anvar Saidenov, Chairman of the National Bank of Kazakhstan (left), and Willy Kiekens, IMF Executive Director for the country group that includes Kazakhstan.

Kazakhstan's central bank in managing the inflows and underscored the measures it had taken to tighten the monetary stance. Inflation had picked up somewhat, Saidenov noted, but remained in check despite the surge in inflows.

Nienke Oomes, the IMF's Resident Representative in Armenia, discussed Armenia's management of rapidly rising remittances, which have increased almost 500 percent in six years. Unlike other countries in the region,

Armenia has tried to keep inflation under control despite the inflows and has kept average inflation over the past two years to less than 2 percent. As a result, the nominal exchange rate has appreciated by about 30 percent over the past two years, despite a continued tight fiscal stance. Even so, the current

account deficit has declined moderately in recent years, exports have remained roughly constant as a share of GDP, and GDP has grown at double-digit levels for the past five years.

Tigran Sargsyan, Chairman of the National Bank of Armenia, agreed with this assessment of Armenia's performance. He noted that it remains an open question whether the real appreciation will adversely affect Armenian exports over the

medium term.

Lively discussions followed each presentation, with participants focusing on how to apply the lessons to their particular country circumstances. Khan noted that the seminar had raised several important questions, at least two of which—the causes of the rapid growth in money demand throughout the region and the likely impact of medium-term real appreciation on exports in the region—will be investigated by IMF staff. ■

*John Wakeman-Linn
IMF Middle East and Central Asia Department*

Remembrances of crises past

Prominent financial sector experts were in the audience at an IMF Book Forum held on May 10. The lessons of sovereign debt crises of the past decade, the likely contours of future crises, and the Fund's role in crisis prevention in emerging markets were discussed.

At the forum, the IMF's Jeromin Zettelmeyer summarized his book, *Debt Defaults and Lessons from a Decade of Crises*, written jointly with Harvard's Federico Sturzenegger. The book provides an in-depth account of seven crises since 1998—in Russia, Ukraine, Pakistan, Ecuador, Argentina, Moldova, and Uruguay—and a brief description of the crisis in the Dominican Republic. Each account tackles key questions: How did the crisis develop? What were the costs to the countries? What debt was restructured and on what terms?

Evaluating crises

The general conclusions were that crises were very costly to countries in terms of output loss and economic dislocation; crises were typically “twin” or even “triple” crises, affecting the currency, debt, and banking; and countries recovered fairly quickly once the debt was restructured. The restructurings themselves were found to be reasonably quick and with high participation rates in almost every case. The size of investor losses—that is, the “haircut”—was estimated to vary from zero to as high as 75 percent in some of the crises. These haircuts notwithstanding, investors have enjoyed much higher returns on emerging market debt since 1990 than the historical average.

The book shows that, contrary to expectations, the shift from syndicated loans to bonds (increasingly, investors are the creditors, and they typically have less enduring business relations with the country) has not slowed debt restructuring; nor has it reduced participation rates or made it necessary for countries to restructure again. Also, in recent years, a number of countries have restructured their debt without going into arrears, a good sign for the prevention of deeper crises.

The book also outlines a comprehensive “tool kit” for the analysis of debt problems: it discusses the main solvency and liquidity indicators and shows how to carry out debt dynamics decom-



During the Russian crisis, which began in 1998, the economy retracted almost 8 percent.

positions and debt sustainability analyses, how to estimate recovery values, and how to assess the financial impact of default.

In a roundtable discussion, experts from the Brookings Institution, the Peterson Institute for International Economics, the private sector, and the International Institute of Finance praised the book, calling it an essential reference work for understanding the crises of the 1990s. William R. Cline of the Peterson Institute also lauded the book but said he wished it had “graded countries on how they handled crises” and been more candid in stating that some countries had “handled the crisis very poorly.”

IMF First Deputy Managing Director John Lipsky described the book as “a very useful compendium” of the experience of sovereign debt crises of the past decade. He noted the book’s “great discussion” of what domestic policymakers have achieved and of how work on the international financial architecture had made the global financial world a safer place. He noted, however, that much more remained to be done. Sturzenegger and Zettelmeyer discussed some of the newer proposals for crisis prevention and resolution. They put forward the notion of “crisis preparation,” partly through the use of “fire walls”—policies that make it more difficult for a crisis in one sector to spread to another. Forum discussant Brad Setser of Roubini Global Economics thought that the idea of crisis preparation held promise. ■

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