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IMF Works with Vulnerable States on Food Price Policies

The IMF is working with vulnerable member countries to assess the fiscal, balance of payments, and income effects of higher food prices and of higher commodity prices more generally.

Several countries have asked for extra financial support to cover higher food import costs, and an IMF mission will shortly travel to Haiti to review the country's need for increased financial assistance.

External Relations Department Director Masood Ahmed said at an April 24 news conference that the IMF is also "working with the member countries that are likely to be affected to assess the impact of the higher food prices, and of higher commodity prices more generally, on their balance of payments and fiscal situation."

The impact of food price increases on the most vulnerable populations, notably the urban poor, has significant social implications—as attested by recent food riots and strikes in several African countries. Many sub-Saharan African countries

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Dibyangshu Sarkar/AFP

In Africa and Asia, higher food prices undermine the fight against poverty, representing a new kind of imbalance.

Resilient Europe Faces Further Tests

Michael Deppler, head of the IMF's European Department for the past 11 years, speaks in the following interview about the effects of the subprime crisis on Europe and the IMF's first multilateral consultation, a high-level initiative aimed at reducing global economic imbalances.

Deppler, who is retiring after nearly four decades of service, also gives his take on the future of the IMF.

IMF Survey: What impact will the subprime crisis have on Europe's economy?

Deppler: First, you have to be clear about the nature of the problem. In the United States, the housing market was both the spark and the fuel of the crisis. The situation in Europe is different—household saving, loan-to-value ratios, and household balance sheets are generally far stronger there than they are in the United States. This means that the adverse feedback loop between the financial sector and housing in the United States does not have the same force in Europe.

But there is no escaping the fact that we have a global shock to the financial system, and it is bound to affect Europe as well. The slowdown in the United States will pervade the world economy, and the IMF is steadily bringing down its forecasts for Europe. Some people have expressed great pessimism about Europe's prospects. I would not go that far. In my view, Europe will experience a couple of years of slow growth. Unemployment, which until now had been declining steadily, will probably start to rise

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Fiscal Policy in Small States

Fiscal policy carries greater importance in small states than in large countries, and certain fiscal characteristics of small states can affect the implementation of sound policies, according to IMF research.

A new IMF study cites two reasons for fiscal policy's greater weight and leverage in small states: first, there is greater need for

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Food Price Policies

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have resorted to emergency measures in response to a food price situation that is still evolving.

IMF research shows that higher prices for food pose new challenges for African policymakers, in particular, and could have especially adverse effects on the poor because food represents a larger share of what poorer consumers buy.

Follow-up action

In response, the IMF is acting on several fronts:

- ***Additional financing.*** About 10 countries, mostly in Africa, have raised with the IMF the possibility of augmenting their existing arrangements under the Poverty Reduction and Growth Facility (PRGF) to provide for additional financing to cover the import costs associated with higher food prices. "We are now discussing those on a priority basis with each of the countries and our objective is that, where it makes sense to indeed augment the PRGF, we should proceed," Ahmed said.
- ***Help with policy response.*** The IMF is further working with the PRGF-eligible countries and with other economies on the appropriate policy response to higher food prices. Although policies need to be determined country by country, targeted social assistance is seen as the best initial policy, with other temporary moves—such as tax and tariff cuts on food products—also available as supporting measures.
- ***Use of IMF financing.*** The IMF has several financing instruments available to help members cover food-related balance of payments strains. Stand-By Arrangements are designed to help all members address short-term balance of payments problems. The Exogenous Shocks Facility was designed to cover shocks to PRGF-eligible countries that have a significant negative impact on the economy, such as the ongoing food price shock, and the IMF is considering ways to modify it to enhance its usefulness.
- ***Work with exporters.*** The IMF has encouraged food-exporting members to avoid disruptions to global markets, such as through export restrictions on food, and to preserve domestic production incentives.
- ***Coordination with other agencies.*** The IMF is also coordinating closely with the World Bank, the UN system, other international agencies, and donors on issues that require regional and international action, including trade policies and the need for additional financing resources from donors. IMF Deputy Managing Director Murilo Portugal represented the IMF at an April 28 meeting of the UN Chief Executives Board (CEB) that discussed the impact of high food import costs. The CEB groups the executive heads of UN system organizations under the chairmanship of the UN Secretary-General.

The UN's World Food Program (WFP) said on April 22 that high global food prices were creating "a silent tsunami," threatening to plunge more than 100 million people into hunger. The WFP estimates it needs an additional $755 million on top of its base budget to cover the increased cost of food and fuel since June 2007—a target backed by the IMF and the World Bank.

Haiti's food price shock

Andreas Bauer, the IMF's mission chief for Haiti, visited Port-au-Prince on April 22–24 to assess the impact of rising food prices on the government's economic program and discuss how the IMF can best support the country. Haiti agreed to a three-year PRGF-supported program with the IMF in November 2006.

In a statement at the end of his visit, Bauer noted that Haiti—a large net importer of food—had been particularly affected by the sharp rise in international prices, which continued to impose enormous hardship on the country's population. The food price shock also had a significant impact on domestic inflation and caused a widening of the trade deficit.

"The IMF is deeply concerned about the social impact of higher food prices

and is firmly committed to supporting efforts to ease this burden while safeguarding economic stability and maintaining focus on continued economic and social progress in Haiti," Bauer said. He added that the IMF supports the government's response strategy, which seeks to provide immediate relief from higher food prices and to boost agricultural output.

The IMF is working closely with donors and the authorities to review Haiti's need for increased financial assistance and will adapt the macroeconomic framework of the PRGF-supported program to reflect the external shock. An IMF mission team will travel shortly to Haiti to finalize this work and conduct the third review of the program.

Narinder Nanu/AFP

Wheat harvest in Amritsar, India: The impact of food price increases on the most vulnerable populations, notably the urban poor, can have significant social implications.

New era of high food prices

Participants at an IMF conference heard on April 25 that the world economy has entered a different era in which commodity prices are likely to stay high. Michael Dooley of the University of California, Santa Cruz, told the IMF's Conference on International Macrofinance in Washington that macroeconomic factors were likely to continue to propel food prices.

"The only thing really special going on right now in commodity markets is the recent and projected world growth rates. We've entered a different era. I think those commodity prices are going to stay high," Dooley said. "Outside of oil, I think this will be a relatively durable price change, so we're looking at this for the foreseeable future."

Takatoshi Ito of the University of Tokyo noted at the conference that a bubble usually starts with good fundamentals. And, in the current case, increased demand from emerging markets such as China and India has driven up food prices. "But once the price starts moving, and momentum traders come in and speculators come in and hedge funds come in and drive up the prices, it's a mix: There is a fundamental reason at the root and there is a bubble on top."

Poverty gains at risk

IMF Managing Director Dominique Strauss-Kahn warned on April 10 that the rise in food prices of 48 percent since end-2006 could undermine the gains the international community has made in reducing poverty.

Strauss-Kahn told a news conference in Washington that policy responses to higher food prices have to be tailored to meet the needs of each country. He said the IMF could take four steps to help address higher food prices in the short term:

- Support countries in designing appropriate macroeconomic policies to deal with shocks;
- Provide advice and technical assistance for countries where rising food prices are eroding the terms of trade, through targeted income support for the poor—without jeopardizing hard-won gains on economic stabilization;
- Provide assistance through IMF lending facilities to countries where price shocks are affecting the balance of payments; and
- Work, along with other agencies and donors, to help countries mitigate negative impacts.

An April 11 meeting of the IMF's African Consultative Group discussed the impact of high world food and fuel prices and the challenges they present for policymakers in sub-Saharan Africa and also globally. A group statement said the meeting noted that many sub-Saharan African countries have significant exposure to higher prices for fuel and other commodities, especially food. High food prices risk undermining the gains made by many countries in reducing poverty in the past 5–10 years, the statement said.

Temporary, targeted subsidies

"The speed and size of the price increases have been large. We agreed that policies should aim at helping those least able to cope with high prices while not jeopardizing hard-won gains on economic stabilization," the consultative group's statement said.

Participants at the meeting agreed that the effect of shocks could be mitigated by temporary, targeted subsidies to help protect the most vulnerable, although authorities should ensure that subsidies do not become permanent.

Delegates resolved that countries should avoid distortionary policies such as untargeted subsidies. Moreover, they observed that direct price and export controls might discourage food production, be difficult to enforce, and drain scarce resources from other critical purposes. ■

Africa Seeing Rewards of Better Policies

In recent months, prices of oil, nickel, tin, corn, and wheat have hit record highs, building on dramatic increases since their lows of 2000. What does this mean for sub-Saharan Africa, a highly diverse region of net commodity importers and exporters?

Abdoulaye Bio-Tchané, who recently stepped down as Director of the IMF's African Department, tells the *IMF Survey* that, so far, unlike in past commodity booms, Africa is coping well.

But Bio-Tchané, who will shortly take over as president of the West African Development Bank, warns that Africa needs to move swiftly to sustain and broaden growth—given that few African countries look likely to meet the UN Millennium Development Goals (MDGs) on poverty and human development.

IMF Survey: How is Africa as a whole faring with the boom in oil, metals, and food prices now affecting the global economy?

Bio-Tchané: In contrast to earlier commodity booms, this time around Africa has been coping remarkably well. Resource-rich countries have been using their windfall profits to scale up outlays on infrastructure and social services, and they've also been saving a lot more than in previous episodes, reducing the risk of a boom-bust cycle.

IMF photo

Abdoulaye Bio-Tchané: "I have seen, over and over again, that good economic policies make a real difference in how a country fares."

Net commodity importers have held up quite well so far. But with the recent further increases in fuel prices and the unexpected surge in food prices, they're now facing a double blow, which could lead to higher inflation and slower growth. And, given the dire social situation in some countries, the high prices are being felt more severely than in other regions.

For African policymakers, the immediate challenge will be to find an appropriate mix of financing and adjustment. The IMF can help by being sufficiently flexible and imaginative to help them address not only an economic but also a social situation. In the years ahead, stabilization and economic reform offer the best means of adjusting to the boom.

IMF Survey: What can governments do about the impact of food price hikes?

Bio-Tchané: In the short run, they could alter tax policies or introduce targeted subsidies. For instance, in some countries, import duties on products like rice and milk are running at 40 percent, so the tax could be lowered to 30 percent or even 20 percent. In fact, a couple of countries have done just that—and the IMF has temporarily accepted the reduction. Similarly, some countries might want to subsidize transportation in urban areas, and, here again, the IMF could be supportive.

IMF Survey: Some countries have even banned exports of certain products to ensure sufficient domestic supplies. Should the IMF be supportive of that, too?

Bio-Tchané: Those kinds of measures should really be exceptional because supply, even in the short run, can be increased dramatically. Banning exports might sound like a good solution because it will allow the population to access needed commodities, such as corn. But in the short run, farmers are hurt. If prices are attractive, farmers will produce more. And there are many global initiatives now under way to help Africa increase agricultural production so that it can feed itself.

IMF Survey: What do you see as the top challenge currently facing sub-Saharan Africa?

Bio-Tchané: This is an exciting time in Africa's economic history, with sub-Saharan Africa as a whole experiencing its best growth in 30 years. Most countries have made significant progress, based on the supportive global environment of recent years, strong domestic investment, and productivity gains that have been supported by sound economic policies in most countries. All across the region, countries are using increased resources from commodity exports, debt relief, and private inflows to scale up expenditures in pursuit of the MDGs.

That said, few countries in Africa are likely to meet the MDGs, and I think this is the main challenge that Africa is facing.

IMF Survey: What types of policies will Africa need to pursue?

Bio-Tchané: It will need to take steps to sustain and broaden growth, building on a virtuous circle of reform, stabilization, and growth. The importance of developing a more dynamic private sector cannot be stressed enough. Other priorities include investing in physical and human capital (in health and education), deepening financial sectors, liberalizing business regulations, reducing trade barriers, and furthering regional integration. Also, better governance and public financial management will help to

make the most out of the continent's limited resources, unlock aid, and attract foreign direct investment.

IMF Survey: What are some of the most promising changes now under way on the continent?
Bio-Tchané: One would be that the number of conflicts has declined dramatically over the past 10 years. To me, that suggests that something has improved substantially in national and international processes. From an IMF perspective, I find it extremely encouraging that more and more countries are implementing sound economic policies and that they're being rewarded with improved economic performance, thus reinforcing their commitment. These efforts need to be sustained over the long run.

IMF Survey: Turning to the IMF, how is it regarded in Africa? Are we still vulnerable to criticisms that we're holding back spending on social issues or limiting outlays because of worries of debt sustainability?
Bio-Tchané: My experience from numerous meetings with African officials and my travels through Africa—to 26 countries—is that the IMF's policy advice, financial support, and technical assistance are not only much needed but also really appreciated. During the Managing Director's recent visit to the region, African leaders asked for more, not less, Fund involvement in Africa.

That said, the IMF is also criticized, and it would be quite odd if it weren't, given the depth of its involvement in Africa. Sometimes this criticism is justified in substance, and then we have to reflect on how the IMF can improve and make changes accordingly. One such example is the more sparing use of wage bill ceilings, which can be useful tools in individual countries. Often, however, the criticism reflects misunderstandings, especially when it comes to issues such as balancing the need for higher spending on social issues with the overarching issue of preserving macroeconomic stability.

IMF Survey: What can the IMF do to remain relevant and to continue to effectively address Africa's key economic problems?
Bio-Tchané: The IMF has long helped African countries achieve and maintain macroeconomic stability, improve public financial management systems, and develop an effective financial sector that helps foster growth spearheaded by the private sector. Much has been achieved in that respect—as evidenced by strong growth and benign inflation in most countries of the region. And all these activities continue to be relevant for a large number of our African members.

But as African countries' needs change, the Fund must adapt. Going forward, we recognize that—beyond stabilization—more needs to be done for African countries to move toward middle-income status. The Fund has already made progress in reviewing the effectiveness of its policy advice and program design, and it is continuing to refine its tool kit for low-income countries. As countries make strides toward reaching the MDGs, we've tried to help ensure that they have the fiscal space needed to expand priority spending on social services, find ways to increase their capacity to absorb aid and debt relief effectively, and raise economic growth. We've also worked on finding ways to better assist postconflict and fragile countries, and we hope to bring our proposals to the IMF Executive Board soon.

At the institutional level, the IMF's emphasis is shifting from financing to policy support. Multilateral surveillance aims to better manage the risks stemming from global imbalances. For low-income countries, the IMF introduced the Policy Support Instrument, which enables us to support those countries that do not want—or need—Fund financial assistance.

IMF Survey: Should the IMF get involved in governance issues?
Bio-Tchané: The IMF has been promoting good governance for quite some time. But since its mandate in this area is limited, its involvement centers on issues that could have a significant macroeconomic impact or are critical to achieving the objectives of an IMF-supported program. In practice, this has translated into work on public resource management, financial sector soundness, and central bank safeguards. The IMF also assists resource-rich countries through a number of specialized initiatives, including the U.K. Extractive Industries Transparency Initiative.

Overall, I'm encouraged to see that African countries have made substantial progress in strengthening governance in recent years, something that is increasingly reflected in, for example, the World Bank's governance indicators. But experience in Africa and around the world suggests that real and sustainable success in this area lies in the hands of key domestic stakeholders, including parliaments and civil society organizations.

IMF Survey: At the country level, can we point to any IMF success stories in Africa in recent years?
Bio-Tchané: We've seen much improved performance in many of our members, notably the emergence of a group of "mature stabilizers," comprising countries such as Uganda, Ghana, Tanzania, and a number of others that have moved well beyond stabilization and are now trying to establish the foundations for a move to middle-income status, such as Nigeria. As an aside, the strong rise in private capital inflows to these countries provides an independent assessment of how far we have come there. Also, the IMF has helped return a number of postconflict countries to macroeconomic stability and, in some cases, move even beyond that.

IMF Survey: How has your position at the center of policymaking for so many years changed your own thinking about Africa?
Bio-Tchané: I would say, if anything, I have become more optimistic. I have seen, over and over again, that good economic policies make a real difference in how a country fares. I have seen more and more countries making real progress in that regard. And I have seen how much the IMF, in its core areas, has been able to contribute to formulating and implementing these policies. Overall, I am hopeful that we are getting close to achieving a critical mass that will finally lift the continent onto a higher trajectory of growth and development. ■

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Study Shows Many Small States Need Smaller Governments

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countercyclical fiscal policy because small states are more prone to shocks; and second, because most small states have fixed exchange rate regimes, fiscal policy is the main tool for adjustment.

Since the early 1990s, a growing public debt problem in many small states has been worsened by a slowdown in growth rates, owing partly to the erosion of trade preferences and to shocks. During this period, sluggish growth and fiscal pressures have emerged in some Pacific islands, for instance, while rising debt has been especially pronounced in the Caribbean countries. Small low-income and African states also tend to have very high external debt, which curtails these economies' fiscal flexibility.

Small states are broadly defined as developing and emerging market countries that have a population of about two million or less. Using a new fiscal data set for 42 small states, the analysis showed that small states tend to have higher government expenditures, including spending on goods and services, wages and salaries, and capital investment.

Weak governance

Small states also tend to have weaker primary balances, higher public debt, and higher external debt than the large countries examined. Furthermore, the study unveiled evidence that weak governance is significantly correlated with higher total public and external debt in small states.

Why, in recent years, do many small states tend to spend more, have weaker primary balances, and have more public debt than large states? The literature shows that these fiscal challenges principally reflect the following characteristics of many small states:

- ***Remoteness and limited economies*** of scale help explain small states' higher cost structure, which raises government expenditures and can increase public debt. Remoteness tends to raise transport and input costs, and keeps the economy isolated.
- ***A lack of economic and export diversification*** stemming from fewer human and capital resources and small domestic markets can raise government expenditures because it makes small states particularly vulnerable to commodity- or weather-related shocks.
- ***Human resource constraints,*** often accentuated by a "brain drain," tend to limit capacity in both public and private sectors, which can inflate wages and government spending because skilled labor is scarcer.
- ***A high degree of openness,*** as reflected in a high ratio of external trade to GDP and in reliance on foreign capital and investment. Openness results from the fact that although small states tend to produce a narrow range of goods and services, they use a wide variety.
- ***Greater output volatility*** owing, first, to small states' greater openness, which exposes them more to changes in world market prices and world demand; second, to their lack of economic and export diversification, which leaves them more exposed to terms of trade shocks; and, third, to a propensity for natural disasters that can affect the whole country, rather than a single area.

The greater the economic volatility, the greater the volatility in government revenues and expenditures, which can affect public debt because shock-induced deficits may not be fully offset by surpluses during good times.

Fiscal consolidation in small states can reduce the vulnerability caused by their weaker fiscal positions and greater susceptibility to shocks. Low public debt and a sound fiscal position give policymakers the flexibility to respond countercyclically to shocks or downturns. Weak fiscal discipline may also exacerbate economic volatility by, for example, causing bouts of fiscal expansion and contraction.

Reverse crowding out

Fiscal discipline can help reverse the crowding out of private investment and spur private-sector-led growth in many small states. This can be important because, in small states, the public sector tends to have a larger economic role. It is important to promote private investment for economic and export diversification in small states, which in turn can help mitigate their vulnerability to shocks.

Furthermore, there is evidence that growth is higher in small states with a smaller government and a lower public debt. Since about 1993, high-growth small states on average have had lower revenues and grants, lower expenditures, stronger fiscal balances, and lower public debt than medium-growth and low-growth small states.

A study of episodes of large fiscal adjustment in small states confirms that, in most cases, growth actually rose. An episode of large fiscal adjustment occurs when the average primary balance as a percent of GDP was at least 10 percentage points of GDP greater for a three-year period than the average primary balance for the previous three-year period.

From 1990 to 2004, there were 12 such episodes, involving nine small states. In 67 percent of these episodes, economic growth increased, and the average change in growth was 1.3 percent. In fact, in only one episode was average growth negative.

The most effective way to achieve fiscal adjustment is to reduce spending. The majority of episodes of large fiscal adjustment in small states involved hefty cuts in both current and capital spending; increases in revenue tended to be less frequent and less pronounced.

The small-state fiscal data also suggest that reducing current expenditure on goods and services, transfers and subsidies, and wages is associated with higher growth. High-growth small states tended to have lower spending in these three categories and higher capital spending than medium- and low-growth small states.

The study's empirical results suggest that improving governance may also help small states reduce public and external debt and thus support fiscal adjustment. This means that many small states should strive to improve their institutional capacity to devise and implement government policies and improve the quality of public services. Measures that enhance policy credibility, such as increasing the accountability of the government to fiscal targets, should also help raise governance standards. ■

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Europe Seen as Resilient, but Still Held Back by Structural Issues

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again. That said, I remain reasonably sanguine that Europe's economy will be more resilient than that of the United States.

IMF Survey: How real is the risk of a financial crisis in Europe's emerging markets?
Deppler: In my view, Europe's emerging countries are also resilient. But some of them are susceptible to financial shocks, which could make the situation dramatically worse. While financial markets clearly are backing away from assets they view as too uncertain, there is still an appetite for relatively high-yielding assets for which risks are perceived as less influenced by the crisis in advanced country financial markets. Therefore, lending to emerging Europe remains reasonably buoyant and growth is being sustained, at least for now.

In sum, we do not know yet how big the shock is going to be in emerging Europe. But these countries will not be able to avoid the more general slowdown, and a number of them need to work harder at ensuring the continued confidence of investors.

IMF Survey: As Director of the European Department, you have led missions to the euro area for a number of years. Do you think Europe has finally overcome the ills that has prevented its economy from realizing its full potential?
Deppler: I wish I could say yes, but I have to say no. Europe has made major strides forward over the years, and its prospects are the better for it. But it still has structural problems it really needs to address. During the 1970s and 1980s, these problems were essentially ignored. But since then, reforms have been implemented—to my mind, with considerable success. If you look at employment, clearly we are in a different frame of reference than we were 10 to 15 years ago. And if you think in terms of Europe's standing in the world economy, the continent has also come a very long way—the 27-member European Union is, at current exchange rates, the world's largest economy. European goods are renowned for their quality and design, and Europe's institutions are admired for what they have been able to achieve—not least, a single European currency.

That being said, Europeans still have a lot of problems to deal with, and some are quite tough. These problems can often be traced back to privileges that have been bestowed upon various social groups—privileges that have now become deeply embedded in society, dragging down economic performance and productivity.

IMF photo

Michael Deppler: "I remain reasonably sanguine that Europe's economy will be more resilient than that of the United States."

European performance relative to that of the United States has flagged, most noticeably in terms of lagging productivity in the service sector. However, while it is clear that sectors sheltered from competition are doing poorly, it is less clear how Europe's politicians can put together the majorities needed to reform them. The people who profit from the lack of competition are obviously not keen to see these protectionist measures dismantled. Collectively, however, these privileges add up to a huge burden on overall performance.

IMF Survey: Does Europe's positive experience with integration hold lessons for the rest of the world?
Deppler: It is hard to imagine what Europe would look like today if it were not for integration. It has been a source of tremendous growth and opportunity, essentially because it brings competition to markets that would otherwise remain protected. Although there are some downsides, such as the agricultural policy, being a member of the European Union amounts to reform by stealth. That is why, of course, there has been a certain backlash against integration in some countries. But I firmly believe that Europe stands tall. The continent's experience—including with the euro and the single market—has excited a lot of interest around the world.

IMF Survey: You are about to leave the IMF after 37 years. As you look back at your career, what stands out as the most important events, for the Fund and for you personally?
Deppler: It has been a very exciting 37 years. I received my letter of acceptance to the Fund on April 15, 1971—the day Nixon announced the break with gold. All my colleagues in university were saying: "Why are you going to the Fund? The Fund no longer has a job." And yet, looking back, I have been involved in many exciting things over the years.

First there was the creation of the IMF's *World Economic Outlook*—a secret activity back in the early 1970s. Then came the oil facility, the debt problems in the 1980s, the transition economies in the 1990s, and our programs with Poland and Bulgaria, and later Turkey. So it has been a career full of continuing interest.

The lessons to take from these varied experiences are pretty basic, but they have been important to me—as well as to the institution—over the years. The first lesson that has struck me repeatedly is how critical politics is to economics.

I was on the 1976 Stand-By mission to the United Kingdom when confidence in sterling reached a low ebb and the country came to the Fund for support [the United Kingdom

was the last industrial country to borrow money from the IMF]. As far as I could tell, this crisis reflected mainly a lack of political resolve. They could have taken a few measures, told us to go home, and done fine.

Twenty years later, I was leading the missions to the United Kingdom when Gordon Brown became Chancellor of the Exchequer. He came into office with an ambitious reform program, including a commitment to achieve the very tough expenditure targets of the previous government, which had lost all credibility. He promptly set out to do just that, gained massive credibility, and succeeded in crowding in even larger volumes of private spending, which helped spur the sustained growth that has followed.

Turkey was the same thing. The government that was in place from 1998 to 2002 wanted to do the right things, particularly once Kemal Dervis became treasury minister, but it did not have the necessary political cohesion to make its commitments credible. When the new government came in with a large majority, it committed to basically the same policies, also with financial support from the IMF. We now had a success in the making. So politics is central to economic outcomes—an obvious point, but one that economists focused on doing things right by the lights of our trade need to bear in mind.

The other big lesson I take away from my years at the Fund is the importance of institutions. I was in favor of shock therapy back in the early 1990s working on the transition economies, and I remain in favor of it. Political opportunities must be seized. But the transition experience has taught us the importance of institutions to well-functioning markets. The Fund's new emphasis on governance and capacity building stems from that lesson.

But probably the most important lesson for today is the quickening of financial markets, all the more so in the face of political and governance issues. I remember thinking, back in Poland and even Bulgaria in the 1990s, how slow the markets were to react. Nowadays, of course, markets can—and often do—react almost instantaneously. Here, also, the Fund has moved in the right direction by giving much higher priority to the financial sector and its links to the real economy.

IMF Survey: You were one of the leaders behind the Fund's first multilateral consultation, which aimed to reduce global economic imbalances. What lessons did you take away from that experience?

Deppler: The multilateral consultations were proposed by former IMF Managing Director Rodrigo de Rato. In his view, the world had become much more multipolar, and the IMF needed to have procedures in place that would enable us to engage key players on key problems, directly and at a high level. The need for such a mechanism—with the Fund acting as an independent broker—remains patently obvious, in my view. And to make progress, you need genuine, active debate, which means keeping participation limited and engaging high-level policymakers.

The first multilateral consultation did so. It was aimed at reducing global economic imbalances, and involved the United States, the euro area, China, Saudi Arabia, and Japan. My view of the outcome is very positive: it remains the touchstone of how we look at global imbalances. The context, of course, is evolving. The financial crisis has brought a new dimension, and there is a need to incorporate the lessons learned so far.

But I would say that in terms of both the concept itself and our achievements—a better understanding of what the key players thought about global economic imbalances, and how their policy intentions fit with those of other key players—the consultation was very much to the Fund's credit. I am certain it will be viewed as a significant first step toward redressing the imbalances that have made the global economy vulnerable to a slowdown. ■

Camilla Andersen
IMF External Relations Department

Regional outlook for Europe

Financial market strains, spillovers from the U.S. slowdown, and the global reassessment of risks will adversely affect Europe in 2008, the IMF's latest *Regional Economic Outlook* (REO) says. The euro's appreciation and the increase in commodity prices are adding to these troubles.

In advanced Europe, output growth is expected to slow from 2.8 percent in 2007 to 1.5 percent in 2008. In emerging Europe, growth should decelerate from 6.9 percent in 2007 to 5.5 percent (see table). Uncertainties surrounding the outlook remain unusually high, emphasizes the REO, published on April 21.

Headwinds to growth

Growth in Europe is expected to slow significantly in 2008–09, reflecting spillovers from weaker global growth, rising commodity prices, and the strains in financial markets.

(real GDP growth; annual percent change)

	2007	2008	2009
Advanced European economies[1]	2.8	1.5	1.4
Emerging European economies[1, 2]	6.9	5.5	5.2
Euro area	2.6	1.4	1.2
Advanced European economies			
France[3]	1.9	1.4	1.2
Germany[3]	2.5	1.4	1.0
Italy[3]	1.5	0.3	0.3
Spain[3]	3.8	1.8	1.7
United Kingdom[4]	3.1	1.6	1.6
Switzerland	3.1	1.3	0.9
Emerging European economies			
Czech Republic[4]	6.5	4.2	4.6
Hungary[4]	1.3	1.8	2.5
Poland[4]	6.5	4.9	4.5
Russia	8.1	6.8	6.3

Source: IMF, *World Economic Outlook*.
[1]Average weighted by purchasing power parity GDP.
[2]Montenegro is excluded from the aggregate calculations.
[3]Member of both the European Union (EU) and the euro area.
[4]Member of the EU.

Germany: Policy Lessons from Financial Market Turbulence

Reverberations from the U.S. subprime mortgage crisis that first hit Germany in mid-2007 have started to change the country's financial sector.

The near-collapse last July of IKB, the first midsize German bank in three decades to face serious problems, indicates low profitability and excessive risk taking among some German banks.

IKB's problems heralded the arrival in Europe of the financial crisis that was unleashed in the U.S. subprime market. Although the IMF's most recent annual assessment of Germany's economy covered a broad range of issues, it specifically highlighted the lessons from the ongoing financial market turbulence.

The ensuing rescue of IKB, a private bank, was shouldered in large part by the KFW, a public sector bank that owned 38 percent of IKB at the onset of the crisis. Sachsen LB, a public sector bank, faced similar difficulties in August 2007 and was rescued by Germany's largest public sector bank.

Large write-downs

West LB, another prominent public sector bank, also faced severe difficulties that necessitated a rescue package in early 2008. In addition, many other private and public banks reported larger-than-expected write-downs, including Bayern LB and Deutsche Bank more recently.

What do these events have in common? First, all three rescue efforts were swift but appreciably burdensome to the public purse. Notably, the KFW is widely expected to more than double its shareholdings of IKB as a result of the latest recapitalization, although efforts to divest its stake are already under way.

Risky business

Supervisors could encourage more widespread use of international financial reporting standards to better capture off-balance-sheet activity.

(exposure of selected German banks to conduits and special investment vehicles (SIVs), percent)

	Ownership[1]	Conduit- and SIV-financed assets	
		Over equity	Over assets
Sachsen-Finanzgruppe	Public	1,126	30.3
West LB	Public	542	12.7
IKB (until July 29, 2007; that is, before bailout)	Private	494	20.5
Dresdner Bank (mitigated by integration into Allianz group)	Private	364	9.9
Landesbank Berlin (mitigated by integration into S-Verbund Bayern)	Public	179	2.2
BayernLB (mitigated by integration into S-Verbund Bayern)	Public	170	5.1
HSH Nordbank	Public	126	4.0
Deutsche Bank	Private	114	3.3
HVB (mitigated by integration into UCI group)	Private	105	6.6
NORD LB	Public	89	2.9
Commerzbank	Private	85	2.2
Helaba (mitigated by integration into S-Verbund HT)	Public	68	1.1
DZ-BANK (mitigated by integration into Cooperative Network)	Private	61	1.3
LBBW	Public	59	1.7
KfW (mitigated by unlimited sovereign guarantee)	Public	58	2.6

Source: Fitch ratings.
[1]Majority ownership.

Structural challenges

As a result of deep-rooted fragmentation, interest margins remain low by international standards, and Germany's banking sector has made only modest progress in generating income from nontraditional services (see Chart 1). Sectorwide profitability remains low, and banks may therefore be inclined to take on excessive risks.

A case in point is the combination of high leverage ratios and the large scale of the conduits that were operated by the rescued institutions. More broadly, the recent turbulence has raised questions as to whether many banks—especially the Landesbanken—have viable business models. The latest report maps out policy options for effective banking sector restructuring, enhanced supervision, and successful crisis prevention and management.

Banking sector restructuring

Amid heightening competitive pressures, banking sector consolidation is proceeding, with the number of banks having declined by approximately one-fourth since the beginning of this decade (see Chart 2). Although public sector banks have been critical to this progress, the process of public mergers has often been ad hoc.

Moreover, the current policy of consolidating mainly from within the public pillar of the three-pillar banking system—comprising the private, cooperative, and public pillars—risks creating regional banks that may be unable to withstand intensifying global financial sector competition.

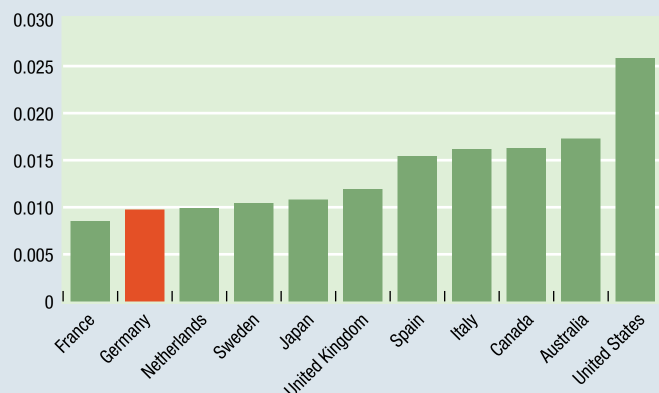
To ensure that business models are viable, policy measures must ensure that market forces and private sector capital can play their legitimate role. Broadening private sector investment opportunities in

Chart 1

Not much in the vault

Germany's banks have made only modest progress in generating income from nontraditional services, and sectorwide profitability remains low.

(net interest margin, 2005)



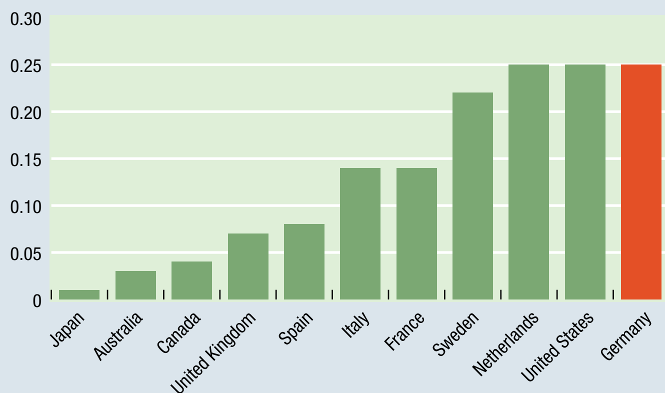
Source: World Bank, Financial Sector Development Indicators.

Chart 2

A bank near you

Tighter competition has triggered consolidation in Germany's banking sector, and the number of banks is down by around one-fourth since 2000.

(credit institutions per 10,000 people, 2005)



Source: World Bank, Financial Sector Development Indicators.

the public pillar—as was the case of HSH Nordbank in 2006—would be a major step forward.

Regional limitations on the business operations of the publicly owned savings banks will need to be lifted to enhance the efficiency of the public pillar. Political compromises should not be made at the cost of constraining future options.

Strengthening supervision

Failures in U.S. mortgage origination and an internationally accepted ratings methodology also played a major role in the developments that led to the rescue of the above-mentioned banks. Although their operations were, at least in broad terms, known to the supervisory authorities, the risks posed by their conduits were underestimated, not unlike in other countries.

In the current arrangement, supervision relies on both the Bundesbank and BaFin, the Federal Financial Supervisory Authority. Some progress has been made in reducing duplication of supervisory visits by both institutions as a result of a recently revised protocol governing coordination across these institutions.

However, more could be done, and consolidation of bank supervision and prudential enforcement in either one of these institutions would increase accountability. Regulation will need to stay with BaFin so that it maintains its role as a consolidated supervisory agency. Under any supervisory arrangement, the Bundesbank would need all necessary information to fulfill its financial stability and lender-of-last-resort responsibilities.

Support crisis prevention

Effective implementation of the Basel II minimum capital adequacy standards will require reduced reliance on external auditors and stepped-up efforts to attract and retain skilled supervisors.

Greater transparency and stronger incentives for prudent action will support crisis prevention and management. The bank resolution framework should allow for quick resolution but improve management incentives by allowing for dilution of private shareholders' equity. Supervisors should require more frequent financial statements and encourage more widespread use of International Financial Reporting Standards to better capture off-balance-sheet activity. ■

Jurgen Odenius
IMF European Department

A swift but costly rescue

Although there was a confluence of factors at work, two factors in particular precipitated the latest financial market crisis. They pertain to banks' so-called conduits or special investment vehicles. Banks would sponsor these vehicles to maintain off-balance-sheet investments, typically in an attempt to minimize costly capital requirements (see table, page 77).

First, these investment vehicles tended to invest in longer-dated securities, such as subprime mortgages, and financed these investments by issuing short-dated commercial paper.

Second, as an increase in default rates on subprime mortgages created doubts about the asset quality of their investments, the investment vehicles encountered serious difficulties in rolling over their short-term financing.

The resulting financing squeeze triggered a contractual obligation on the part of IKB and other banks to provide financing to the investment vehicles they sponsored. However, once it became apparent that IKB was unable to honor its commitment, a swift rescue was put in place to limit any further fallout. As the crisis deepened, further write-offs necessitated additional support and, by March 2008, the estimated rescue costs mounted to almost €8 billion, exceeding the bank's equity about fivefold.

Czech Fiscal Reforms Need Further Steps to Consolidate Gains

Fiscal reform measures adopted by the Czech Republic in January 2008 aim to strengthen government finances, lower the tax burden, and promote growth and employment. But some of the measures may be hard to sustain over the medium term.

The IMF has prepared a detailed evaluation of the package, which reveals several desirable features, such as a shift from income to consumption taxation, making the tax system less distortionary to savings and investment.

The reduced reliance on internationally mobile tax bases, such as corporate profits, is an important step in an era of increasing globalization. As a result, the system is expected to become more conducive to investment and growth.

The key element in the fiscal reform package is a flat rate for personal income tax, following a widespread trend in the region. The corporate income tax rate is also lowered in a phased manner, reflecting, in part, growing pressure from regional tax competition.

To partly offset the revenue loss from these tax cuts, the lower rate of the value-added tax is raised, and new environmental excises are introduced. On the spending side, social benefits are streamlined, and health care user fees introduced in an effort to stem rapidly rising social spending.

Nevertheless, the reform package stops short of addressing the key fiscal challenges that the Czech Republic faces in terms of fiscal consolidation, strengthening of work incentives, and long-run debt sustainability in the face of population aging.

Fiscal consolidation. Since joining the European Union in 2004, the country's public deficits have declined. Yet these budgetary improvements have largely reflected cyclical gains—that is, tax revenues have been strong and expenditures low because of strong growth and not because of policy action.

Similarly, fiscal discipline has been particularly susceptible to the political cycle—that is, it has tended to loosen in preelection periods. This has contributed to a procyclical fiscal policy that is expansionary even during economic upswings.

Social spending. To correct the excessive deficits, the reform package partially reverses previous slippages, such as the large increase in social spending that preceded the 2006 election. But it still fails to sufficiently advance the goal of fiscal consolidation.

The most serious shortcoming is that measures to contain social spending, such as deindexation and nominal freezing of social benefits, are likely to be temporary and reversed over the next few years. Similarly, plans to compress the public sector wage bill will also be hard to sustain over the medium term.

With the recent tax cuts well defined and permanent, new spending reductions need to be identified to ensure a sustained consolidation. Otherwise, taxes will have to be increased.

Work incentives. Work incentives continue to be severely hampered by high marginal effective tax rates (METRs). These rates, which take into account the combined incremental impact on take-home pay of taxes, social security contributions, and benefit changes, increased considerably in 2007 as a result of the preelection spending surge.

Dallas Heaton/Newscom

Shoppers in Prague, Czech Republic, where the new fiscal package moves toward taxing consumption rather than income.

Unfortunately, the 2008 reform package fails to reduce the METRs at the low- and middle-income levels, leading to persistent, large welfare traps and disincentives for work effort.

An analysis of the distributional impact of the fiscal reform package shows that it benefits mainly the low- and high-income groups. At the high end, the introduction of a ceiling on social security contributions and the reduction of personal income taxes lower the tax burden significantly without much evidence that structural improvements will result.

Long-run debt sustainability. The Czech Republic faces one of the more daunting demographic challenges in the European Union, with the share of elderly people relative to the working-age population expected to nearly triple by 2050. Neverthless, the Czech Republic remains one of the few central and eastern European countries that have not reformed the public health and pension systems to ensure their viability.

The reform package does not adequately address the fiscal pressures arising from this demographic shift. Although political consensus has been reached on extending the statutory retirement age, it has not yet been enacted, and a decision on deeper reforms to reduce the burden on the public pension system has been elusive.

In health care, the introduction of a nominal level of copayments marks an important step toward limiting excess demand and reducing inefficiencies in the system. Systemic reforms in both pensions and health care remain key priorities to effectively deal with the long-run challenge to public debt sustainability. ■

By Anita Tuladhar
IMF European Department

What Makes Growth Sustained?

Understanding the variables that contribute to sustained growth is critical for helping poor countries close the income gap with rich countries. This is the issue explored in our recent working paper titled "What Makes Growth Sustained?"

Closing the gap between poor and rich countries requires long periods of relatively fast growth in developing countries. Although growth surges are relatively common in the developing world—even in such regions as sub-Saharan Africa, which have fared poorly in recent decades—what really sets poor-performing regions apart is that their growth spells tend to end relatively quickly, and often with periods of negative growth rather than "soft landings." How to forestall the end of growth spells is thus critical, especially for the large number of developing countries now enjoying strong growth.

Previous research has sought to explain the differences in long-term growth between countries, for example, between the rapid growth episodes in Asia and the stagnation in sub-Saharan Africa and Latin America. But it ignored the lack of persistence of growth—why some growth episodes end more quickly and abruptly or why some downturns are relatively protracted. We look at what a country is doing right prior to a deceleration of growth, focusing on the determinants of the length of growth spells, using duration analysis techniques. This approach has advantages over just looking at the causes of "turning points" or decelerations because we actually use the information about what a country is doing right during a growth spell.

Key Points

The issue: What are the social, political, and economic factors that contribute to sustaining economic growth in poor and emerging market countries?

The evidence: The main variables that seem to sustain growth include more equal income distribution, democratic institutions, openness to trade and foreign investment, and an export structure favoring manufacturing and relatively sophisticated exports underpinned by a competitive exchange rate.

Policy considerations: Sustaining economic growth in poor and emerging market countries is an overriding concern for policymakers seeking to accelerate development and reduce poverty. The evidence highlighted in the paper suggests key policies that may be useful in achieving these objectives.

Main findings

Our main findings confirm some earlier results, mainly that external shocks and macroeconomic volatility are negatively associated with the length of growth spells and that good political institutions help prolong growth episodes. We also find that trade liberalization seems to help not only in starting growth but also in sustaining it, especially when combined with competitive exchange rates, current account surpluses, and an external capital structure that favors foreign direct investment (FDI). And we find that a high share of manufacturing in exports—an indicator of the sophistication of export products—tends to prolong growth, perhaps by building constituencies for reforms that themselves are conducive to sustaining growth. Most strikingly, we find that the duration of growth is strongly related to income distribution; specifically, more equal—and therefore arguably more cohesive—societies tend to enjoy more durable growth.

Our specific findings are as follows:

- ***External shocks.*** Changes in a country's terms of trade and in external (U.S.) interest rates affect the duration of growth. A 1 percent improvement in terms of trade will reduce the probability of a growth downturn by 2–3 percent, while a 1 percentage point rise in U.S. interest rates could raise the probability that a growth spell will end in the next year by 25–50 percent.
- ***Political and economic institutions.*** Democratic institutions are strongly associated with durable growth, supporting the well-established link between long-run growth and political institutions. Economic institutions—such as protection of the rights of investors and entrepreneurs, or property rights more generally—also appear to matter, but estimates are imprecise and not always statistically significant. This could be driven by data limitations (data on economic institutions are only available for a relatively short period).
- ***Inequality and fractionalization.*** Income inequality is strongly associated with the duration of growth spells, and the effect appears to be economically highly significant. Measures of ethnic, linguistic, or religious heterogeneity appear to be less significant determinants of the duration of growth spells.
- ***Social indicators.*** Although there is some (inconclusive) evidence that indicators of primary education help to sustain the duration of growth spells, there is greater evidence that health indicators—especially for child mortality—matter. An increase in infant mortality of 1 death per 100, for example, is estimated to raise the risk that a growth spell will end by about 10 percent a year.
- ***Globalization.*** Trade liberalization and growth duration are strongly linked. Countries with liberal trade appear to enjoy a 70–80 percent reduction in the risk of a break in growth. The effects of financial integration on growth are less clear cut (perhaps reflecting the impact of higher foreign debt on the volatility of growth), but FDI flows clearly seem to have a substantial protective effect on growth. An increase in FDI liabilities of 1 percent of GDP in recipient countries is associated with a 4–7 percent reduction in the probability of a growth downturn.

• ***Current account, competitiveness, and exports.*** Running a current account surplus during a growth spell seems to increase the sustainability of growth, whereas currency overvaluation seems to undermine growth duration. The link between growth spells and export structure—measured by the degree of export sophistication and/or the share of manufacturing exports—is also strong. What seems to matter is not so much the share of manufacturing at the start of a growth spell, but whether manufacturing exports rise as a share of total exports during the growth spell. A 1 percentage point rise in manufacturing exports, for example, is estimated to reduce the risk of an end to growth by 2–4 percent.

• ***Macroeconomic stability.*** Two indicators of macroeconomic instability—inflation and exchange rate depreciation—are significant risk factors for ending growth spells. A 1 percentage point increase in inflation, for example, raises the likelihood of an end to growth by 1–4 percent, while a 1 percentage point increase in currency depreciation leads to a 2–6 percent increase in risk. These effects, moreover, are present even at moderate rates of inflation, underscoring the need for countries to avoid (even moderate) degrees of nominal instability if they are to reap the benefits of growth spells.

More equal—and therefore arguably more cohesive—societies tend to enjoy more durable growth.

Conclusion

Our findings seem consistent with several themes prominent in the literature on economic development in the past 20 years. These include the view that less equal and less cohesive societies experience lower or more volatile growth, perhaps because social conflict breeds populist policies or because it leads to weaker institutions and a reduced capacity for managing external shocks. Our findings also support the notion that export orientation may help growth by building constituencies in favor of better institutions and the idea that sophisticated export or production structures matter for future growth because they favor innovation and allow economies to react more flexibly to shocks. Exploring, differentiating, and testing these channels are challenges for future work. ■

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IMF Research Department

Emerging Markets See Sharp Decline in Corporate Funding

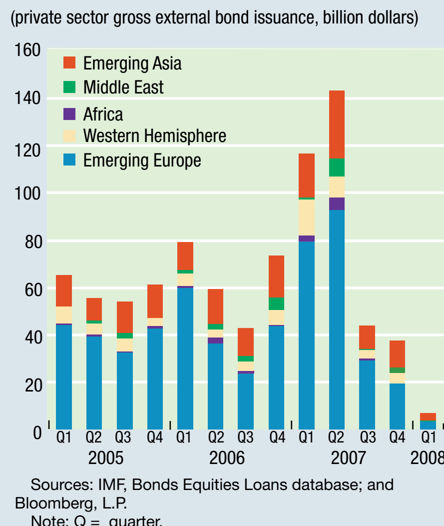
Capital inflows to the corporate sector in emerging markets have declined dramatically in recent months, signifying spillovers from the funding and credit risks in mature markets in the wake of the ongoing financial crisis.

Debt spreads in emerging corporate markets have widened, and primary market bond issuance has fallen sharply as market conditions have deteriorated, according to the IMF's Monetary and Capital Markets Department. Private sector forecasts of emerging market corporate financing have been scaled back, with JPMorgan Chase estimating financing at $72 billion for 2008, roughly half of last year's level.

So far, emerging market corporates have issued only $7 billion in the first quarter, so there are risks to the remaining $65 billion in the pipeline (see chart). "This shows very clearly that the financial condition for private corporations in emerging markets is hit by the financial crisis," IMF Managing Director Dominique Strauss-Kahn said at a press conference April 10. "That is one of the reasons why there is no decoupling, even though there may be some delay in the transmission of the slowdown of economic growth," he added.

Tighter corporate funding

Emerging market corporations are facing greater difficulty in getting external financing: a result of contagion from mature markets.



Sources: IMF, Bonds Equities Loans database; and Bloomberg, L.P.
Note: Q = quarter.

One reason this trend is worrisome is that the dedicated investor base for emerging market corporates is narrower than for sovereigns. Although some corporates are shifting into financing through syndicated loans and private placements, there is a risk that prolonged turbulence could begin to bind.

Corporate debt has been more correlated with similarly rated mature market credit than with other types of emerging market assets, especially sovereign bonds, according to the IMF's April 2008 *Global Financial Stability Report* (GFSR).

"With the expansion of emerging market corporate debt as an asset class, along with the development of CDSs [credit default swaps] and index-based contracts that facilitate the trading of that debt, investors have drawn fewer distinctions between mature and emerging market debt," the GFSR observed.

The report noted that, although this has been a positive development for the asset class, it has also opened a "new potential channel of contagion." It warns that a further widening of mature market spreads would increase emerging market corporate funding costs, putting pressure on domestic funding. ■

New PRGF Loan

In Signal of Progress to Donors, IMF to Lend Togo $108 million

The IMF's Executive Board approved on April 21 a low-interest loan for Togo of about $108 million to help rebuild its economy, becoming the first major international financial institution to resume lending to the west African state after most donors withdrew financial support more than a decade ago.

Parliamentary elections last year paved the way for the resumption of financial support by major donors to the West African country of 6 million people that lies sandwiched between Ghana and Benin.

"Togo has made significant progress since 2006 in advancing economic and political reforms," said Takatoshi Kato, IMF Deputy Managing Director and Acting Chair, following the Board discussion.

Improved fiscal position

"With the support of a successful IMF Staff-Monitored Program, the authorities have implemented important fiscal governance reforms that have boosted tax revenues and strengthened expenditure control. This has resulted in a much-improved fiscal position and reversed the accumulation of domestic arrears. Structural reforms in the banking, cotton, phosphate, and energy sectors have begun," Kato added.

The Board approved a three-year arrangement under the IMF's Poverty Reduction and Growth Facility (PRGF) amounting to SDR 66.06 million (about $108 million) to support the government's economic program for 2008–10. An initial disbursement of SDR 13.26 million (about $22 million) will become available immediately.

Improving prospects

The new loan will help support Togo's medium-term program.

(percent of GDP, unless otherwise indicated)

		Est.	Program[1]		
	2006	2007	2008	2009	2010
Real GDP (percent change)	4.1	2.1	3.0	4.0	4.0
Consumer prices (annual average, percent change)	2.2	1.0	4.1	3.8	3.5
Broad money (M2, percent change)	22.1	16.4	10.0	...[2]	...[2]
Total revenue and grants	18.3	18.7	19.5	21.2	22.1
Revenue	16.9	17.0	17.2	17.5	17.8
Total expenditure and net lending	22.1	20.6	21.9	22.9	23.4
Domestic primary expenditure	17.9	16.8	17.2	16.9	16.7
Overall balance (payment order basis)	–3.8	–1.9	–2.4	–1.7	–1.3
Primary balance	–1.1	0.2	0.0	0.6	1.1
Change in domestic arrears	–0.4	–0.8	0.0	–0.4	–0.7
Current account balance	–6.0	–6.4	–7.9	–6.7	–6.4
Exports of goods and services	42.3	42.0	44.4	45.3	46.2
Imports of goods and services	61.8	62.6	68.0	69.4	70.2
External public debt	83.9	80.9	64.2	60.8	36.3

Sources: Togolese authorities; and IMF staff estimates and projections.
[1]Assumes external debt/arrears relief in 2008–10, broadly in line with potential HIPC/MDRI debt relief.
[2]Data not available.

Emile Koulon/AFP

Phosphate mine in Togo: Reforms of state-owned entities in the phosphate sector aim to sustain the country's medium-term economic growth.

"The authorities' medium-term economic program, supported by the new PRGF arrangement, will help sustain the reform momentum. The program, anchored in Togo's Interim Poverty Reduction Strategy Paper, aims to revive economic growth and reduce poverty within a stable macroeconomic environment, Kato said.

Bringing down public debt

A central objective is to reduce Togo's excessive public debt to a sustainable level through gradual fiscal adjustment and debt relief. The PRGF-supported program will help Togo move toward comprehensive debt relief under two IMF-backed initiatives.

"The program also envisages a significant boost in spending on infrastructure, health, and education to promote economic growth and improve basic living conditions. Prudent macroeconomic policies and close coordination with regional partners and donors will be critical for addressing external shocks, such as the recent surge in food and oil prices," Kato stated.

Reviving economic growth

The IMF says that reforms of state-owned enterprises in the cotton and phosphate sectors, measures to address energy supply problems, investment in transport infrastructure, and improvement of the business environment will help to revive and sustain economic growth over the medium term.

"A coordinated effort to reengage with donors and creditors will be vital to program success. A sharp increase in concessional financing will be necessary for the growth-oriented investment and social expenditures envisaged in the program. Stepped-up technical assistance will be critical for rebuilding institutional capacity, which has been eroded by the long sociopolitical crisis and interruption in donor support," stressed Kato.

The new loan to Togo follows the recent IMF announcement backing Liberia's economic recovery, after its ruinous 14-year civil war, with debt relief and new financing. ■

Credit Growth

Vietnam's New Challenges amid Overheating

Vietnam has emerged in recent years as one of the world's most attractive new investment destinations.

The country's 2007 accession to the World Trade Organization and a surge of new foreign direct investment and portfolio inflows highlight an impressive course of economic reform, particularly in trade and investment liberalization.

These reforms have led to strong economic performance—an average annual growth rate over the past decade of 7.5 percent, one of the fastest rates in Asia.

The number of people living below the poverty line fell from 58 percent of the population in 1993 to about 16 percent in 2006. Growing access to international markets and greater opening of the domestic economy will likely bring further benefits in the future.

However, increased global integration has posed significant challenges to Vietnam. The government needs to maintain sound macroeconomic policy, increase policy flexibility to deal with new risks, and press ahead with its broader reform agenda.

Increasing vulnerability

Although Vietnam's recent economic performance has rightly drawn much praise, the economy is overheating, threatening sustained economic growth over the medium term.

Increasing domestic and external imbalances are a major concern. Credit growth rose to about 63 percent in March 2008, contributing to a rise in inflation, which reached 21 percent in April 2008.

Property prices in large cities have risen sharply. While exports have continued to grow strongly, strong demand pressures have fueled rapid import growth, resulting in a sharp widening of the current account deficit to an estimated $5.3 billion in the first quarter of 2008, compared with $7 billion for the whole of 2007, with the deficit increasingly financed by short-term capital flows.

Hoang Dinh Nam/AFP

In Hanoi, the retail trade has been booming, stimulated by Vietnam's strong economic growth.

A slowdown in the United States and Europe, which are Vietnam's largest export markets, will confront Vietnam with two challenges: first, it will lower economic growth in 2008; second, it will further widen the current account deficit and thus increase Vietnam's vulnerability to external shocks—a vulnerability heightened by the relatively rigid exchange rate regime.

Key challenges

An immediate challenge for Vietnam is to take a number of steps to reduce domestic and external imbalances:

- ***Rein in rapid credit growth.*** The recent increase in interest rates and the decision to raise the reserve requirement in June 2007 and February 2008 are welcome steps in the right direction. However, the State Bank needs to make more effective use of interest rate policy to ensure that market interest rates are positive in real terms, without disrupting financial intermediation in the banking system. Taking steps to address imprudent lending practices in commercial banks will also be a priority.
- ***Adopt greater exchange rate flexibility.*** Vietnam has a de facto currency peg to the dollar, which has complicated monetary policy in the face of large capital inflows. A more flexible exchange rate regime would make monetary policy more effective, thereby assisting macroeconomic management. It also would create an incentive to manage exchange rate risks effectively, deepen financial markets, and enhance Vietnam's resilience to external shocks.
- ***Restrain public sector expenditures.*** Monetary policy will need to be complimented by restraining off-budget and state-owned enterprises' (SOEs) expenditures, which resulted in a sharp increase in public sector borrowing in 2007. Because there is a great need to improve Vietnam's infrastructure, the emphasis should be on improving the efficiency of public sector investment and scaling back unproductive projects. In this context, the expeditious implementation of SOE reforms, including the "equitization" program, can play an important role. Equitization is a form of privatization, involving the sale of shares representing a portion of state capital in an enterprise.

Over the medium term, Vietnam needs to advance structural reform to sustain high growth. One key priority is banking sector reform, which will help develop the banking sector and safeguard its stability. The planned equitization of state-owned commercial banks and the development of a sound regulatory and supervisory framework are important steps in this process. Advancing tax reform, improving the business environment, and enhancing human capital are also high on the reform agenda.

Recognizing these challenges, the government decided to lower the 2008 growth target to 7 percent and give top priority to controlling inflation. It announced that it will tighten monetary and fiscal policy and restrain public sector expenditures to ensure macroeconomic stability. With its strong commitment to sound economic management and reform, Vietnam has good prospects for sustained growth and poverty reduction in the medium term. ■

Shogo Ishii
IMF Asia and Pacific Department

IMF Reform Secures Backing by Wide Margin

The IMF's Board of Governors on April 28 adopted by a large margin far-reaching reforms of the institution's quota and voting share structure. The reforms will enhance the participation and voice of emerging market and developing countries, as well as realign members' shares with their relative weight and role in the global economy.

"This vote shows the overwhelming level of support across the Fund's membership for these reforms, and I thank the members for this resounding endorsement," said IMF Managing Director Dominique Strauss-Kahn. "With a voting turnout of 97.8 percent of member countries, and with 94.6 percent of the members approving these reforms, I see this result as the beginning of the new legitimacy of the Fund."

The reform package will increase the voting shares of more than two-thirds of the 185 member countries. It will also enhance the voice and participation of low-income countries through a tripling of basic votes—the first such increase since the Fund's creation in 1944—and will enable each of the two Executive Directors representing African constituencies to appoint an additional Alternate Director.

IMF Restructuring

The IMF announced in late April that it had completed the voluntary separations phase of its organizational restructuring begun several months ago. The results will enable the institution to achieve its principal objectives: to maximize reliance on a voluntary, rather than mandatory, separation process and to better align its staff profile with its future business needs.

As part of the restructuring, IMF Managing Director Dominique Strauss-Kahn also announced his intention to appoint Anoop Singh as Director of the Asia Pacific Department, Masood Ahmed as Director of the Middle East and Central Asia Department, and Barry Potter as Director of the Office of Internal Audit. All three economists are currently on the IMF's staff.

Daniel Mihailescu/AFP/Getty Images

Southeastern Europe's Banks Need to Boost Efficiency

High intermediation costs among banks in southeastern Europe are hampering economic development in the region, an IMF study shows. For these banks, the costs of intermediation—that is, transforming deposits from one set of customers into loans for another—need to be lowered more rapidly toward industrial country levels.

Governments can help reduce financial intermediation costs by changing the business environment through institution building and by exposing banks to greater competition, the IMF says.

Siemens AG/Getty Images

Which Firms Go Global?

Financial market integration has taken the form of increased cross-border capital flows, tighter links among financial markets, and a greater presence of foreign financial firms around the world. Many standard measures of financial globalization offer aggregate insights, but provide few details.

A new IMF Working Paper, "International Financial Integration Through Equity Markets: Which Firms and Which Countries Go Global?" uses a large data set to answer such questions as which country and firm characteristics help or hinder integration with global financial markets. The study finds that integration may remain limited to a small group of firms and countries.

IMF*Survey*

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