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Multilateral consultation to focus on imbalances

page 163

China, the Euro Area, Japan, Saudi Arabia, and the United States have agreed to participate in the IMF's first multilateral consultation. The exercise—a key element in the implementation of the Fund's medium-term strategy endorsed by the International Monetary and Financial Committee in April—will focus on how global imbalances can be addressed while robust global growth is maintained. Staff contacts are set to begin soon, with subsequent meetings expected of Fund management and staff with senior representatives of the participating countries and economies.

Targeting inflation

page 166

For a growing number of emerging market and developing countries, inflation targeting has become the monetary policy framework of choice. How well is it serving these countries? Over the past decade, macroeconomic performance has improved in most nonindustrial countries, but countries that have adopted inflation targeting have, on average, outperformed those with other monetary policy frameworks. The IMF, in a paper recently discussed by its Executive Board, reviews this experience and considers the implications for the Fund's work.

A resilient Singapore

page 172

Over the past decade, Singapore's economy has withstood a regional crisis, the bursting of the technology bubble, a SARS scare, and stiff competition from regional economies with lower labor costs. Strong macroeconomic policies and effective structural reforms, which have allowed the economy to not only survive but adapt and thrive, will remain essential tools as Singapore positions itself to remain competitive in a fast-growing region and an increasingly globalized economy.

Steven Allen/PictureArts

Pragmatism in Latin America

page 176

Javier Santiso, chief development economist for the OECD, argues that although populism gets much of the attention, the real story coming out of Latin America may be the rise of pragmatism. In his new book, *Latin America's Political Economy of the Possible,* Santiso documents the continuity in economic policies in many countries despite political transitions. Panelists at a recent IMF book forum mostly agreed but cautioned that the move to pragmatism remains an unfinished agenda.

Eugene Salazar/IMF

IN THIS ISSUE

What's on

June

15 European Research Workshop in International Trade, Joint Vienna Institute, Vienna, Austria

15–16 World Economic Forum on East Asia, "Creating a New Agenda for Asian Integration," Tokyo, Japan

16 Bank of Korea International Conference 2006, "Monetary Policy in an Environment of Low Inflation," Seoul, Korea

19–23 World Urban Forum III, Vancouver, Canada

19–23 Financial Action Task Force, Third Plenary Meeting, Paris, France

20–22 Latin American Corporate Governance Roundtable, Buenos Aires, Argentina

22 IMF Book Forum, *Divergent Paths in Post-Communist Transformation—Capitalism for All or Capitalism for the Few?* by Oleh Havrylyshyn, Washington, D.C., United States

22–23 "The East Asian Financial Markets—The Next Frontier," conference sponsored by the World Bank and the Hong Kong Monetary Authority, Hong Kong SAR

23–25 China-U.S. Symposium on Building the Financial System of the 21st Century, Beijing, China

July

3–5 High-Level Meeting of the United Nations Economic and Social Council, Geneva, Switzerland

11–12 IMF High-Level Seminar on Crisis Prevention in Emerging Markets, Singapore

15–17 Group of Eight Summit, St. Petersburg, Russia

August

27–September 1 International Disaster Reduction Conference, Davos, Switzerland

September

10–11 China Business Summit 2006, Beijing, China

19–20 IMF-World Bank Annual Meetings, Singapore

19–20 United Nations General Assembly, High-Level Meeting on the Review of the Brussels Program of Action for the Least Developed Countries, New York, United States

25–26 World Trade Organization Public Forum, "What WTO in the 21st Century?" Geneva, Switzerland

November

23–24 World Economic Forum in Turkey, "Connecting Regions—Creating New Opportunities," Istanbul, Turkey

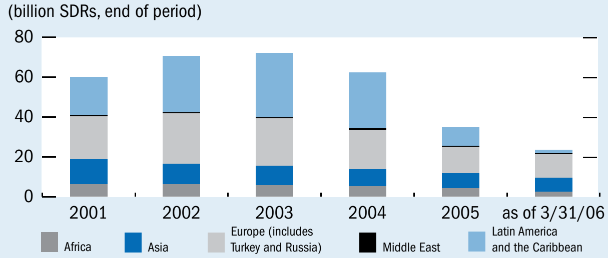
26–28 World Economic Forum, "India: Meeting New Expectations," New Delhi, India

IMF Executive Board
For an up-to-date listing of IMF Executive Board meetings, see *www.imf.org.external/np/sec/bc/eng/index.asp.*

IMF financial data

Total IMF credit and loans outstanding, by region

(billion SDRs, end of period)



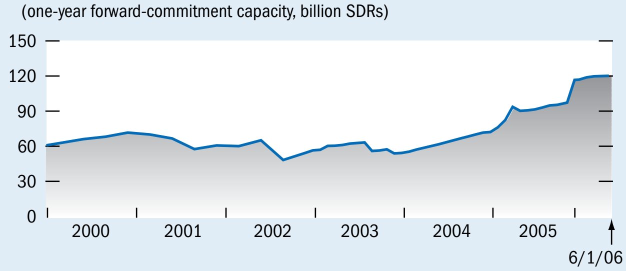
Largest outstanding loans

(billion SDRs, as of 4/30/06)

Nonconcessional		**Concessional**	
Turkey	8.90	Pakistan	0.98
Indonesia	5.19	Congo, Dem. Rep. of	0.55
Uruguay	1.26	Bangladesh	0.28
Ukraine	0.73	Cameroon	0.17
Serbia and Montenegro	0.66	Yemen, Republic of	0.16

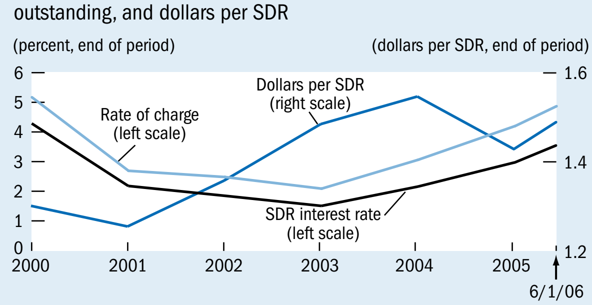
Available IMF resources

(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.

First multilateral consultation to focus on global imbalances

China, the Euro Area, Japan, Saudi Arabia, and the United States have agreed to participate in the IMF's first multilateral consultation. The exercise will focus, in a comprehensive and collective way, on how to address global imbalances while maintaining robust global growth.

Welcoming the step, IMF Managing Director Rodrigo de Rato noted that the cooperative action of the participants "can play a major role in the orderly unwinding of these imbalances and in sustaining global growth as savings, consumption, and investment patterns adjust."

Multilateral consultations—an initiative de Rato proposed in April as part of the Fund's medium-term strategy—form part of the Fund's multilateral surveillance responsibilities and are designed to complement the organization's regular Article IV consultations with individual member countries. They will provide a forum for debate, with each consultation focusing on a specific international economic or financial issue and directly involving the countries party to that issue.

The consultations are meant to strengthen the IMF's analysis of the potential benefits of collective action. They will aim to enable the Fund and its members to agree on policy actions and help policymakers show that the measures they propose will be matched by their counterparts in other countries to the benefit of all.

The first consultation, involving these systemically important members and group of members, will focus on spillovers and linkages among these and other economies, rather than on domestic economic issues. The IMF announced that staff contacts for the first consultation would begin soon. These are expected to be followed by meetings of Fund management and staff with representatives from all participating countries and economies. The outcome of the consultation, which should be completed by the end of 2006, will be discussed by the IMF's Executive Board and, ultimately, by the International Monetary and Financial Committee, the primary advisory committee of the Fund's Governors. ■

Productivity gains will be essential to sustain Euro Area growth

The Euro Area's recovery is gaining traction, with real GDP growth in 2006 expected to be about 2 percent, according to the IMF. A statement issued June 6 at the conclusion of the Fund staff's discussions with Euro Area officials noted, however, that prospects for a sustained pickup hinge on decisive progress with structural reforms, including in fiscal policy. More must be done "to exploit the synergies between fiscal adjustment, welfare reform, and enhancing the efficiency of all markets, whether for labor, capital, goods, or—but perhaps especially—services, including financial services." The region must also cope with "appreciable headwinds" in the form of higher oil prices, a strengthening euro, sluggish productivity growth, and a decline in the region's population beginning in 2010.

On the monetary side, the IMF projected headline inflation to remain above 2 percent a year through much of 2006 and 2007 before dipping thereafter. With inflation only slowly returning to its benchmark and the recovery gaining traction, there was some scope for further withdrawal of monetary accommodation. The Fund did not, however, see the necessary conditions in place "for continued, and thus more substantial, tightening." This "would seem to require a quickening in the fundamentals of the recovery—notably, under present circumstances, in employment growth—or the emergence of second-round effects or of yet further shocks likely to prompt increased domestic inflationary pressures." Following the discussions, the European Central Bank raised rates by 25 basis points on June 8.

Boosting the payoff from reform

After a decade of reforms, the Euro Area's labor markets are more flexible, pension programs are more fiscally sustainable, and some product and service markets have been liberalized. But, the IMF said, "labor utilization is still low, unemployment high, productivity growth decidedly disappointing, and long-term fiscal sustainability still an issue." More reforms are needed, and, as the experience of Europe's most successful long-term reformers suggests, the key ingredient will be devising mutually reinforcing and sustainable packages of fiscal and structural policies. Specifically, the IMF recommended more ambitious measures in several areas:

Fiscal. Given the formidable challenges ahead, adjustment should be at least ½ of 1 percent of GDP a year over the next four to five years—largely on the expenditure side.

Product and labor markets. More flexible labor markets remain a top priority, but greater emphasis needs to be placed on liberalizing product and services markets so that moderating wages translate into more jobs rather than higher rents.

Financial sector. More rapid integration of Europe's financial markets is essential and should help boost productivity and alleviate regional imbalances. Greater regulatory oversight will also be needed to keep pace with integration. ■

Caruana named to head IMF's financial and monetary work

On June 7, IMF Managing Director Rodrigo de Rato named Jaime Caruana, currently Governor of Banco de España (Spain's central bank), as Counsellor and Director of a new department that will be responsible for all aspects of the Fund's financial, capital market, and monetary work.

Caruana, 54, has headed Spain's central bank since 2000. In addition to serving on the Governing Council of the European Central Bank, he also chairs the Basel Committee on Banking Supervision and, in that capacity, is a member of the Financial Stability Forum. Before joining the Banco de España, Caruana served as Director of the Spanish treasury and headed investment services and fund management companies for some 10 years.

In announcing the appointment, which becomes effective in August, de Rato said: "Jaime Caruana has had a highly distinguished career spanning more than 30 years in the public and private financial sector in Spain and on the international stage. I believe that, with his mix of private, public, and international experience, Mr. Caruana is ideally positioned to provide the Fund with a very respected and influential voice on financial sector issues and to lead the new department with vision and skill."


Bernardo Rodríguez/EFE

Jaime Caruana

The department that Caruana will head will be created from the merger of two existing IMF departments—the International Capital Markets Department (ICM) and the Monetary and Financial Systems Department (MFD) (see IMF Press Release No. 06/21 for more information about the merger, which was announced in February).

The selection was made following consideration of qualified applicants by an internal staff panel and members of the IMF management team. Caruana will succeed Gerd Häusler, who has headed ICM since its creation in 2001 and who earlier announced his intention to leave the IMF in July 2006, and Stefan Ingves, who headed MFD until his appointment as Governor of Sveriges Riksbank, Sweden's central bank (see IMF Press Releases Nos. 06/29 and 05/223). ■

Lasting growth in Marshall Islands hinges on further fiscal and structural reform

The Marshall Islands enjoyed a decade of expansion after independence in 1986 before seeing activity decline sharply in the mid-1990s and pick up in the late 1990s. Real output growth slowed in 2003 and 2004, hampered by delays in implementing an upgraded public works program and the closure of a privately owned tuna processing plant, which eliminated about 500 jobs, according to the IMF's latest economic review.

The country depends heavily on external assistance. Government expenditure accounts for more than 70 percent of GDP, and about 50 percent of government revenue consists of external grants, mainly from the United States. The private economy remains underdeveloped, primarily providing services to the government, with small contributions from agriculture, fishery, and tourism. In 2004, the Compact Agreement with the United States was amended and extends U.S. financial support until 2023, with grants declining steadily. Overall, unemployment has increased, except in the civil service, as a result of increased spending on education and health in line with the amended Compact.

Marshall Islands	2002	2003	2004	Est. 2005	Proj. 2006
Real GDP (percent change)	4.0	1.8	0.4	3.5	4.0
Consumer price index (percent change)	–0.4	–0.9	2.0	3.5	2.9
Revenue and grants (percent of GDP)	64.2	65.0	56.2	58.1	69.6
Compact Trust Fund (million dollars, end-period)[1]	...	...	32.0	47.1	60.4
External debt (percent of GDP, end-period)[2]	70.6	71.2	76.4	69.8	63.6

Note: Fiscal year ends September 30.
[1]Assets in trust funds are treated as nonusable.
[2]Government and government-guaranteed debt only.
Data: Marshall Islands authorities and IMF staff estimates and projections.

The country's fiscal position deteriorated in 2004, partly because of a decline in grants for infrastructure projects, lower income tax collection, and volatile nontax revenue. Total expenditure increased, with some shift from capital to current expenditure. Spending on wages and goods and services continued to rise, exacerbating the fiscal position. In 2005, reflecting an expansionary fiscal stance and improvements in agriculture, real growth is expected to have picked up, and the government's overall deficit is estimated at 2 percent of GDP, stemming mainly from low revenue collection.

The IMF Executive Board welcomed the authorities' efforts to move the Marshall Islands toward lasting growth by retiring high-cost commercial debt and building reserves to meet its mandatory contribution requirement to the Compact Trust Fund. Directors commended the strengthening of the government's institutional capacity but underscored the need for further fiscal and structural reforms, given the anticipated declines in Compact grants and prospective increases in debt-service payments. While calling for reduced outlays, especially for wages, Directors stressed the importance of protecting core expenditure. ■

Malaysia's economic position is strong, but challenges lie ahead

Prudent macroeconomic policies and structural reforms underpinned Malaysia's robust economic performance in 2005. Real GDP growth was estimated at 5.3 percent and is projected to rise to 5.5 percent in 2006, owing to strong private consumption and the ongoing recovery of fixed private investment, the IMF said in its annual review. Inflation rose to 3 percent, primarily as a result of adjustments in retail fuel prices, but core inflation remained subdued. The federal government deficit declined to 3.8 percent of GDP, while the surplus of the consolidated public sector is expected to have stabilized at 4 percent, aided by the impact of world oil prices on the national oil company. The external position remains strong, with reserves reaching $70.5 billion at end-2005, and the current account surplus widened to 15.2 percent of GDP. Corporate and financial sector soundness continued to strengthen.

Malaysia	2003	2004	Est. 2005	Proj. 2006
Real GDP (percent change)	5.4	7.1	5.3	5.5
CPI inflation (period average)[1]	1.1	1.4	3.0	3.1
Gross official reserves (billion U.S. dollars)[1]	44.9	66.7	70.5	85.4
		(percent of GDP)		
Federal government overall balance	–5.3	–4.3	–3.7	–3.4
Federal government non-oil primary balance	–6.6	–7.0	–6.9	–7.9
Current account balance	12.8	12.6	14.3	14.2

[1]For 2005, actual outcomes as of end-December.
Data: Malaysian authorities and IMF staff estimates and projections.

The outlook is favorable, but policy challenges remain. Growth is projected to be strong—underpinned by robust domestic private demand and a favorable external environment—but high world oil prices and an avian flu pandemic are major downside risks. Key policy challenges include reducing the significant reliance on oil and gas revenues and anchoring inflation expectations through clear monetary policy communication.

The IMF Executive Board commended the authorities for skillfully managing the economy and welcomed the favorable near-term outlook. Hailing the removal of the peg as a "vital first step," Directors suggested that greater exchange rate flexibility can now be achieved by allowing the exchange rate to be determined by economic fundamentals. Directors also noted that increased exchange rate flexibility would facilitate smooth adjustment to structural changes and broader-based growth in Malaysia, contributing to an orderly resolution of global imbalances. With regard to the fiscal framework, it will be imperative to reduce the federal government deficit and tackle the reliance on oil and gas revenues, Directors said. They added that making the tax system more efficient and phasing out fuel subsidies in favor of well-targeted support for the poorest would be prudent. ■

Transparent management of oil revenue is top priority for São Tomé and Príncipe

Economic reforms pursued since 1998 have helped São Tomé and Príncipe increase real GDP growth, lower inflation, and push forward key structural reforms. Fiscal performance has been uneven, however, with the fiscal deficit reaching a peak in 2004. Since 2005, under an adjustment program supported by the IMF's Poverty Reduction and Growth Facility (PRGF), the authorities have managed to attain significant fiscal consolidation.

Prospects for 2006 remain favorable despite a recent rise in inflation, with the expectation of strong growth and a relatively favorable external position, the IMF said in its economic review. Under the PRGF, the authorities are addressing tax arrears, overhauling customs administration procedures, and changing the composition of government spending in favor of the poor.

São Tomé and Príncipe	2003	2004	Est. 2005	Proj. 2006
		(percent change)		
Real GDP	4.0	3.8	3.8	4.5
Consumer prices (end of period)	10.2	15.2	17.0	13.0
		(percent of GDP)		
Current account balance[1]	–56.7	–58.9	–59.2	–59.8
Overall fiscal balance, including grants[2]	–17.0	–26.6	56.9	59.6

[1]Excluding official transfers.
[2]Includes oil signature bonuses in 2005 and 2006.
Data: Sãotomean authorities and IMF staff estimates and projections.

Monetary policy is aimed at decelerating inflation, and structural reforms will focus on fostering private sector growth in the non-oil economy.

The IMF Executive Board welcomed the authorities' continued commitment to address macroeconomic imbalances while strengthening the conditions for sustained economic growth and poverty reduction. The main challenge for the medium term, Directors said, will be to develop strong institutions that promote transparent oil-revenue management, strengthen growth in the non-oil economy, and support attainment of the Millennium Development Goals.

Directors welcomed the authorities' decision to sustain the process of fiscal consolidation, which will be supported by a modernized budget and public expenditure management system. They observed that monetary policy remained broadly adequate, supporting the authorities' inflation target and safeguarding the central bank's international reserve position. Directors also welcomed improvements in banking sector supervision.

Directors urged the authorities to accelerate structural reforms, emphasizing the importance of implementing the plan to improve the finances of the water and electricity company and completing the feasibility studies of the airport and seaport authorities. They also recommended improving the business climate and approving new codes for personal and corporate income taxation. ■

For more information, please refer to IMF Public Information Notices Nos. 06/26 (Marshall Islands), 06/30 (Malaysia), and 06/36 (São Tomé and Príncipe) on the IMF's website (*www.imf.org*).

Inflation targeting can work in nonindustrial countries

Monetary policy based on inflation targeting is typically associated with industrial countries, such as Canada, New Zealand, Sweden, and the United Kingdom, where the strategy was pioneered in the early 1990s. Today, however, two-thirds of countries that implement inflation targeting are nonindustrial, and that number is likely to double within the next five years. Drawing on the experience of nonindustrial countries since the 1990s, a recent IMF staff paper explores the extent to which inflation targeting has delivered better macroeconomic results than have alternative policy frameworks. It surveys two groups of nonindustrial countries—some with inflation targeting and some without—and compares their macroeconomic performance. It finds that countries adopting inflation targeting regimes have improved their macroeconomic performance—lowering inflation at no cost in terms of growth—both over time and relative to countries with alternative monetary policy regimes.

When industrial countries began adopting inflation targeting frameworks for monetary policy in the 1990s, a common view, including at the IMF, was that inflation targeting was not a suitable strategy for nonindustrial countries because of the institutional and technical requirements necessary for its successful implementation: effective institutional autonomy for the central bank; well-developed analytical capabilities at the central bank, together with the necessary data; largely unregulated and market-determined prices; and a sound financial system with effective transmission mechanisms for monetary policy.

Preconditions for inflation targeting

The IMF study questions the appropriateness of setting such preconditions for two reasons. First, they are important for *any* monetary policy framework and may be even more so for non–inflation targeting regimes. For example, if a country has a fiscal dominance problem, or its financial system is unsound, an exchange rate peg may be more difficult to sustain than an inflation targeting regime. It is therefore incorrect to assume that, if the various preconditions for inflation targeting are not met, another regime will necessarily perform better.

Second, it is difficult to gauge the extent to which a country meets the conditions necessary for inflation targeting to succeed. In practice, most countries have been able to begin inflation targeting regimes even with significant economic policy deficiencies. An IMF Research Department survey of central banks suggests that improvements in conditions have generally accompanied or followed, rather than preceded, the adoption of inflation targeting. Other empirical evidence indicates that having standard preconditions in place was not more critical to macroeconomic performance in nonindustrial inflation-targeting countries than it was in other nonindustrial countries. This suggests that it may be more appropriate to think of the traditional technical conditions for successful inflation targeting as "co-requisites" rather than as prerequisites for adopting inflation targeting.

That said, nonindustrial countries do generally have more difficulty in achieving their inflation targets, perhaps in part because they have weaker initial conditions. However, performance has tended to improve quickly, which suggests that there are benefits from learning by doing. Although good initial conditions are likely to improve inflation targeting performance, they may be less important for establishing the credibility of an inflation targeting regime and anchoring expectations. More important is a strong commitment by political authorities to

Executive Board discusses inflation targeting

At a recent Board seminar, Directors welcomed the study because emerging markets and developing countries are increasingly adopting inflation targeting. Directors agreed that inflation targeting in emerging market economies has been associated with more significant improvements in macroeconomic performance than have alternative monetary frameworks and that countries adopting the regime were able to commit to credible strategies to reduce inflation.

Directors pointed out that important caveats should be considered before drawing conclusions about the potential benefits of inflating targeting relative to those of other regimes—namely, the short experience with inflation targeting; the relatively small sample of countries studied; the difficulty of pinpointing success because of benign global conditions and the general decline of inflation, which have benefited all countries; and a broader shift in country preferences toward price stability.

The technical and institutional conditions needed for inflation targeting may be less stringent than previously believed, Directors noted. They underscored the importance of preconditions for success, particularly the need for central bank autonomy, fiscal consolidation, and adequate financial market development. They highlighted the need for a clear commitment to the inflation targeting framework by both the monetary and fiscal authorities, firm political support, and a consistent fiscal policy. Many Directors cautioned against viewing inflation targeting as a macroeconomic panacea because many countries would still need to overcome substantial operational and capacity constraints.

support the policy framework and foster the development of the conditions for its success.

What might make inflation targeting unsuitable? Five key factors stand out.

Weak feasibility. In some countries, the central bank's operational capacity may be too weak, or the financial system too underdeveloped, for any independent monetary policy.

External determination of wages and prices. Wages and prices may be almost fully determined by foreign prices and the exchange rate, in which case inflation targeting would not reduce output or inflation volatility better than an exchange rate peg.

High initial inflation. There is little experience with starting inflation targeting in a high-inflation environment, and this may reflect the perception that the risks of missing targets for disinflation would not enhance the credibility of the inflation targeting framework.

Inadequate political support. Without a clear political commitment—to central bank independence and the adoption of fiscal and wage policies consistent with the inflation targets—the credibility of the inflation targets may be severely undermined.

Inability to follow through. Inflation targeting should be adopted only if central banks are prepared to follow through with decisions and actions; in particular, the inflation objective must consistently be their top priority.

Tailor-made targeting

Inflation targeting is not a one-size-fits-all framework. The challenges of implementation differ among countries. In nonindustrial countries, challenges include weak public sector financial management, weak financial institutions and markets, low monetary policy credibility, extensive dollarization of financial liabilities, and vulnerability to sharp changes in capital flows and international investor sentiment. Many of these countries also face greater uncertainty about the structure of their economies and the monetary policy transmission mechanism, and data weaknesses may make it more difficult to judge the cyclical position of the economy.

Weak financial institutions and markets alter the relative efficiency and speed of different channels of monetary policy transmission. Extensive dollarization can significantly modify monetary policy transmission, often amplifying the impact of exchange rate movements on activity. In such circumstances, more smoothing of the exchange rate may be appropriate. Prudential measures and other reforms may also be necessary to strengthen financial systems, especially to reduce vulnerabilities to exchange rate changes.

Nonindustrial countries have often adopted inflation targeting as part of a more comprehensive package of economic reforms. Capital account liberalization, together with privatization and new investment opportunities, has led to strong capital inflows in a number of countries, putting significant upward pressure on exchange rates. A commitment to the inflation target may then conflict sharply with pressures to maintain exchange rate stability and external competitiveness. Heavy foreign exchange market intervention or administrative measures have been used to contain exchange rate pressures, but the effectiveness of such measures may be limited and raise doubts about the central bank's policy priorities. The proper role of foreign exchange market intervention in an inflation targeting framework is not clear-cut, and additional research is needed to develop approaches to intervention that are consistent with inflation targeting.

Data limitations and uncertainty about economic structure and monetary policy transmission may also lead to adjustments in inflation targeting implementation. Ambiguity about the current state of the economy, and how quickly or effectively policy adjustments will be transmitted to inflation, can be reflected in the policy choice and the degree of aggressiveness in adjusting policy settings to prospective inflation developments and risks.

The bottom line

The study shows that the level and volatility of inflation declined more in nonindustrial countries with inflation targeting than in countries without, but not at the cost of weaker or more volatile growth. Both groups of countries experienced similar increases in growth over the 1990s, and inflation targeting countries experienced a slight decline in output volatility. However these results should be interpreted cautiously because correlation does not imply causation. For example, it is difficult to distinguish between the specific impact of inflation targeting and the general impact of more far-reaching concurrent economic reforms.

As more nonindustrial countries adopt inflation targeting, the IMF is likely to experience an even higher demand for technical assistance. Meeting this demand may lead to changes in how assistance is delivered. Methods of IMF surveillance will need to be modified and research on inflation targeting issues stepped up. IMF-supported programs and conditionality may also need to be further adapted. In 2000, the framework for applying conditionality in IMF-supported programs was modified for inflation targeting countries. However, because few countries have used this framework to date, it is difficult to judge its effectiveness. Currently under discussion is whether conditionality could be made more forward looking by focusing on indicators of future inflation. ■

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Peter Breuer, IMF Policy Development and Review Department
Scott Roger, IMF Monetary and Financial Systems Department

The full text of "Inflation Targeting and the IMF" is available on the IMF's website (*www.imf.org*).

"Offshoring" of services boosts U.S. productivity

For centuries, the United States has used imported material inputs to produce goods that it then exports. But the revolution of recent years in information technology (IT) has made it possible for U.S. firms to find overseas suppliers of services, allowing them to take advantage of cheaper foreign labor and different skills in that sector also. Between 1992 and 2000, this "offshoring" of services by U.S. firms increased by 6.3 percent a year, on average, and it has continued to grow rapidly, spawning fears of job losses among U.S. workers. A recent IMF Working Paper by Mary Amiti and Shang-Jin Wei explores the offshoring phenomenon and finds evidence that a small number of jobs have, indeed, been lost in manufacturing industries. However, it also finds that offshoring has boosted labor productivity in the United States and that, partly because of this, there has been offsetting job creation elsewhere in the economy.

Index Stock Imagery

Progress in information technology has rapidly boosted service offshoring.

Although the offshoring of material inputs (see charts) still far exceeds that of services, progress in IT, as measured by the rise in Internet use worldwide and advances in digital telephone equipment and lines, has been rapidly boosting service offshoring. Industries that rely heavily on service inputs are more likely to respond to technological changes that reduce the cost of offshored services. Already, the offshoring of call centers and computer software development to India is common.

These developments have created concerns in the United States that U.S. jobs will be transferred to developing countries. A 2004 study by the University of Maryland found, for example, that support for free trade among white-collar workers in the United States with annual incomes of more than $100,000 slid from 57 percent in 1999 to 28 percent in 2004. Opposition to offshoring is evident in the passage of restrictions on offshoring by the U.S. Senate that barred companies from most federal contracts if they planned to carry out any of the work abroad (although this legislation was not passed in the House of Representatives).

Perception versus fact

Some elements of the media and some politicians, often using estimates provided by management consultants, have played up the connection between offshoring and job losses. A report by a leading IT analyst projects that offshoring will grow by 30–40 percent a year over the next five years and that the number of U.S. jobs that will be offshored will rise from 400,000 today to 3.3 million by 2015. Of this total, 8 percent of current IT jobs are forecast to move offshore over the next 12 years, according to the report. But, say Amiti and Wei, it is unclear how these numbers were derived.

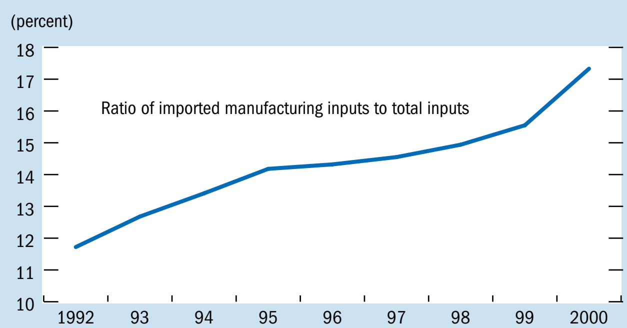
In fact, the effects of offshoring on labor productivity and employment have not been systematically examined. Amiti and Wei's study fills a gap in the literature by looking at these relationships between 1992 and 2000 in the United States.

Are U.S. jobs in danger?

To measure the effects of offshoring on U.S. jobs, Amiti and Wei use a standard labor demand framework and combine trade data with information contained in detailed input-output tables from the U.S. Bureau of Labor Statistics. To

Slow but steady

Material offshoring has been commonplace for decades and continues to grow.



Data: Authors' calculations.

measure changes in service offshoring, the authors calculated the following shares of five categories of imported services in the inputs of manufacturing industry in 2000: business services (12 percent), finance (2.4 percent), telecommunications (1.3 percent), insurance (0.5 percent), and computing and information (0.4 percent).

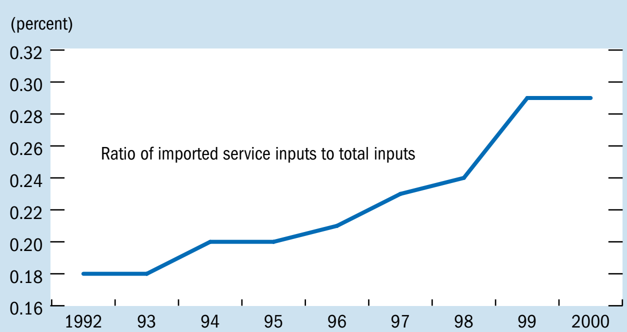
When manufacturing was finely disaggregated into 450 industries, Amiti and Wei found that service offshoring reduced jobs in manufacturing by about 0.4 percent. When the manufacturing sector was divided into 96 industries, however, they found that service offshoring had no significant effect on employment, indicating that there was sufficient growth in demand in other industries within these broadly defined classifications to offset any negative effects.

Offshoring can affect the demand for labor through three channels. First, there is a substitution effect through the input price of materials or services. That is, a fall in the price of imported services leads to a fall in the demand for labor if labor and imported services are substitutes. Second, if offshoring improves productivity, then firms can produce the same amount of output with fewer inputs. Hence, for a given level of output, offshoring may be expected to reduce the demand for labor. Third, offshoring can affect labor demand by affecting the demand for the product: an increase in offshoring can make a firm or a sector more efficient and competitive, increasing demand for its output and, hence, for labor.

Within a sector, offshoring can thus have a positive or negative effect on employment depending on whether a positive demand effect outweighs the negative substitution and productivity effects. For the U.S. economy as a whole, Amiti and Wei found offshoring had very little effect on aggregate employment.

Climbing services

Service offshoring, though still at low levels, is booming because of technological advances.



Data: Authors' calculations.

Offshoring boosts productivity

The authors' analysis indicates that service offshoring boosted labor productivity in U.S. manufacturing by between 3 percent and 4.5 percent between 1992 and 2000. With value added per worker in manufacturing increasing by an average of 35 percent over the sample period, the authors estimate that service offshoring accounted for 11–13 percent of the total growth in labor productivity in the manufacturing sector and that material offshoring accounted for 3–6 percent.

Offshoring can affect productivity through at least three channels: a static efficiency gain, restructuring, and learning spillovers. First, when a firm relocates relatively inefficient parts of its production process to another country that can produce them more cheaply, it can expand its output in the stages in which it has a comparative advantage. In this case, the remaining workers become more productive, on average, as a result of the change in the composition of the workforce. Second, the remaining workers may become more efficient if offshoring enables firms to restructure in a way that pushes out the technology frontier. This is more likely to occur, say Amiti and Wei, from offshoring service inputs, like computing and information, than from offshoring material inputs. Third, firms might perform activities more efficiently by importing services. A new software package, for example, can improve workers' average productivity.

Offsetting job creation

Amiti and Wei find that service offshoring has led to the loss of a small number of U.S. jobs in manufacturing industries but that the loss has been offset by job creation elsewhere in the manufacturing sector in part because of increased productivity. Although the overall employment effect in U.S. manufacturing is negligible, there could be differential effects on skilled and unskilled workers that have not yet been studied. This was certainly true of materials offshoring. For example, a study by Robert Feenstra and Gordon Hanson in 1999 found that offshoring of material inputs accounted for 40 percent of the increase in the wage skill premium, as the unskilled intensive production stages were being relocated to other countries. It will be interesting to see if service offshoring actually leads to a decline in the skill premium, given that service providers are considered to have a higher average skill intensity than manufacturing production workers. ■

This article is based on IMF Working Paper No. 05/238, "Service Offshoring, Productivity, and Employment: Evidence from the United States," by Mary Amiti and Shang-Jin Wei. Copies are available for $15.00 each from IMF Publication Services. Please see page 176 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

Why too much public sector lending can be harmful

In recent years, governments in many middle-income countries have reduced their external debt and have come to rely increasingly on domestic financing. This is a welcome development because domestic debt does not carry the sustainability risks associated with debt held in foreign currencies. But an associated development may be less welcome: in many of these countries, government debt has absorbed a fast-growing share of the credit available to the economy. A new IMF Working Paper explores the potential adverse implications of this trend for financial sector development.

Just how big is public sector credit? The study analyzes 73 middle-income countries, most of which have a financial sector but continue to face challenges in developing the sector further. It finds that the public sector soaks up more than 20 percent of total bank credit in more than half of these countries and more than 50 percent in 13 of them. Moreover, the share of public sector credit has been rising rapidly in many of these countries in recent years (see chart).

While public sector credit remains much smaller than external debt, it has been edging up slowly since the beginning of the 1990s, while external indebtedness has declined markedly. Combined with crises-induced shrinkages of some banking sectors, this trend has contributed to a dramatic rise in the average ratio of public sector credit to total credit since the mid-1990s, from 18 percent to more than 27 percent in 2003. There appears to be a broad trend to replace external with domestic borrowing: among the countries that reduced their external debt as a share of GDP between 1990 and 2003, about four-fifths increased their domestic public sector borrowing as a share of GDP. Although this trend could be due to financial deepening, about two-thirds of the countries also increased their shares of public sector credit in total bank credit.

Potential for harm

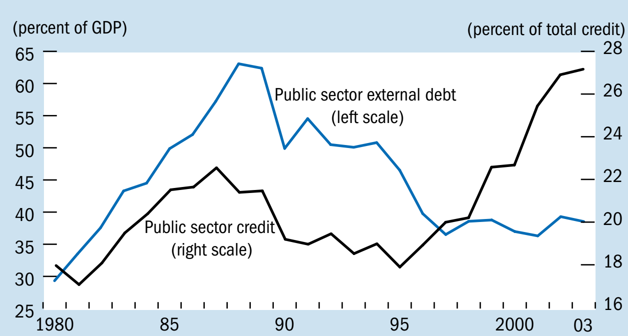
This trend in public sector borrowing is worrisome because government borrowing that squeezes the private sector out of the credit market can hurt economic growth. In addition, banks that lend mainly to the public sector might become lazy: sitting on large, relatively secure, and easy-to-maintain government debt may make them profitable but inefficient. And, in the long run, laziness could hold back the progress of financial deepening because lazy banks can be expected to have little drive to develop the banking market. Low efficiency is also likely to widen the interest rate margin between lenders and borrowers and thus increase the deadweight loss created by financial intermediation. Although there is no doubt that some government debt oils the wheels of financial development, beyond a certain level, the oil might turn into sand.

Is the lazy bank concern more than hypothetical? The study says yes. Its findings suggest that banks that are invested mainly in government debt tend to be more profitable and less efficient than others and that when the public sector absorbs higher shares of bank credit, financial deepening in developing countries slows. This syndrome occurs because the return on a loan is determined by the lending rate, the refinancing rate, administrative costs, taxes, the expected loss, and the cost of capital (determined by the risk of unexpected loss).

Loans to private borrowers tend to be disadvantageous in all these respects: they will be more costly to refinance if they are more risky, and depositors require a risk premium from banks that have riskier loan portfolios; lacking the economies of scale that benefit large public sector loans, they will be more expensive to administer; the interest on them may be subject to higher taxes than that on government debt; and the expected losses and cost of capital associated with them will almost certainly be higher than on loans to the government (unless the government is in very dire financial straits). To make private lending just as profitable as lending to the government, a bank will need

Public sector debt and credit

When governments borrow more domestically, they may end up squeezing the private sector out of the credit market.



Note: Average for 42 middle-income countries with sufficiently long data series.
Data: IMF, *International Financial Statistics* and *World Economic Outlook*, and author's calculations.

to charge its private borrowers a substantial interest rate premium.

In practice, market distortions often prevent banks from obtaining this premium. One such distortion is that banks themselves are loath to lend to borrowers who are willing to pay interest rates above a certain level because they suspect that such borrowers are involved in very risky projects. Other distortions are interest rate regulations or collusion among banks, which can produce an interest rate that exceeds the return on most private sector projects.

At the limit, these distortions could result in a segmented credit market: if private borrowers are not allowed or not able to pay the required premium, banks will first lend whatever they can to the government and only the remainder to the private sector. Indeed, while financial repression, such as deposit rate ceilings, has been receding in many developing countries, the continued large bank lending to the public sector in many developing countries suggests that such is the banks' preference.

There are several ways in which large lending to the public sector potentially reduces banks' efficiency. First is its relatively high profitability; the promise of relatively high and secure profits is likely to loosen the pressure to control costs. This effect could ultimately more than make up for any efficiency gain from large-scale lending to the government.

Second, governments that rely heavily on financing from the banking sector are likely to be reluctant to relinquish control over state-owned banks—which, in turn, have been shown to be less efficient than private banks. Third, banks that lend mainly to the government are likely to have only a muted interest in competition: the fact that they all have the same large customer, whose demand is also likely to be quite insensitive to the interest rate, can be expected to exert a powerful incentive for collusion in government bond auctions.

Massoud Etemadi

Banks that lend mainly to the public sector might become lazy: sitting on large, relatively secure, and easy-to-maintain government debt may make them profitable but inefficient.

Potential headaches

To what extent does public sector credit affect financial development? The study finds empirical evidence that large government borrowing from domestic banks tends to harm the depth and quality of financial development and at least partly offset the positive impact that public sector borrowing tends to have on liquidity in the banking system.

This finding should be of concern to policymakers, given the well-recognized link between financial development and economic growth and the increasing awareness that underdeveloped financial sectors can amplify macroeconomic volatility. They can do so, for example, by forcing financial openness on a poorly prepared economy, making it more susceptible to capital account crises. Shallow financial sectors also complicate economic policy—not least fiscal policy—such as by limiting the level of debt that an economy can sustain. And the pronounced effects, particularly on interest rates, that public sector financial activities have in thinly developed domestic financial systems, in turn, cause headaches for monetary policy.

These relationships between fiscal policy and financial development should be taken more fully into account in assessing the costs and benefits of running public sector deficits and in weighing the pros and cons of domestic versus external debt financing. The implication for developing countries is that as long as their public sectors keep absorbing a large share of bank credit, financial liberalization and improvements in the institutional environment for financial development will not yield big enough improvements in credit access for the private sector. ■

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This article is based on IMF Working Paper No. 06/26, "Fiscal Policy and Financial Development." Copies are available for $15.00 each from IMF Publication Services. Please see page 176 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

Singapore: From recovery to sustained economic expansion

In the past decade, Singapore's economy has successfully weathered a series of external shocks and heightened regional competition—thanks, in large part, to supportive macroeconomic policies and structural reforms. The current economic momentum remains strong, but rising inflation underscores the importance of maintaining an appropriate macroeconomic policy mix. Intensifying regional competition will mean continuing challenges, thus underscoring the need for Singapore to keep structural reform high on its policy agenda.

In the past decade, Singapore's economy was hit by a series of adverse external shocks: the Asian crisis in 1997–98, the bursting of the technology bubble in 2001, and the Severe Acute Respiratory Syndrome (SARS) shock in early 2003. The country's economy, however, managed to ride out these shocks and recovered relatively quickly (see chart, this page). This resilience owes much to sound economic fundamentals and the government's supportive monetary and fiscal policies.

Singapore's monetary policy—which is based on the management of a trade-weighted exchange rate index (TWI) within an undisclosed band—has as its primary objective maintaining price stability. The Monetary Authority of Singapore (MAS) responded to the macroeconomic shocks over the past decade by allowing the TWI to depreciate. On the fiscal side, the government halved the public saving rate (measured in percent of GDP) between 1997 and 2005.

Over this same period, Singapore saw its competitiveness tested by the rise of low-cost economies in the region, notably China and India. Their emergence had a particular impact on Singapore's electronics sector, which currently accounts for about one-third of GDP. With its higher labor costs, Singapore had a particularly difficult time competing in the low-tech segment.

To respond to these competitiveness pressures, the authorities geared up structural reforms focused on increasing wage and labor market flexibility; liberalizing the banking, telecom, and utility sectors; enhancing the financial regulatory and supervisory framework; and negotiating free trade agreements with major trading partners. Fiscal policy was also used effectively to strengthen competitiveness. The authorities lowered the corporate income tax rate and provided tax incentives to encourage new growth sectors (including pharmaceuticals). In addition, private companies took steps to restructure—moving their products up the quality ladder, relocating parts of their operations to low-cost economies, and more generally diversifying their business base by investing throughout Asia and penetrating new markets.

Safeguarding the momentum

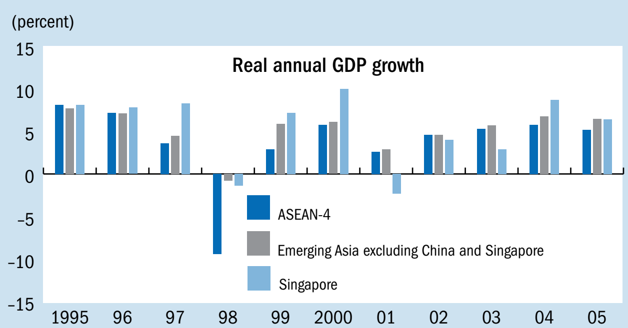
In 2005, the economy grew at a brisk 6.4 percent (year on year). Domestic demand growth slowed, but external demand strengthened—especially for pharmaceuticals and oil rigs and, toward the end of the year, for electronics. The growth momentum slowed somewhat in the first quarter of 2006 (see chart, page 173) but remained buoyant at a 6.8 percent (annualized quarter on quarter).

Prospects for the near term are favorable. Growth is projected to remain strong in 2006—reaching 5½–6 percent—with domestic demand, especially investment, likely to make a larger contribution to economic activity. Overall, risks to this outlook are broadly balanced. On the upside, investment could rise more sharply if high corporate savings unwind more rapidly in response to favorable economic conditions. Stronger global demand for information technology could provide an additional impetus to growth. On the downside, the range of risks include higher oil prices, which could dampen spending by eating into disposable incomes; the potential for a disorderly unwinding of global imbalances, which would seriously dampen activity, given the openness of Singapore's economy; and the possibility of terrorist attacks or a bird flu pandemic, which could negatively affect investor sentiment.

When economic growth recovered after the SARS shock, the MAS in April 2004 started to tighten monetary policy, tar-

Weathering shocks

Thanks to supportive macroeconomic policies and effective structural reforms, Singapore has successfully weathered a series of external shocks and intensifying regional competition.



Note: ASEAN-4 = Indonesia, Malaysia, Philippines, and Thailand.
Data: IMF, APDCORE database and staff estimates.

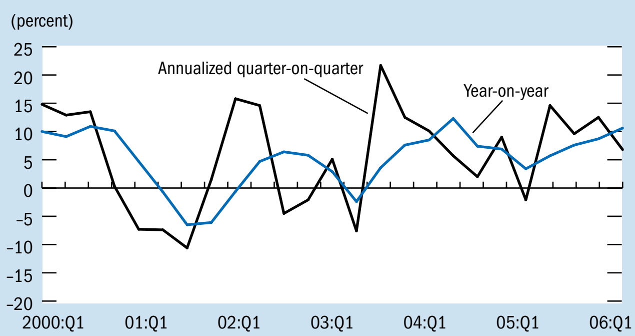
geting a gradual appreciation of the TWI. This stance remains appropriate, given the little slack currently in the economy. With the labor market tightening and real wages set to rise, these developments—along with high energy prices—could increase inflationary pressures. Although short-term interest rates have increased in recent months, and the MAS has allowed additional appreciation of the TWI, monetary policy may need to be further tightened if inflationary pressures increase. Indeed, the authorities should stand ready to take full advantage of the flexibility afforded by the monetary framework and adjust the exchange rate as needed to safeguard the monetary objective.

Fiscal policy, on the other hand, is expansionary. Singapore's FY 2006/07 budget provides for an increase in social spending in line with the government's strategy to help low-income families and low-skilled workers through targeted assistance. Under this initiative, the government will provide broad means-tested transfers to households, income supplements for low-wage workers, and assistance in meeting rising health care costs and utility bills. The budget also includes a number of measures designed to upgrade and further restructure the economy, including more spending on research and development. The country's very large fiscal reserves provide ample scope to undertake these initiatives, which will also contribute (albeit only marginally) to a reduction in global imbalances. However, the expansionary stance adds somewhat to demand pressures, underscoring the need for monetary policy to remain vigilant to ensure price stability.

Increasing competition . . . will continue to pose a challenge for Singapore's economy and will mean that the government will need to keep structural reform high on the agenda.

Buoyant growth momentum

Strong external demand propelled economic growth in 2005 and early 2006, although the momentum recently eased somewhat.



Note: Annualized quarter-on-quarter data show what the annual growth rate will be if the quarterly growth rate is maintained for a year. As such, it is a good indicator of the current economic momentum.

Data: IMF, APDCORE database and staff estimates.

Sustaining the economic expansion

Increasing competition from other economies in the region, and, more generally, further globalization, will continue to pose a challenge for Singapore's economy and will mean that the government will need to keep structural reform high on the agenda. Reforms should also pay due attention to advancing targeted social programs and increasing retirement incomes.

To respond to these challenges, a government-sponsored Economic Review Committee in early 2003 recommended a number of measures intended to enhance competitiveness and entrepreneurship and diversify the economy. The committee specifically suggested that Singapore shift from direct to indirect taxation, promote the growth of its service sector, reform its compulsory Central Provident Fund savings scheme, divest nonstrategic government-linked companies, foster greater labor market flexibility, and strengthen job training programs. The government has already implemented many of these recommendations.

More recently, the authorities have announced additional plans to strengthen the manufacturing sector by promoting integrated supply chain systems, developing new growth sectors, improving education and skills training, and increasing investment in research and development. Further to this, however, the authorities should explore the scope for accelerated divestment of nonstrategic government-linked companies to encourage private sector entrepreneurship.

Moreover, large fiscal reserves continue to provide ample scope to pursue targeted social programs that would assist low-income families. Such programs could be designed to enhance the social safety net without labor market distortions and could support private consumption by reducing the need for precautionary savings. Redesigning the Central Provident Fund system, including permitting greater flexibility and risk-return options, could help increase retirement income and thus allow higher consumption for retirees or lower savings ahead of retirement. ■

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Copies of IMF Country Report 06/150, *Singapore: 2005 Article IV Consultation–Staff Report*, are available for $15.00 each from Publication Services. See page 176 for ordering information. The full text of the report is also available on the IMF's website (*www.imf.org*).

What is driving Pakistan's inflation: Money or wheat?

Inflation in Pakistan rose rapidly in 2004 and remained high through 2005. Fingers of blame are pointing in two different directions: an increase in the wheat support price and monetary growth. A recent IMF Working Paper examines the contributions that both have made and finds strong evidence that the influence of monetary policy is decisive.

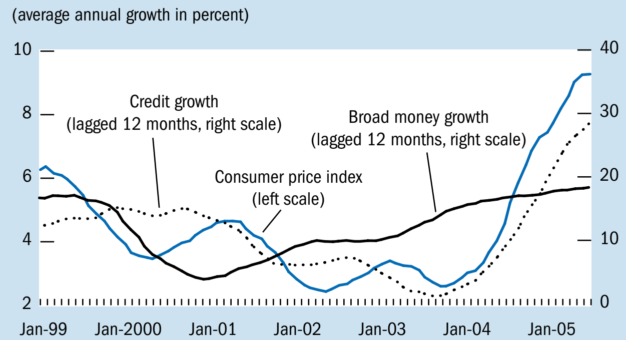
Following a financial crisis in 1998–99, Pakistan's inflation dropped to less than 5 percent a year and remained at that level through 2003. Tight monetary policy, combined with fiscal consolidation, contributed to this low-inflation environment (see top chart). Starting in 2002, however, monetary growth picked up, and inflation, with a one-year lag, increased sharply in late 2003 and 2004. This acceleration also coincided with two increases in the country's wheat support price—the guaranteed minimum price that the government pays for wheat (see bottom chart).

What was to blame for the rise in inflation? Do supply constraints (or administered prices) drive up the prices of specific goods and, through second-round effects, affect the overall price level and inflation? To take a closer look at what was driving Pakistan's inflation, the study examined the role played by monetary growth (measured by broad money or credit to the private sector), real GDP growth, the interest rate, exchange rate movements, and increases in the wheat support price.

The results suggest that monetary factors are the main drivers of inflation in Pakistan. Monetary factors, particularly private sector credit, affect inflation with a lag of about one year. In addition, increases in the wheat support price influence inflation in the short run. Thus, over the medium term, the wheat support price can affect inflation only if accommodated by monetary policy.

Inflation drivers

Broad monetary growth and credit growth lead inflation by 12 months.



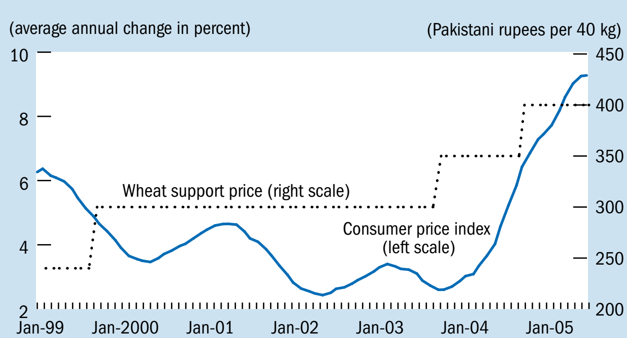
Data: Pakistani authorities and IMF staff calculations.

To test these findings further, the study tracked the effects of increases in the wheat support price in 1999, 2003, and 2004. When the price was increased in 1999, monetary growth was subdued and inflation remained low. Pakistan experienced a slight increase in headline inflation in mid-2000, stemming from nonfood inflation, but this suggests that the wheat support price played only a small role, if any, in explaining headline inflation. In contrast, when the wheat support price increased in 2003 and 2004, monetary growth was high and increasing, which triggered nonfood inflation. Food inflation rose even more, which could reflect the additional impact of increases in the wheat support price. And, given the accommodating monetary conditions, there may indeed have been second-round effects from food to nonfood inflation.

Why is all of this important for Pakistan? The overarching objective of the State Bank of Pakistan should be price stability. High and persistent inflation is a regressive tax that hurts the poor. There is also evidence that inflation beyond a certain threshold hampers growth and financial sector development. For Pakistan, this threshold is estimated to be in the 3–6 percent range. Thus, the authorities' medium-term inflation target of 5 percent is appropriate. In the future, monetary policy will need to focus foremost on keeping inflation close to this target. ■

Price of wheat

Recent support price increase coincided with an uptick in inflation.



Data: Pakistani authorities and IMF staff calculations.

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Copies of IMF Working Paper No. 06/60, "Inflation in Pakistan: Money or Wheat?" are available for $15.00 each from IMF Publication Services. Please see page 176 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

Mapping a brighter future for the Kyrgyz Republic

How can the Kyrgyz Republic reduce its heavy debt burden and step up its poverty reduction efforts? This question formed the basis of discussion among delegates of the Jogorko Kenesh, the Kyrgyz Republic's parliament, and IMF staff and representatives of other international financial institutions on May 19–20 at a high-level seminar in Bishkek. The event was organized by the IMF's External Relations Department in cooperation with the National Bank of the Kyrgyz Republic.

Ayilchiev Sagyn

At the Bishkek seminar (from left): Marat Alapaev (Chair, National Bank, Kyrgyz Republic), Marat Sultanov (Speaker of the Parliament), David Owen (Senior Advisor, IMF Middle East and Central Asia Department), and Paulo Neuhaus (IMF Mission Chief for the Kyrgyz Republic).

Over the past decade, the Kyrgyz Republic has made substantial economic progress, with per capita income almost doubling to $473 from the mid-1990s to 2005. Prudent macroeconomic policies have reduced inflation to low single-digit annual rates, growth has averaged 4 percent a year since 2000, and the poverty rate declined from 63 percent in 2000 to 46 percent in 2004. Moreover, despite a difficult political climate since the March 2005 "Tulip Revolution," the government has been able to consolidate economic stabilization and press on with reforms. But public debt is still high; poverty remains widespread, particularly in rural areas, where three-fourths of the poor live; and income inequality has worsened.

Designing an economic road map

Participants agreed that it is important to accelerate structural reforms to achieve rapid, sustained improvements in living standards. This includes enhancing fiscal sustainability, modernizing the financial system, and creating a regulatory and legal environment that fosters private sector–led growth. Further efforts to strengthen tax administration, as well as debt relief under the IMF–World Bank Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative should also make the external debt burden more manageable and create fiscal space for poverty-reducing spending.

IMF participants stressed the vital role legislators could play in advancing the reform agenda by finalizing tax reform and the new tax code, approving the financial sector reform package—including bills to increase central bank autonomy—privatizing the Kyrgyz Agricultural Finance Corporation, and taking steps to curtail money laundering and the financing of terrorism.

On the issue of debt, delegates debated whether the Kyrgyz Republic should apply for debt relief under the enhanced HIPC Initiative. Some expressed concern that participation in the HIPC Initiative would damage the country's reputation and deter potential investors—a sentiment shared by wide sections of the country's civil society. David Owen, Senior Advisor in the IMF's Middle East and Central Asia Department, addressed a number of misconceptions about the HIPC Initiative and pointed to the potential benefits of participation, including the opportunity to boost poverty-reducing spending.

Need for greater participation

While the process of designing the country's national poverty reduction strategy had been commendably open and inclusive, delegates called for a greater role in economic decision making, in particular with regard to the current economic program supported by the IMF's Poverty Reduction and Growth Facility. Parliament Speaker Marat Sultanov called for greater parliamentary scrutiny of the policies agreed to under the IMF-supported program.

Participants also underscored the importance of broad participation of parliament and civil society as the country updates its poverty reduction strategy through 2010. In the meantime, as member of parliament Bolotbek Maripov noted, "it is not easy to design a successful road map, but we need to do a better job in aligning the goals of the national poverty reduction strategy with the budget and government expenditure policies." ■

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For more information about the seminar, please see Press Release No. 06/108 on the IMF's website (*www.imf.org*).

Pragmatism: Latin America's new "ism"?

About 80 people turned up at a May 23 IMF Book Forum at IMF Headquarters in Washington, D.C., to listen to dispatches from the front lines in the "battle for Latin America's soul" (as the cover of a recent issue of *The Economist* has it). The OECD's Javier Santiso, author of *Latin America's Political Economy of the Possible,* put forward the controversial hypothesis that the real story coming out of Latin America is the move to the "politics of pragmatism."

In his opening remarks, IMF Deputy Managing Director Agustín Carstens called this "a fortunate phrase"—one that captures particularly well what has happened in the arena of monetary policies. He said that the low inflation in Latin America today compared with around 1990 is an "expression of a political consensus" that high inflation is not good for society, least of all the poor. The granting of independence to a number of central banks in the region was a reflection of that political consensus.

Eugene Salazar/IMF

Javier Santiso speaking on Latin America's political economy.

Pragmatism is taking hold . . .

Carstens hoped that people in Latin America would similarly say they were "sick and tired" of banking crises and grant greater independence to supervisory and regulatory agencies, thus enabling better financial sector policies. Periodic banking crises had set back growth in the region. Carstens called the move to pragmatism "an unfinished revolution." It still had to take hold outside the sphere of monetary policies.

Santiso described the onset and spread of pragmatism in Brazil, Chile, and Mexico. By maintaining policy continuity through political transitions, these countries have offered other Latin American countries a model to follow. He predicted that the election in Brazil this year would result in a further "decoupling" of economic policies from political transitions.

Bolivia, Santiso acknowledged, offers the other end of the spectrum in the "menu of options" available to Latin America. The nationalization of that country's energy sector, the *Miami Herald's* Pablo Bachelet said, had introduced a schism within the left in Latin America and made it difficult to put players into "neat little boxes" such as "left versus right or pro-U.S. versus anti-U.S." If anything, the box these days in Latin America seemed to be that of the "energy-haves versus the energy have-nots."

IMF Western Hemisphere Department Deputy Director Charles Collyns said that Santiso's assertion about the spread of pragmatism "matches my own personal experience" from travel in the region and meetings with policymakers over the past five years. He also cited as examples of pragmatism Brazilian President Luiz Inacio Lula da Silva's maintenance of the fiscal framework he inherited from his predecessor and policymakers' abstention thus far from the "spend and borrow" tendencies of the past, despite the present good times.

Picking up on Carstens's theme, Collyns said that the realm of pragmatism "has to be expanded" into the fiscal and structural arenas. He cited Guatemala, where increased trust in the government's ability to use taxes in the general interest is needed, so that the country's low ratio of tax revenue to GDP can be raised, thereby providing much-needed public spending.

. . . or isn't it?

The other two speakers expressed greater skepticism about Santiso's assertion of the spread of pragmatism. The Independent Institute's Alvaro Vargas Llosa worried that when the beneficial global waters recede, the move to pragmatism will be exposed as rather shallow because the region did not really undertake fundamental institutional reform during the 1990s shift to neoliberalism. *Foreign Policy*'s Moisés Naim agreed. He lamented the region's "profound intellectual bankruptcy" and said that the agenda for institutional reform had been turned into "platitudes" rather than into successful electoral platforms. Provocative as always, Naim asked why, if "Chileanismo" is such a grand success in its outcomes, so many people in Latin America continue to be drawn to "Chavezismo." ■

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