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IMF agenda builds on its Medium-Term Strategy

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The IMF Executive Board agreed on a new six-month work program through November 2007. The IMF will focus on strengthening the framework for its economic oversight of member countries, further defining its role in low-income countries, aligning IMF quota shares with members' economic size, and enhancing the voice and representation of low-income members in the institution. It will also work on a new income model to ensure long-term financing for its activities.



Thomas Dooley/IMF

IMF strengthening exchange rate advice

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The IMF is updating its policy framework for monitoring exchange rates and improving the analytical underpinnings for its surveillance. A critical initiative is updating 30-year-old guidance about the IMF's surveillance over exchange rate policies. Updated guidelines will take account of the globalization of financial markets and would encourage best practice by clarifying the IMF membership's expectations on the proper scope and conduct of surveillance.



Banki Muhammad/Reuters

Unraveling Asia's trade pact "noodle bowl"

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The continued proliferation of regional trade agreements (RTAs) risks turning the world trade system into a "noodle bowl" of overlapping and potentially inconsistent and unmanageable RTAs. But an IMF study that examined such pacts in Asia suggests that participation in an RTA does not, in general, seem to have occurred at the expense of trade with non-members. The findings reinforce the need for countries with more restrictive trade regimes to continue reducing high tariffs.



Stephen Jaffe/IMF

Central Asia benefits from cooperative approach

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In recent years, Central Asian countries have grown rapidly, increased their reserves, and made progress in reducing poverty. Despite the region's rich oil and mineral endowments, the countries would have difficulty achieving further progress individually. To maintain their growth momentum and make more of a dent in poverty, they have joined forces through the Central Asia Regional Economic Cooperation program.



Oleg Nishchik/Getty Images

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Reasons for change: Research indicated that many readers need more immediate and frequent access to *IMF Survey* content. At the same time, readers expressed a desire for a digest of news and research from the Fund. To accommodate these different requirements, and taking account of the varied levels of access to the Internet around the world, *IMF Survey* started a regularly updated electronic edition and will soon offer a monthly print digest of the web content. This is the final issue in the old print format.

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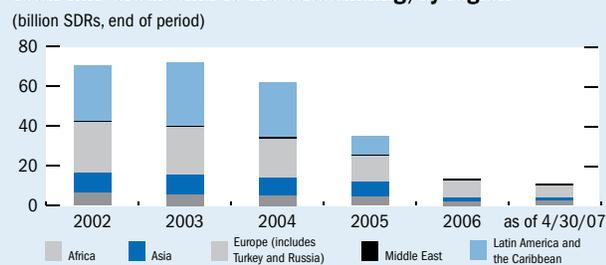
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IMF financial data

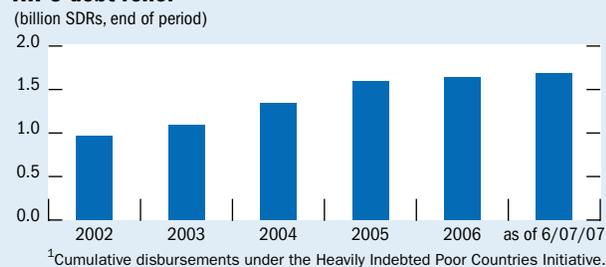
Total IMF credit and loans outstanding, by region



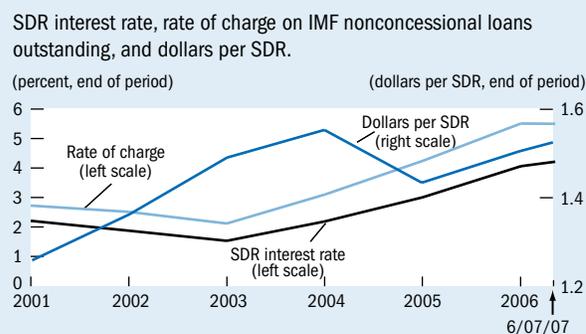
Major currencies, rates per SDR

	June 8, 2007	Year ago (June 8, 2006)
Euro	1.130	1.165
Yen	182.680	168.540
U.K. pound	0.767	0.802
U.S. dollar	1.510	1.480

HIPC debt relief¹



Related rates



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.

IMF sets agenda to update, modernize

During the next six months, the IMF will seek to modernize its economic oversight and better define its role in low-income countries as part of a six-month work program set out by Managing Director Rodrigo de Rato and agreed to by the IMF Executive Board on June 6.

Every six months, the IMF draws up a work program that prioritizes and sequences planned action on its policy agenda. The program for June–November 2007 focuses on issues vital to the global economy and on the IMF’s internal workings, such as bringing member countries’ voting shares into line with their weight in the world economy and developing a sustainable revenue model to finance its operations.

De Rato said that the Board should give priority to the most pressing issues while recognizing that the IMF’s Medium-Term Strategy (MTS) targets a substantial number of areas for progress for the 185-member institution. “We must build in particular on those elements of the MTS on which discussions are most advanced,” he said in a meeting with the Board.

Safeguarding economic stability

Economic oversight, or surveillance, is the IMF’s core responsibility and has become increasingly important in today’s global economy. A central feature of the new work program is a stronger framework for surveillance: doing more to identify and respond effectively to threats to economic stability. Accordingly, the IMF plans to update the 1977 Decision on Surveillance over Exchange Rate Policies, drafted after the breakdown of the fixed exchange rate system in the early 1970s (see pp. 148–49).

Related work includes a follow-up on the recent external evaluation of IMF exchange rate policy advice and a review of the IMF’s first multilateral consultation on global imbalances, involving China, the euro area, Japan, Saudi Arabia, and the United States. On May 17, the Independent Evaluation Office (IEO)—set up in 2001 to assess IMF performance—released its assessment of IMF exchange rate policy advice to its member countries between 1999 and 2005. It called for remedying what it referred to as an “effectiveness gap” in that advice. The IEO acknowledged that the advice had improved over the years under review but said that, too often, “there was a lack of effective engagement on exchange rate issues.”



The IMF’s 24-member Executive Board tackles the day-to-day work of the institution.

Work on low-income countries

With IMF members favoring the institution’s continued engagement in low-income countries, the work program calls for the IMF to assess the consistency among aid flows, economic stability, and development goals; public financial management responses to additional aid; and IMF instruments to assist postconflict countries. The Board will also discuss the IMF’s role in poverty reduction strategies and coordination between aid donors, as well as the IEO’s recent evaluation of the Fund’s role in sub-Saharan Africa.

New quota formula, financing of IMF

On IMF governance, the program aims to build on recent efforts to align IMF quota shares with the size of members’ economies and to enhance low-income countries’ voice and representation in the IMF. The Board will aim to have a new formula for determining quotas no later than the 2008 Spring Meetings.

Based on the recommendations of a committee that explored the IMF’s long-term financing, the Board will work on a new income model that is better aligned with the range of activities the IMF now undertakes and is more responsive to evolving global economic conditions. Several financing proposals pertain to investment operations and will require amendment of the IMF’s Articles of Agreement and, possibly, the approval of national parliaments. Thus, broad support among member countries will be needed to move ahead. De Rato said on June 12 that he planned a further discussion at the Board on the main issues related to implementing the recommendations. ■

IMF strengthening exchange rate advice to member countries

The emergence in recent years of large global imbalances and changes in global trading patterns have propelled exchange rates and related policies to the forefront of the public debate in many countries. Accusations of unfair currency practices are being waved at a number of countries with large trade surpluses, and calls for defensive measures—whether in the form of trade protectionism or of exchange rate policies—are heard in some countries running large deficits. This has brought back into the spotlight a key mandate of the IMF, namely exchange rate surveillance—the focus of a recent report by the IMF’s Independent Evaluation Office (IEO) that assesses the Fund’s advice in this critical area. (See *IMF Survey*, May 28, 2007.)

Enhancing the IMF’s work in this area is a key component of the Medium-Term Strategy (MTS)—Managing Director Rodrigo de Rato’s strategic plan for enhancing the IMF’s relevance and effectiveness in the 21st century. Under the MTS, a number of initiatives aim to ensure that exchange rate surveillance is as clear, candid, technically expert, and influential as it can be.

Part of original mandate

Since its creation, the IMF has been closely involved in exchange rate matters. Indeed, one of the main reasons for establishing the IMF and putting it in charge of the Bretton Woods system was to promote dialogue and cooperation among countries to rebuild international trade and finance. The founders understood that the alternative could be a return to the vicious cycle of competitive depreciation and protectionism that contributed to the turmoil of the 1930s.

The current role of the IMF’s exchange rate surveillance—or of surveillance more generally—is to assess how countries’ policies fare in light of the commitments they undertake as members of the IMF. More specifically, the IMF assesses the impact of countries’ exchange rates and other policies on their external stability and, hence, on the stability of the international system of exchange rates.

The goal is to support policies that are good for the member but also good for other countries through a process of collaboration, in which dialogue and persuasion are key. In the global economy, one country’s policies can have powerful ripple effects on other countries, and the case for such collaboration now is therefore arguably even stronger than in 1944.

In the global economy, one country’s policies can have powerful ripple effects on other countries.



Currency signs displayed at a bank in Seoul, Korea.

Kim Kyung-Hoony/Reuters

Float or peg?

Under Article IV of the IMF’s Articles of Agreement, which sets out the foundations of surveillance, members are largely free to choose their own exchange rate regime (for example, whether to float or peg). However, they are committed to collaborating with the IMF to promote a stable system of exchange rates, follow exchange rate policies compatible with this undertaking, and avoid manipulating exchange rates to prevent an effective balance of payments adjustment or to gain an unfair competitive advantage over other countries.

Further guidance adopted by the IMF (in the landmark 1977 Decision on Surveillance over Exchange Rate Policies) stipulates that members should intervene in the exchange market if it becomes necessary to counter disorderly conditions and that they should take into account the interests of other member countries in their exchange intervention policies.

Countries with a freely floating exchange rate, which do not have exchange rate policies per se, are subject to surveillance all the same with respect to their domestic policies. Indeed, all members are committed to managing their domestic policies in a way that fosters domestic stability because unstable domestic conditions can cause severe disturbances to external stability.

Exchange rate surveillance in practice

The IMF’s country reports, which analyze economic developments and describe policy discussions between member

countries and IMF staff, are the main channel for surveillance. In these reports, which are prepared annually for most of the Fund's 185 members, the IMF staff is expected to provide an accurate description of each country's exchange rate regime (whether the currency is floating, pegged, or fixed), a candid appraisal of the regime's appropriateness and consistency with underlying policies, and a forthright assessment of the exchange rate level (the currency's value compared with that of other currencies) through the systematic use of a broad range of indicators and analytical tools to evaluate external competitiveness.

IMF staff members are also expected to assess policy spillovers, including those operating through exchange rate policies, and to describe the policy dialogue they had with government officials from the central bank, the finance ministry, and other stakeholders. In performing this task, staff members face long-standing challenges, reflecting a combination of technical uncertainties and political sensitivities.

Technical uncertainties

The technical uncertainties arise because many questions in exchange rate economics remain unsettled, including what constitutes the "right" exchange rate regime or the optimal level of international reserves for a given country at a given time. Assessments of exchange rate levels are also often subject to large margins of uncertainty.

To address these challenges, the IMF strives to stay at the forefront of research on exchange rates. Its staff is engaged in an active research program, including in such new areas as defining what constitutes an optimal level of international reserves. For the past few years, the IMF has, on average, issued more than 30 working papers a year on exchange rate-related issues.

Data availability is also a problem in many countries. Data availability issues are often discussed in country reports, and the IMF provides technical assistance in this area to countries that request it.

Another challenge confronting the IMF is that exchange rate policy can be politically controversial as well as market sensitive. This can constrain the depth and candor of the dialogue between the IMF and its members and affect the reporting in documents that are subsequently published. To mitigate this risk and preserve the IMF's ability to serve as a trusted advisor to its members, its transparency policy includes safeguards to maintain the appropriate balance between transparency and confidentiality. This policy allows for deletions of highly market-sensitive material in country reports before they are made public.

Strengthening exchange rate surveillance

A cornerstone of the MTS is that the IMF must give more emphasis to exchange rate surveillance. A critical initiative under way in this connection is the updating of the policy framework for exchange rate surveillance, most prominently through a review of the 1977 Surveillance Decision. An updated decision would encourage best practice in surveillance by clarifying the membership's expectations of the proper scope and conduct of surveillance. It is also an opportunity to reflect the changes that have taken place in the world economy since 1977, in particular the emergence of globalized financial markets.

Much work is also under way to strengthen the analytical underpinnings of exchange rate surveillance. In particular, the IMF's Consultative Group on Exchange Rates, which relies on cutting-edge methodologies for assessing exchange rate levels, has recently expanded its coverage from industrial countries to include all major emerging market currencies. A further broadening of this coverage is envisaged.

Best practices

The IMF is also disseminating more of its knowledge and best practices. A book collecting the best exchange rate analysis at the IMF is being prepared, and the institution's 2007 annual research conference will focus on exchange rate policies. Training of IMF staff on exchange rate issues has increased. Recent efforts have also focused on better integrating exchange rate surveillance with analysis of financial sector issues and a deeper examination of cross-country spillovers.

Finally, the IMF is enhancing its internal monitoring of the quality of exchange rate surveillance. As demonstrated by a stocktaking earlier this year, all these efforts are gradually bearing fruit. The IMF considers its 2006 country report on China one example among many others of good practice in terms of exchange rate surveillance.

As noted, many initiatives to improve the IMF's exchange rate policy advice are already under way as part of its MTS. Over the next few months, the IMF's Executive Board will consider specific proposals on how to follow up on the IEO's recommendations. ■

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For more information about the IMF's work on surveillance, please refer to www.imf.org/imfsurvey.

Unraveling Asia's "noodle bowl" of trade pacts

Regional trade agreements (RTAs) have proliferated across the Asia and Pacific region over the past 20 years. As of May 2007, more than 40 RTAs had been signed among Asian countries themselves or between one or more of these countries and selected trading partners outside the region, and an additional 70 RTAs were under negotiation. However, unlike in other regions, most RTAs in Asia have followed, rather than preceded, trade liberalization on a multilateral, most-favored-nation (MFN) basis. Regional trade integration has thus been only one facet of a much more broadly based process of international integration. Is the trend toward more regional trade pacts helpful, or does it hamper more broad-based multilateral trade liberalization?

An IMF study found that RTAs can be an effective means to expand regional trade and cooperation. However, the discriminatory aspects of RTAs can also be harmful if they are pursued not as a complement to, but as a substitute for, multilateral trade liberalization. In fact, RTAs can give rise to welfare losses for countries that are both members and nonmembers of the pact by diverting imports from low-cost nonmember sources to higher-cost member suppliers. In such cases, the cost difference borne by importing members is commonly known as a trade diversion effect.

If, on the other hand, resources previously devoted to high-cost domestic production are reallocated domestically to more efficient producers as a result of the RTA, economic welfare can increase—a process known as the trade creation effect. The risk of a net welfare loss is more likely to be minimized if the protection versus nonmembers is low to start with, or if the RTA partners agree to introduce swift reductions in their MFN tariffs over time, which ideally should eventually match their preferential rates. However, vested interests within RTA members can sometimes turn the agreements into closed blocs, discouraging multilateral trade liberalization and distorting the pattern of international trade.

Why so popular?

So why are countries eager to enter into an RTA? The upsurge in RTAs around the globe reflects both economic and noneconomic motivations. Regional trade integration can serve as a vehicle for dialogue and coordination on regional issues that are not part of the multilateral agenda. These might include regulatory harmonization, infrastructure development, and collaboration among members to facilitate transit trade and transport. And they can stimulate inward foreign direct investment and growth through technological transfers.

Their proliferation can also be motivated by a growing sense that regional agreements elsewhere put the left-out countries at a disadvantage. By entering first into a regional agreement, a country may increase its bargaining power in multilateral negotiations by having a common (regional) position on sensitive sectors (for example, textiles and agriculture) in which some developed countries still maintain a protectionist stance. Moreover, some economists have argued that by entering into multilateral negotiations as a region rather than as a country, small states might face lower fixed costs of negotiation. Although liberalization on an MFN basis is generally agreed to be the

best policy under most circumstances, the extent to which RTAs produce trade diversion or trade creation remains an empirical question.

Consequently, it is useful to ask whether the recent proliferation of preferential agreements in Asia has had welfare-enhancing or welfare-reducing effects on trade among their memberships. To shed light on this question, the IMF study used a gravity model of trade—which predicts trade flows based on a country's economic size and distance from a trade partner—to estimate how membership in the Association of Southeast Asian Nations (ASEAN), the South Asian Preferential Trade Agreement (SAPTA), the Asia Pacific Economic Cooperation (APEC) forum, and the Australia-New Zealand Closer Economic Relations (ANZCER) agreement may have influenced the level and the direction of trade.

The issue: The continued proliferation of regional trade agreements (RTAs) risks turning the world trade system into a "noodle bowl" of overlapping and potentially inconsistent and unmanageable RTAs.

Bottom line: A recent IMF Working Paper (WP 07/53) that examined RTAs in Asia during 1984–2005 suggests that participation in an RTA does not, in general, seem to have occurred at the expense of trade with nonmembers.

Policy implications: The paper's findings reinforce the need for countries with more restrictive trade regimes to continue reducing high tariffs even if they are participating in regional arrangements.

The study's empirical estimates suggest that membership in these RTAs did promote trade among their members, but not at the expense of trade with nonmembers during 1984–2005. Such results appear to reflect Asian countries' strong inclination to pursue nondiscriminatory liberalization at an early phase in their development. Indeed, most of these countries' integration with the global economy preceded regional integration, and members of Asian RTAs recorded more trade with the rest of the world than other countries with similar characteristics in other regions, with this effect being strongest for countries with the lowest MFN rates.

However, it is conceivable that a proliferation of RTAs that is not accompanied by unilateral and multilateral liberalization could lead to suboptimal trade patterns. To guard against this, countries whose MFN rates are higher than those in the rest of the region would be well advised to continue to pursue broad-based trade liberalization on an MFN basis in tandem with their regional integration.

How about a pan-Asian trade zone?

Asia's trade pacts currently link specific groups of regional countries (see table). But would a pan-Asian free trade area produce greater benefits? The study suggests that greater coherence



Container ship in Shanghai harbor, one of Asia's trading hubs.

among existing RTAs in terms of tariff preferences and rules of origin could help minimize the administrative costs associated with verifying that rules of origin have been observed and limit possible distortions in trade patterns. Rules of origin are established in free trade agreements to ensure that only goods originating in participating countries enjoy preferences.

Indeed, since late 2006, Japan has advocated the creation of a pan-Asian free trade area, which could include Australia, China, India, Japan, Korea, New Zealand, and the 10 ASEAN countries. Such a free trade area could potentially avoid some of the risks associated with proliferating RTAs. However, it is difficult to tell whether a consolidation of Asian RTAs into a single free trade area would address all the pitfalls of RTAs. An assessment of this question would require further analysis to estimate the possible implications for Asian intraregional trade and the region's trade with the rest of the world. ■

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Interlocking ties

A growing list of countries is involved in preferential trade agreements in the Asia and Pacific region.

Regional trade agreements¹

AFTA (ASEAN Free Trade Area), 1992, 1993	Pacific Island Countries Trade Agreement (PICTA), 2001, 2001
ASEAN-China Free Trade Agreement, 2004, 2005	South Asian Preferential Trade Agreement (SAPTA), 1993, 1995
ASEAN-Japan, 2003, 2004	South Asia Free Trade Agreement (SAFTA), 2004, 2006
ASEAN-Korea 2003, 2004	Trans-Pacific Strategic Economic Partnership Agreement (TPSEPA), 2005, 2006
Asia-Pacific Trade Agreement (APTA), 1975, 1976 ²	

Bilateral trade agreements¹

Australia-New Zealand (CER), 1983, 1983 ³	Japan-Singapore, 2002, 2002
Australia-Singapore, 2003, 2003	Korea-Chile, 2003, 2004
Australia-Thailand, 2004, 2005	Korea-EFTA, 2005, 2006 ⁵
Australia-United States, 2004, 2005	Korea-Singapore, 2005, 2006
China-Chile, 2005, 2006	Lao PDR-Thailand, 1991, 1991
China-Hong Kong SAR, 2003, 2004	Lao PDR-United States, 2003, 2005
China-Macao SAR, 2003, 2004	Malaysia-Pakistan, 2005, 2006
China-Niger, 2005, 2005	Malaysia-United States, 2004, 2004
China-Thailand, 2003, 2003	New Zealand-Singapore, 2000, 2001
India-Afghanistan, 2003, 2003	New Zealand-Thailand, 2005, 2005
India-Bangladesh, 2006, 2006	Singapore-EFTA, 2002, 2003
India-GCC, 2004, 2006 ⁴	Singapore-Jordan, 2004, 2005
India-Nepal, 1991, 1991	Singapore-Panama, 2006, 2006
India-Singapore, 2005, 2005	Singapore-United States, 2003, 2004
India-Sri Lanka, 1998, 2001	Sri Lanka-Pakistan, 2002, 2005
India-Thailand, 2003, 2004	Thailand-Bahrain, 2002, 2002
Japan-Malaysia, 2005, 2006	Vietnam-United States, 2000, 2001
Japan-Mexico, 2004, 2005	

Source: Author's compilation.

¹As of June 2007. Years after agreements named refer to the year each pact was signed and the year it entered into force.

²Previously called Bangkok Agreement.

³Closer economic relations.

⁴Gulf Cooperation Council.

⁵European Free Trade Association.

This article is based on IMF Working Paper No. 07/53, "Are Regional Trade Agreements in Asia Stumbling or Building Blocks? Some Implications for the Mekong-3 Countries." Copies are available for \$18.00 each from IMF Publication Services. Please see page 160 for ordering details. The full text is also available on the IMF's website (www.imf.org).

Encouraging economic cooperation in Central Asia

In recent years, Central Asian countries have registered strong growth (see chart), boosting per capita incomes and making a dent in poverty. Maintaining their growth momentum and further reducing poverty are these countries' top priorities. However, it will be difficult for them individually to achieve these goals because the region is hampered by its landlocked setting, underdeveloped transport links, and institutional weaknesses. These countries are benefiting from the Central Asia Regional Economic Cooperation (CAREC) program, which helps Central Asian and neighboring countries realize their potential in an increasingly integrated Eurasia.

At the same time that their growth has increased, the Central Asian countries have seen generally stronger balance of payments positions, improved public finances, a buildup of official foreign currency reserves, and a decline in their debt-to-GDP ratios. As a result, they have become more resilient to external shocks. Inflation is generally under control, although inflationary pressures have recently reemerged as a result of large foreign exchange inflows and strong domestic demand. The countries will have to address these pressures by tightening fiscal or monetary policies, or both; increasing exchange rate flexibility; and adopting reforms to enhance productivity and thereby maintain the competitiveness of their economies.

From opportunity to reality

Central Asia—which bridges Europe and East Asia as well as North and South Asia—is richly endowed with oil, gas, copper, gold, uranium, and water for hydropower and is surrounded by some of the most dynamic of the world's economies. These characteristics provide Central Asian countries with the opportunity to emerge as a center for trade, achieve even higher levels of growth, and further reduce poverty. By joining forces with their neighbors, the countries can harness the opportunity presented by their strategic regional location, rich natural resources, and dynamic neighbors.

Turning these opportunities into reality will require, in addition to sound macroeconomic policies, improved connectivity among countries through roads and railways, better management of the region's natural resources, shorter transit times in customs, and open trade regimes, as well as improvements in the investment climate in each country.

A unique partnership

In this context, the CAREC program, initiated in 1997, is unique. It represents a partnership of eight countries and six multilateral institutions. The participating countries, with a

combined population of more than 100 million and occupying a land area of about 7.5 million square kilometers, are Afghanistan, Azerbaijan, the People's Republic of China (focusing on Xinjiang Uygur Autonomous Region), Kazakhstan, the Kyrgyz Republic, Mongolia, Tajikistan, and Uzbekistan (see map). The Russian Federation and Turkmenistan have participated in some CAREC meetings and have standing invitations to join the program. The multilateral partners are the Asian Development Bank, the European Bank for Reconstruction and Development, the IMF, the Islamic Development Bank, the United Nations Development Program, and the World Bank.

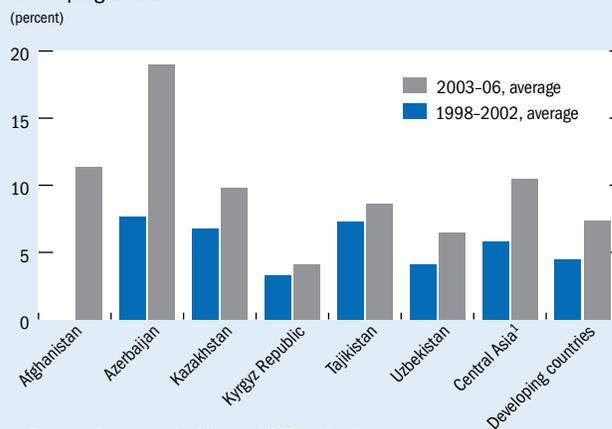
The CAREC program is focused on four priority areas: transport, energy, trade facilitation, and trade policy. A coordinating committee consisting of representatives from member countries and multilateral institutions is leading the work in each area. The Asian Development Bank, which also serves as CAREC's secretariat, coordinates the technical work of the committees for the transport sector and trade facilitation. The World Bank is responsible for the energy sector committee, and the IMF leads the trade policy committee, the only committee that focuses exclusively on policies and not on projects.

The program has various objectives in each of the priority areas:

- In the **transport area**, the objective is to rehabilitate transport networks, improve connections, and reduce transport costs. To this end, the multilateral partners have funded such projects as the Almaty-Bishkek regional road rehabilitation, the southern transport corridor road rehabilitation, and the regional railways rehabilitation.

Strong growth performance

Real GDP growth in the Central Asian countries compares favorably with that in the fastest-growing economies in the rest of the developing world.



Sources: Country authorities; and IMF staff estimates.

¹Data for Afghanistan are available starting in 2002. Therefore, the 1998–2002 column excludes Afghanistan.



- In the **energy sector**, the aim is to support efficient and rational use of energy and water through cooperation. The program has focused on key investment projects, such as the regional power transmission interconnection and power rehabilitation projects.

- In **trade facilitation**, the work is focused on modernizing customs and increasing cooperation among countries through the use of information technology to automate customs services and data exchanges, joint customs control and single window practices, and regional transit development. In this regard, the reform and modernization of customs in the Kyrgyz Republic and Tajikistan is an important project.

- In the **trade policy** area, the objective is to help member countries adopt more open trade regimes, including through membership in the World Trade Organization, and to coordinate their trade policies to facilitate intraregional and international trade. To this end, the work has focused on preparing a series of papers on barriers to trade and regional trade arrangements in Central Asia, with policy recommendations to be adopted by governments. In addition, outreach activities and training seminars on trade policy issues for member countries are important aspects of the committee's work. So far, the trade policy committee has made concrete policy recommendations to reduce barriers to transit trade and reform trade taxes in CAREC countries. Ministers from the CAREC member countries have endorsed the recommendations, and the implementation of the measures is being monitored. The committee is undertaking analytical work related to border trade and quantitative restrictions to trade in CAREC member countries, with a view to making concrete policy recommendations on both issues during the coming year.

Moving in the right direction

In October 2006, at CAREC's fifth ministerial conference, the ministers endorsed a comprehensive action plan for the medium to long term that would be based on a results-oriented program and require strong country ownership and accountability. As part of this action plan, each of the four committees will be developing medium-term sector strategies over the coming year. These strategies will incorporate the priorities identified by CAREC member countries on the basis of the region's needs for integration and will set out the outcomes in a results-based format.

Sound macroeconomic policies at the country level combined with successful regional integration and cooperation are essential to achieving higher growth and reducing poverty in Central Asia. It is encouraging that economic policies are moving in the right direction and that determined efforts to further regional cooperation are under way. With the continuation of these policies and with support from the international community, all countries in the region will be in a better position to exploit their considerable economic potential and meet the legitimate aspirations of their growing populations. ■

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For more details on economic developments and policies in Central Asia, see the *Regional Economic Outlook for the Middle East and Central Asia* (May 2007), which can be found on the IMF's website (www.imf.org).

Cameroon: What next after debt relief?

A year ago, Cameroon received debt relief under two major international initiatives, clearing the way for a write-down of its external debt from about 40 percent of GDP in 2005 to 5 percent of GDP in 2006. Cameroon is now poised to make faster progress toward improving living conditions and reducing poverty. But how is this resource-rich West African country making use of the breathing space created by debt relief, and can it get onto a higher growth trajectory that would edge it closer to achieving the Millennium Development Goals (MDGs)?

Since 1994, Cameroon's economic growth has picked up, although it remains lower than required to make a significant dent in poverty. The devaluation of the CFA franc in 1994 and the accompanying macroeconomic and structural reforms since then contributed to a reversal of Cameroon's declining output. Oil revenues have helped, but the country's crude reserves are dwindling, and economic activity is hampered by weak infrastructure, limited financial intermediation, uneven implementation of structural reforms, and, more generally, an unfavorable business environment. As a result, per capita real GDP has not kept pace with that in comparator countries (see Chart 1), and progress in improving social indicators has been mixed (see Table 1).

Cameroon's debt declined under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). HIPC debt relief cut Cameroon's debt by about \$1.3 billion in net present value terms, reducing future debt service payments by about \$4.9 billion. Debt relief

Table 1

Comparative performance

Cameroon, despite its oil and commodity resources, has not kept pace with comparable economies and it lags on social indicators.

	Cameroon	LMICs ¹
(1995-2005 average, units indicated)		
Economic indicators		
GDP per capita (constant 2000 dollars)	677.0	1,282.0
GDP per capita growth (annual percent change)	2.0	4.5
Gross domestic investment (percent of GDP)	17.9	26.1
Trade in goods (percent of GDP)	33.6	44.2
Broad money (percent of GDP)	15.2	74.8
Physical infrastructure		
Irrigated land (percent of cropland)	0.4	23.1
Paved roads (percent of total roads)	11.5	51.8
Social indicators		
Adult literacy rate ²	64	75
Secondary school enrollment ratio ³	30	70
Life expectancy at birth (years)	47	69

Sources: World Bank, Social Indicators Database; and Cameroonian authorities.

¹Lower-middle-income countries.

²In percent of people ages 15 and above.

³In percent of children of secondary school age.

under the MDRI amounts to a further \$1.1 billion in nominal terms. The IMF provided 100 percent debt cancellation on all debt incurred before January 1, 2005, resulting in the cancellation of \$255 million of its claims on Cameroon.

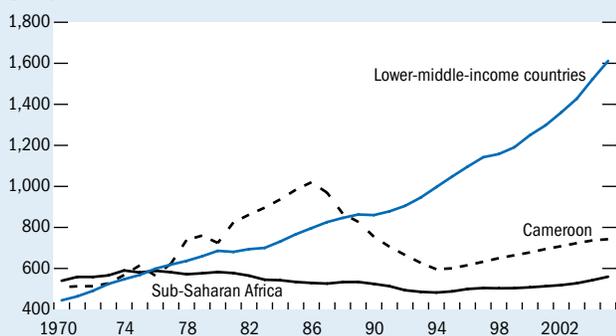
Debt relief has opened up new opportunities. Cameroon is using the freed-up resources to increase priority spending, including on health, education, agriculture, infrastructure

Chart 1

Lagging behind

Although Cameroon's per capita GDP is growing, the country has fallen behind other lower-middle-income countries since suffering a dramatic decline in oil and commodity prices in the mid-1980s.

(per capita GDP, 2000 dollars)

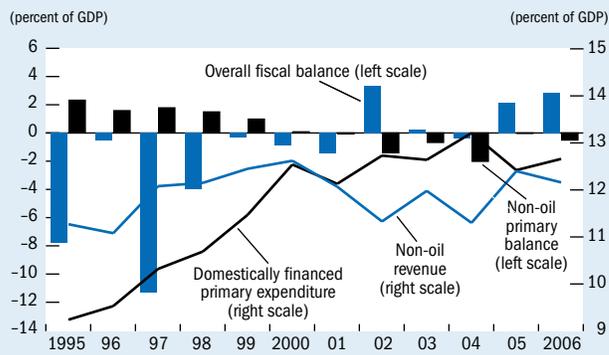


Source: World Bank, World Development Indicators Database, April 2007.

Chart 2

Fiscal challenges

With oil revenues declining over the medium term, key fiscal challenges are mobilizing non-oil revenues and raising the share of priority spending.



Sources: Cameroonian authorities; and IMF staff estimates.

development, and institution building. But expectations for a debt relief “dividend” in the form of higher current spending could undermine fiscal sustainability if not managed prudently. To build on the opportunities presented by debt relief, Cameroon will need to achieve progress in

- preserving long-term fiscal sustainability while expanding priority spending,
- broadening and deepening the financial sector,
- liberalizing trade, and
- improving the business environment by stepping up structural reforms.

Managing the “fiscal space.” Although Cameroon’s overall budgetary position has strengthened over the past two years, the underlying fiscal situation is less favorable. Aided by large oil revenue inflows and improved budget management, the overall fiscal balance has been in surplus. But the non-oil primary balance has deteriorated over the past decade because domestically financed primary spending has expanded faster than non-oil revenues, partly reflecting an increase in debt relief–financed priority outlays (see Chart 2). The fiscal space provided through debt relief should therefore be used prudently. How can Cameroon achieve that?

First, it needs to mobilize additional non-oil revenues over the medium term, which will be critical for preserving fiscal sustainability, given the expected decline in oil reserves and prospects for trade liberalization. But, with tax rates already high, additional revenues would need to come from a broadening of the tax base through policy and administrative measures.

Second, Cameroon should devote a larger part of public expenditures to priority outlays, taking into account its absorptive capacity. Its efforts would need to be accompanied by

reforms in public expenditure management to ensure that the resources are used effectively. Measures that reduce subsidies to public enterprises—a heavy burden on the budget—and redirect those resources toward education, health, and infrastructure would also help boost the quality of spending.

Finally, to preserve its hard-won debt reduction, Cameroon needs to strengthen debt management. It should rely primarily on grants and concessional loans for the next few years to cover its financing requirements and avoid a rapid accumulation of new debt. It will need to monitor debt sustainability indicators closely to avoid a recurrence of past debt problems.

Developing the financial sector. Improved access to finance would help Cameroon diversify its economic base and achieve the more rapid sustainable growth it needs to reduce poverty. However, the country’s financial system is dominated by banks that appear vulnerable to credit and interest rate shocks. Its weak judicial system, lack of adequate land and collateral registries, interest rate ceilings, and limited availability of financial and credit information further hamper bank credit. Contractual savings and capital markets are poorly developed, contributing to the scarcity of longer-term resources to finance the economy. Progress in all these areas will be needed.

Liberalizing trade. Cameroon’s import tariffs are among the highest in sub-Saharan Africa, and its complex customs procedures limit trade and factor mobility. It’s true that a country that reduces such trade barriers can better allocate its resources and accelerate growth. But concerns about possible revenue losses are real, especially in Cameroon, where taxes on international trade exceed 2 percent of GDP. This fiscal reliance largely explains why trade liberalization, including efforts to reduce tariff rates and harmonize regional trade rules, has not advanced very far. The best course of action would be to gradually reduce the maximum common external tariff rates applied by the CEMAC (the monetary union to which Cameroon belongs) and slowly remove obstacles to intraregional trade.

Improving the business environment. Accelerating growth would also require considerable improvement in the business environment. Available indicators of the investment climate show that Cameroon does not do well in contract enforcement, timely issuance of licenses, and cost of registering property (see Table 2). Furthermore, governance is weak and corruption perceptions are widespread. Achieving considerable improvements in all these areas will be critical if greater private investment is to be fostered. In addition, completing public enterprise reform in air transport, telecommunications, and water distribution would reduce the burden on public finances, enhance economic efficiency, and send positive signals to private investors. ■

Table 2

Down the list

Cameroon does not rank well in the World Bank’s 2006 *Doing Business* indicators. Improving the business environment is key to accelerating growth.

	Doing business (overall rank) ¹	Days to acquire licenses	Cost of registering property ²	Days to enforce contracts
Cameroon	152	444	19	800
Indonesia	135	224	11	570
Philippines	126	197	6	600
Botswana	48	169	5	501
Mauritius	32	145	16	630
CEMAC	157	248	16	699
Sub-Saharan Africa	131	230	12	581
LMIC ³	98	214	6	576

Source: World Bank, *Doing Business* Database (2006).

¹Indicates ranking out of 175 countries (lower number = higher ranking).

²Percent of value.

³Lower-middle-income countries.

Iacovos Ioannou and Raju Singh
IMF African Department

Austria: Managing the eastward expansion of its banks

Austria's economy is doing well, and one of the building blocks of its economic success is the banking sector, which has been expanding rapidly in central, eastern, and southeastern Europe (CESE). This process has been highly profitable and has helped financial deepening in the region. It is, however, not without risk. Therefore, it needs to be accompanied by a strong focus on risk management by the banks and effective cross-border cooperation between supervisors in Austria and CESE.

Economic growth in Austria has consistently exceeded that in the euro area in recent years, and unemployment has declined. A number of factors help explain Austria's success. The government's macroeconomic policies have ensured stability, structural reforms have improved the functioning of the economy, and a social partnership has helped keep wages in check. In addition, Austria's private sector has sought out new business opportunities in fast-growing markets located in CESE. Austria's growing relations with the countries in this region are based not only on increased trade and investment but also on stronger financial ties, made possible by the expansion of Austrian banks.

A bit of history

Driven by geographical proximity, historical ties, and a saturated domestic market, Austrian banks were among the first to enter the new markets in central and eastern Europe in the early 1990s. During 2003–05, they gained market share in almost all of the CESE countries (see Chart 1). Today, they are active in virtually all countries in the region.

Even though Austrian banks are not large by international standards, their subsidiaries are large in relation to the size of the economies in CESE. These subsidiaries have also become important to Austria's own banking system because they constitute a significant share of the banks' total assets and generate a large portion of the profits. Austria's exposure to the CESE countries is far larger (relative to GDP) than that of its European peers (see Chart 2). In 2005, the total assets of the five largest Austrian banks in CESE amounted to about 16 percent of total assets—mostly in the form of majority-owned subsidiaries—and Austrian banks derived some 35 percent of their pretax profits from the region.

The profitability of the operations in CESE is driven by rapid credit growth. To a large extent, this reflects the financial market development and deepening that is to be expected in countries that are catching up with western Europe. But the high growth rate of private sector credit has made it more difficult to assess credit risk. It has also, in cases, contributed to macroeconomic imbalances in the form of large current account deficits.

Profitable, but not without risk

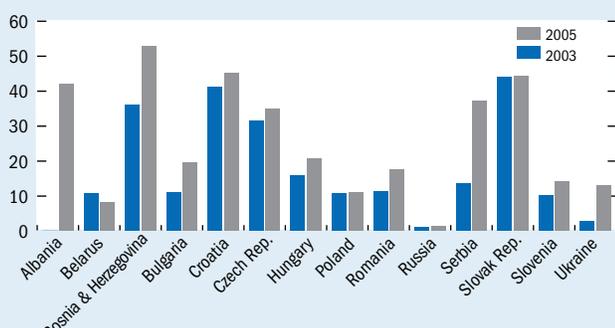
So far, the rapid credit growth in the CESE countries has been good for business because the strong demand for credit has enabled the banks to lend at relatively large margins. But the operating margins may come under strain in the next few years as financial markets there develop further, and credit growth may start to slow. Moreover, the development of financial markets may affect profits more directly by increasing competition, thereby narrowing margins. In fact, some of these factors are

Chart 1

Looking east

Austrian banks have established an important presence in CESE in recent years.

(market shares of Austrian-owned bank subsidiaries, percent)



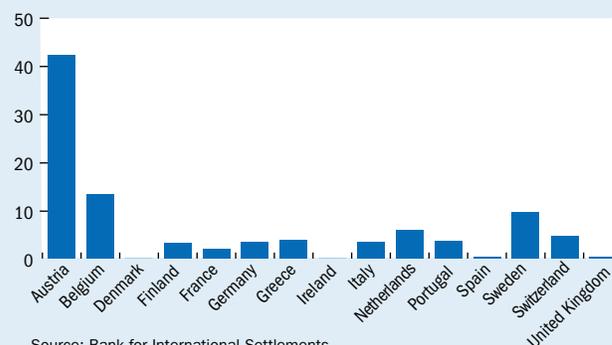
Source: BankScope.

Chart 2

Greater exposure

Austria has a far greater relative exposure to CESE than do other European countries.

(consolidated foreign exposure, percent of GDP)



Source: Bank for International Settlements.

already resulting in a downward trend for the interest rate margins of banks operating in CESE countries (see Chart 3).

Operations in CESE countries entail a number of other risks as well. Various countries in the region exhibit macroeconomic imbalances. Although such imbalances reflect, to a certain extent, the catch-up process with living standards in western Europe, they are considerable in some cases, and there is a risk that they could have a negative impact on investor sentiment. Banks operating in the region also have to cope with significant exchange rate volatility, and they are finding it difficult to enforce proper credit risk standards in an environment with rapid credit growth, partial or nonexistent credit histories, legal risks, and limited experience in credit screening. Good credit assessment skills and effective internal controls and corporate governance structures are essential to effective risk management.

Lending in foreign exchange to households adds to the banks' risks. This practice is prevalent in both Austria and the CESE countries. Domestically, foreign exchange credit—denominated mostly in Swiss francs—is monitored, and Austrian supervisors do their best to educate consumers about the risks of borrowing in foreign currency. But in the CESE countries, monitoring of foreign exchange credits is less well developed, and consumers are presumably less aware of the risks involved. Although banks generally apply prudent lending standards to foreign exchange credits, large exchange rate movements may result in the foreign exchange risks of households translating into credit risks for the banks.

What supervisors should do

The challenges for Austria's banking supervisors are closely related to the challenges faced by the banks themselves. First, the rapidly expanding activities of the financial sector require

close monitoring, and supervisors need to ensure that the banks use adequate risk management and measurement techniques. The banks should pay special attention to the issue of intragroup risk and capital transfers and should also assess the macroprudential risks associated with the macroeconomic imbalances in some CESE countries. This requires, among other things, regular stress testing of the systems.

Second, close collaboration between Austria's supervisors and those of the host countries will be key to effective supervision of cross-border banking groups. The enlargement of the European Union (EU) has facilitated cross-border supervisory cooperation with the new member states, including through the signing of memoranda of understanding (MoUs) between home and host supervisors, which facilitate the exchange of information and cooperation. Such cooperation will need to intensify, and cross-border supervisory cooperation with non-EU member states in which the Austrian financial sector has a significant market share should be deepened.

Austria's supervisory authorities have already devoted considerable attention to risk management and home-host supervisory issues. They have stepped up their on-site inspections and intensified off-site examinations of systemically important banks. They have also signed a large number of MoUs on supervisory cooperation and are involved in a dialogue with foreign supervisors with whom no MoUs have yet been signed. They are increasingly involving their foreign peers in risk assessments and are performing some joint inspections of the cross-border activities of Austrian banks, and they are taking steps to further strengthen corporate governance in the banking sector.

The bottom line

Austrian banks' exposure to CESE countries is large and keeps increasing. Austrian banks now own a major part of the domestic banking system in many countries in the region and derive a large share of their profits from those countries. Banks' risk measurement and management must keep pace with their international expansion, including with regard to the special risks involved in lending in foreign exchange. The Austrian supervisors are aware of the need to ensure that banks use adequate risk control techniques and are already cooperating closely with their counterparts in the CESE countries. Further cooperation will be essential to ensure the effective supervision of cross-border banking groups. ■

Paul Hilbers

IMF European Department

Alexander Tieman

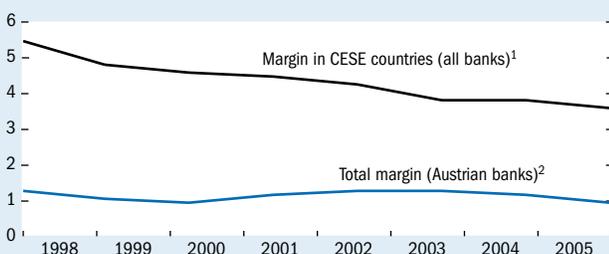
IMF Monetary and Capital Markets Department

Chart 3

Competition is heating up

Banks' interest rate margins are trending down, reflecting stronger competitive pressures.

(net interest income divided by total assets, percent)



Sources: BankScope; and OECD.

¹Margin for all banks in the countries concerned, calculated as a simple average over countries.

²Margin for all Austrian banks on a consolidated basis.

This article is based on Country Report No. 07/143, "Austria: Selected Issues." Copies are available for \$18.00 each from IMF Publication Services. Please see page 160 for ordering details. The full text is also available on the IMF's website (www.imf.org).

Countries take stock of financial soundness exercise

In the aftermath of the financial crises of the late 1990s in Asia, Latin America, and Russia, it became clear that the traditional supervisory focus on the soundness of individual banks needed to be expanded to include the health of a nation's entire financial system and the global system as well.

But there was a paucity of data available to enable authorities to do that. "Even when such data were available, it was unclear what their compilation methodology was, and whether they were optimally constructed for identifying the vulnerabilities of the entire financial sector. Few countries made such data available to markets, and cross-country comparability was unfathomable," Rob Edwards, Director of the IMF's Statistics Department, last month told a conference of countries that have joined with the IMF in a pilot project to begin to fill that void.

Assessing the effort

The conference at the IMF on May 30–31 was held to assess a nearly seven-year effort to construct a framework for, compile, and publish a set of standardized statistics, now called the financial soundness indicators (FSIs), to measure the current strengths and weaknesses of a country's banking system and to allow analysts and authorities to compare it with banking systems in other countries.

The effort first had to settle on what data to collect—and ended up creating a framework that drew on commercial accounting, supervisory, and macroeconomic statistics concepts. There are 12 core indicators that relate to the soundness of banking systems: they measure capital adequacy, asset quality, earnings and profitability, liquidity, and sensitivity to market risk. "Encouraged" FSIs provide additional information on banks as well as nonbank financial institutions (such as pension funds and insurance companies), the nonfinancial economy (corporations and households), the real estate market, and the securities markets.

The question then became whether those FSIs could be produced in a useful and timely way. To find out, 62 countries participated over the past three years in that pilot effort—called the Coordinated Compilation Exercise (CCE)—to col-

lect, compile, and publish financial soundness indicators for December 2005, using the *Compilation Guide* produced by the IMF. Last January, countries began to post those end-2005 financial soundness indicators on the IMF website, www.imf.org. As of May 31, 57 of the 62 countries had done so.

Because of the inevitability that country data would not always be comparable—for legal, regulatory, collection, or cost reasons—countries are also required to produce meta-data (information that describes the underlying data) to enable users to understand and account for differences in

country statistics. For example, one nation's definition of nonperforming bank loans might differ from another's, and this difference has to be taken into consideration in cross-country or systemic analyses.

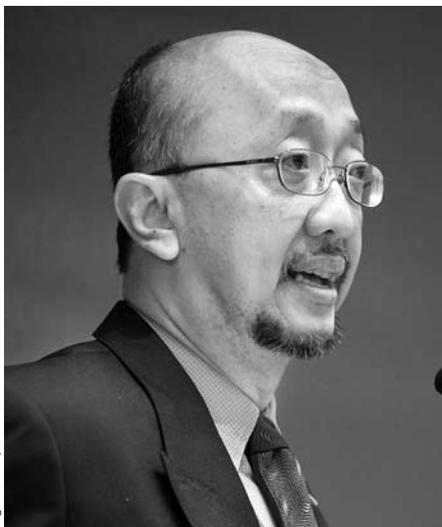
What was the verdict?

The conference participants concluded that the CCE was on the right track and that the effort should continue. Countries have invested heavily in developing and disseminating FSIs and, for the most part, the benefits have outweighed the costs, many delegates said. "It would be a shame if it was stopped at this point," said Stefan Brunken of Germany's Bundesbank. "FSIs should become a standing body of international financial statistics," said Walid Alameddine, chair of

Lebanon's Banking Control Commission, which produced all the core indicators and the encouraged banking indicators despite the turbulence in that country. In fact, during a 90-minute general discussion of the merits of the exercise and the underlying FSIs, not one delegate suggested the FSI project should be terminated.

There also seemed to be a widespread consensus that more countries should join the collection and dissemination process and that the IMF should remain at its center. The Fund "is a better place to look at peer groups," said Pat O'Connor of the Bank of England. It can assess the variations within and among the peer groups that provide early warning signals of banking system problems and systemic risks to global financial soundness.

But conflicts are often in the particulars, and there was far less unanimity when it came to many of the details of



Eugene Salazar/IMF

Nugroho Santoso of Bank Indonesia recounted the difficulty of collecting nonbank data.

data collection and dissemination—issues that the IMF will deal with in the coming weeks as it prepares a report for the Fund’s Executive Board, said Alfredo Leone, Deputy Director of the IMF’s Statistics Department. Those differences ranged from whether to increase the number of core and encouraged indicators, to the relative importance of producing statistics geared for international comparability versus statistics tailored to national circumstances, and how often the data should be collected and published. There were numerous technical critiques of individual indicators and methods of compilation.

On the question of adding to the list of FSIs, there was division among the delegates. Many said that the soundness of some important financial subsectors—such as insurance, pension funds, securities dealers, investment funds, and finance and leasing companies—was not being assessed properly by existing FSIs, making it difficult to draw an accurate picture of the financial system as a whole. But other delegates worried that even though there are gaps in the current list of FSIs, adding new ones at this point would be counterproductive because there is so much work to do on implementing existing indicators.

Hard to compile

For many countries, even compiling the already encouraged nonbank indicators has been difficult. For example, Nugroho Santoso of Bank Indonesia, in a formal presentation on his country’s experience in the CCE, said that for the time being Indonesia compiles FSIs only for the banking (deposit-taking) sector because of the lack of data for nonbank sources. Several other countries—among them Brazil, India, and Turkey—also cited constraints on collecting nonbank data. There was also debate over the existing FSIs aimed at deposit-taking institutions, and several delegates called for careful consideration of the appropriate FSIs to include in the list, with a number of delegates making concrete proposals for new indicators.

As for how often the data should be collected and published, a number of delegates were emphatic that it should be done quarterly, with no more than a three-month lag between collection and dissemination. Mustafa Yuksel, of Australia, said that less frequent collection would make the data “meaningless” for comparison and surveillance. That position was

echoed by Eddy Azoulay of the Bank of Israel, who said “the most important thing is comparability.” Francis Selialia of the South African Reserve Bank said that it “seemed fair to submit on a quarterly basis.” But several other countries said it would be difficult to gather some or all of the data more frequently than every six months.

Harmonizing with international standards

Despite their general enthusiasm for FSIs, though, some delegates warned that national authorities and colleagues in other collaborating agencies in their countries would have to be persuaded of the value of continuing to devote resources to the compilation of the data. Gabriel Jiménez

Romero of the Comisión Nacional Bancaria y de Valores of Mexico pointed to the “complex web of supervisory functions” involved in the collection effort. Cornelio Farias Pimentel, of Banco Central do Brasil, said it is important that the effort get the support “of not just the central bank, but other authorities too.”

Mariela Iturriaga of Banco Central de Chile said the IMF could also help ensure that countries continue to participate by requiring the use of FSIs in such Fund activities as the annual Article IV country surveillance reports. The IMF’s Monetary and Capital Markets Department, which has collaborated with the Statistics Department on FSI development, has begun to use the indicators in its global financial surveillance efforts.

The delegates also debated whether the methodology of compilation

should be modified to conform even more closely to evolving international supervisory and accounting standards. Many country representatives said the methodology in the IMF’s *Compilation Guide* should defer to those standards because of data availability issues, costs of data collection, and analytical considerations. Cristina Luna of Banco de España, for example, said the FSI effort was started “at a time when accounting and solvency rules were changing.” To make “FSIs comparable over time and across countries, we need to integrate the different tasks and techniques related to the areas of accounting, solvency, and financial accounts,” she said. ■



Eugene Salazar/IMF

Cristina Luna of Banco de España called for increased harmonization of FSIs and international accounting and supervisory standards.

James L. Rowe
IMF Survey Magazine

Shifting roles in financial globalization

The changes brought about by financial globalization in cross-border capital flows, financial institutions, and financial markets have been mainly positive, according to Jaime Caruana, Director of the IMF's Monetary and Capital Markets Department. But these opportunities are not without risks, he told the Heinrich Böll Foundation and the Association of German Banks in Berlin on May 30. All participants in the financial system—households, financial institutions, regulators, and the IMF—have roles and responsibilities to ensure that threats to the system from globalization are minimized and benefits widely shared.

Households, in the main, have benefited from increased access to credit at lower cost and more investment options, but they are increasingly exposed to market risks that had been borne by companies or governments. Responsibilities for retirement, health care, higher education, and long-term old-age care are being shifted back to households in many countries. But households often lack the basic knowledge and skills they need to make wise investment and financial decisions.

Caruana said that governments, regulators, and the private sector all have a role to play to help increase the financial literacy of households, which in turn should provide incentives for the financial industry to be competitive. Governments should offer financial education in schools and make counseling available to low-income groups. The private sector should understand their customers and provide appropriate products as providers and good-value savings plans as employers. Regulators can promote transparent products that are appropriate for all investors, Caruana said.

Financial institutions can contribute to financial stability by “increasing the soundness of their risk management systems to match the growing complexity of domestic and international finan-

cial markets, to help ensure that their actions do not have a negative impact on other participants in global financial markets.” In turn, Caruana said, financial market participants “have a responsibility to impose greater market discipline on financial institutions by rewarding those that have better risk management systems and disclosure practices, and punishing those where such systems are weak.” To achieve that discipline will require meaningful disclosure without overburdening financial institutions.

National authorities and regulators have two sets of responsibilities, he said. “First, they need to have in place a risk-based regulatory and supervisory framework that ensures the key financial institutions in their jurisdiction are well managed, with adequate capital buffers and risk management systems in place.”

They also must ensure that the information they require from and provide about regulated institutions “is sufficient for market discipline to be effective.” To ensure financial stability, two key elements are essential: greater cooperation among supervisors, and good transparency and dialogue with the private sector. National authorities and regulators also have to be prepared for crises, and consider the potential international impact of their policies. That is especially true in Europe, Caruana said, because of the increasing integration of financial markets and growing cross-border banking there. But, because of the common framework of regulation in Europe, the continent can also be ambitious and set an example of “good practices for coordination and cooperation for other countries and regions in the world.”

The IMF has a responsibility to monitor global financial stability and threats to it, as well as to advise its 185 member countries—nearly all of the world’s nations—on good economic policies and provide technical assistance and cooperation to help them develop markets and infrastructure to cope with the challenges of globalization. ■



The IMF's Jaime Caruana said all players have roles in the globalized financial world.

Eugene Salazar/IMF



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