

# IMFSURVEY

International  
Monetary Fund  
VOLUME 33  
NUMBER 12  
JUNE 28, 2004

[www.imf.org/imfsurvey](http://www.imf.org/imfsurvey)

*Asia trip*

## De Rato underscores Japan's and China's key economic roles

IMF Managing Director Rodrigo de Rato wrapped up the first half of his trip to Asia after meeting with Japanese and Chinese leaders to seek their views on national and international matters. In Tokyo on June 22, he expressed optimism that Japan is “witnessing the end of a long economic crisis” and appears on track to record growth in the realm of 4½ percent for 2004. In Beijing on June 24, he lauded China’s tremendous progress “in securing a higher standard of living for its people and in reducing poverty” and indicated that the IMF stands ready to assist China in its reforms in any way possible—“including in further strengthening the financial sector.” De Rato will conclude his visit to Asia with consultations with leaders in Singapore and Vietnam.



In Tokyo, IMF Managing Director Rodrigo de Rato meets with Japanese Finance Minister Sadakazu Tanigaki.

After discussions with Japanese Prime Minister Junichiro Koizumi, Finance Minister Sadakazu Tanigaki, and Bank *(Please turn to the following page)*

*Bretton Woods institutions in 21st century*

## How can the IMF uphold its role as guardian of the global financial system?

The 60th anniversary of the Bretton Woods institutions has stimulated debate on the IMF’s future as well as its evolution to date. In a June 10 symposium on the IMF and the World Bank in the 21st cen-

ture, sponsored by the Bretton Woods Committee, Timothy Geithner (president of the U.S. Federal Reserve Bank of New York and former Director of the IMF’s Policy Development and Review Department) and William Rhodes (Chair of Citibank) offered advice on how the IMF could adapt to a changing global economy and ensure that it remains a relevant and effective institution for its membership.

As the IMF looks ahead in this new century, one of its most pressing challenges, Timothy Geithner said, will be helping emerging market economies reduce their vulnerability to financial crises. Over the past decade, emerging market economies have made progress toward this goal, reflecting the increased sophistication and skill of their economic policymakers. Many of them have, on average, increased international reserves (providing a larger financial cushion); improved fiscal *(Please turn to page 183)*



Geithner (left): The IMF “probably needs to raise the bar to increase the level of ambition of its policy recommendations.”

In this issue

181  
De Rato begins  
Asia visit

181  
Bretton Woods  
institutions  
in 21st century

186  
De Rato on  
IMF at 60

187  
Ahluwalia  
congratulated  
on new post

188  
Fiscal adjustment  
in IMF-supported  
programs

192  
Gulf states tackle  
labor market strains

194  
Caribbean faces up  
to globalization

196  
G8 agree on more  
support for HIPC  
Initiative

and...

184  
Recent publications

186  
Selected IMF rates

190  
IMF arrangements

191  
New on the web

## De Rato praises Japanese reform efforts

(Continued from front page) of Japan Deputy Governor Toshiro Muto, de Rato stressed that “the recovery has picked up pace and is broadening, and deflationary pressures are lessening.”

The improved situation partly reflects a stronger global economy, but it also “owes much to steady policy efforts at home,” de Rato said. Speaking with reporters at the Japan National Press Club in Tokyo, he commended the reforms implemented under Prime Minister Koizumi’s government, saying that they have benefited not only Japan’s economy but also Asia and the world. The IMF is convinced, that with “the continuation of the reform agenda of the Prime Minister, and with the current stance of the Bank of Japan, things could be even brighter in the near future.”

### No time for complacency

De Rato also explained, though, that while the current situation gives considerable reason for optimism, “important challenges remain, and reforms, including to stabilize the public debt and further strengthen the financial system, will be needed to ensure a strong and durable expansion.” Reiterating the message that the IMF staff team conveyed to the authorities during the Article IV consultation in May, he encouraged Japan to take advantage of the current favorable global economic climate to pursue further reforms, not just by tackling remaining corporate and financial sector weaknesses and ending deflation but also by undertaking medium-term fiscal consolidation and wide-ranging structural reforms to boost Japan’s long-term growth prospects.

Economic upswings, such as the current one, de Rato told reporters, offer “a very good moment” for all economies to pursue reforms that will, over the longer term, pay off in terms of sustained growth. Asked specifically about the sustainability of U.S. trade and current account deficits, he said that the IMF, the U.S. monetary authorities, and the U.S. Treasury are in accord on the need for an increase in domestic savings, essentially through a reduction of the public deficit. Indeed, countries with aging populations and those seeking to attract foreign capital should be giving a lot of attention to the issue of public debt, he noted.

As for the potential for a disorderly correction in the value of the U.S. dollar, de Rato said that while volatile movements cannot be ruled out, there is now a “much more calm” situation. But here, too, the moment to begin to redress imbalances is now. If not done, he suggested, those imbalances “will come back to us in a higher degree of volatility.”

### IMF view on regional integration

Turning to the push for greater regional integration in Asia, including a possible regional monetary fund, de Rato assured the press that not only is the IMF following such developments in Asia and elsewhere with interest, but it is also taking “an active role as much as we can.” The IMF remains convinced, he said, that there is, more than ever, a need for an international institution to guarantee global financial stability, but it sees no contradiction between the IMF’s international role and regional initiatives such as the Chiang Mai arrangement on currency swaps.

Regarding the prospects for Asian currency integration, de Rato noted that the European Union’s experience testifies to the fact that monetary unions are possible and are successful. But they do entail certain prerequisites in terms of economic and market integration, and they do require political commitment. Currencies are not only economic instruments, he noted, they are also political instruments.

### China seeks soft landing

From Japan, de Rato traveled to Beijing, where he met with Premier Wen Jiabao, People’s Bank of China Governor Zhou Xiaochuan, Finance Minister Jin Renqing, and Liu Mingkang, Chair of the Bank Regulatory Commission. The discussions were wide ranging, with considerable emphasis on the current state of the Chinese economy and the authorities’ recent efforts to slow growth to a sustainable level by addressing overinvestment.

De Rato also discussed the exchange rate question and was pleased to hear the authorities reiterate their view that greater exchange rate flexibility is a desired goal for China. The IMF has believed for some time that this policy would be in China’s best interest, as it would provide more room for the country to pursue an independent monetary policy and facilitate adjustment to structural changes. There was also an exchange of views on the Chinese government’s efforts to maintain the stability of the country’s financial system through banking reforms. De Rato restated the IMF’s longstanding commitment to assist that reform effort in any possible way, including with technical assistance. ■

Important challenges remain, and reforms, including to stabilize the public debt and further strengthen the financial system, will be needed to ensure a strong and durable expansion.

—Rodrigo de Rato

Rodrigo de Rato’s statements at the conclusion of his visits to Japan and China, as well as the transcript of his remarks at the Japan National Press Club, are available on the IMF’s website ([www.imf.org](http://www.imf.org)).

## Geithner on bolstering IMF effectiveness

(Continued from front page) performance; reduced external balances; shifted from fixed but adjustable pegs to more flexible exchange rate regimes; and lowered inflation.

Still, the emerging market countries are not out of the woods yet, according to Geithner. “These aggregate improvements,” he said, “mask substantial differences across countries and . . . areas of lingering vulnerability.” For example, a number of countries face very high and, often, still growing public sector debts. The challenge of managing such large debt burdens is exacerbated by the structure of this debt. With a substantial share of the debt denominated in foreign currencies and carrying short maturities, these countries are vulnerable to foreign currency, liquidity, and interest rate risk. In some countries, Geithner added, large public sector debts have left banking systems highly exposed to the state, constraining governments’ room for maneuver. Recent improvements in external positions could also be reversed as domestic demand strengthens. In addition to the risk of crises, he said, large debts could depress domestic investment and long-term growth.

The IMF can help these countries become more stable financially, Geithner said, “by promoting an unwinding of these large balance sheet risks and, at the same time, providing a credible form of contingent insurance for those hopefully rare circumstances when its members face extraordinary financing needs.” But the IMF would be better able to help, he said, if it took steps to strengthen its own policy advice, surveillance, framework for sovereign debt restructuring, and financing instruments.

### Policy advice

Geithner noted that studies by IMF staff and the Independent Evaluation Office, among others, have criticized the IMF’s reform prescriptions as insufficiently ambitious and as deferring too much to members’ domestic political constraints on adjustment and reform. One result, he said, is that members have run exchange rate regimes incompatible with the rest of the policy framework. Another criticism is that the IMF has not been effective in addressing increases in debt that have created balance sheet problems and made emerging market country crises so damaging and difficult to resolve. The studies also found the IMF overly accommodative of members’ unrealistic policy decisions.

Although Geithner characterized the criticisms as unfair in the degree of influence they expect the IMF to exert over a member country, he acknowledged

that they have substantial merit. Thus, he said, the IMF “probably needs to raise the bar to increase the level of ambition of its policy recommendations.” It should not acquiesce to and validate policies that fall substantially short of what is required in the prevailing environment. As a remedy, Geithner proposed a risk-based framework for determining the hierarchy of policy priorities. Under such a framework, there would be a sharper focus on unwinding balance sheet problems, reducing sovereign debt to more sustainable levels, increasing buffers against liquidity problems, and preserving appropriate exchange rate arrangements. Addressing these issues, he said, would help reduce the risk of future capital account crises and improve the conditions for private sector growth.

### Surveillance framework

Another area that could stand strengthening is the IMF’s existing surveillance framework, through which it delivers policy advice to its members. In its current form, Geithner observed, it is not well suited to small open emerging market economies with fragile credibility, limited buffers against shocks, and considerable exposure to a rapidly changing economic and financial environment. He also argued for more frequent and candid assessments of member economies. Now, they occur only every 12–24 months and are published only with the members’ agreement. This arrangement “tends to take the edge off the diagnoses and the prescriptions.” Furthermore, the assessments represent the judgments of the IMF’s Executive Board and not the staff, so that risks are not clearly and candidly identified and explored. Finally, he noted, there are no consequences for members because critical evaluations can be withheld from the public.

The IMF has considered a number of ways of strengthening surveillance, Geithner noted. One of the most promising entails more frequent publication of staff assessments of members’ performance against a medium-term framework that each member country would design. These assessments would then measure the progress countries are making in reducing vulnerabilities, improving resilience, and strengthening the structural underpinnings of growth. Geithner also argued that such a framework should be combined with contingent access to IMF resources. Currently, surveillance does not provide a meaningful check on members’ policies before they are adopted, even though good policies



Geithner: Providing access to supplemental resources on a precautionary or contingent basis could help prevent short-term liquidity crises from becoming full-blown solvency problems that lead to default.



Rhodes exhorted the IMF to keep two things constant: its support of meaningful reforms and its role as a catalyst for private sector finance.

are a country's best defense against crises. Moreover, the IMF makes resources available only when the financing need is acute.

Providing access to supplemental resources on a precautionary or contingent basis could help prevent short-term liquidity crises from becoming full-blown solvency problems that lead to default. "With an enhanced surveillance framework designed to help keep policy on a stronger path that does reduce risk over time, and with contingent finance that could be mobilized quickly," Geithner argued, "the IMF would be better positioned to contain the risk of deeper financial crisis."

**Framework for sovereign restructuring**

In the past few years, some progress has been made in improving the framework for restructuring sovereign debt. Geithner noted, in particular, that collective action clauses have become the market standard for emerging market governments issuing debt under foreign law.

Geithner laid out his view of how the international community could credibly approach situations in which a country must restructure its obligations to private creditors. He proposed two conditions for the IMF to lend to a country in default.

First, the country should commit to a credible medium-term adjustment program that offers the prospect of a successful restructuring and a reasonable early return to the capital markets. The coun-

try must determine its own adjustment path, which must be endorsed by the IMF.

And, second, the country should develop, in consultation with its advisors, a credible and monitorable framework for a viable debt restructuring that leaves it with a sustainable debt burden. This framework should be outlined to the IMF and accepted by the country's creditors. It would also need to be consistent with the country's macroeconomic framework and repayment prospects.

Reaffirming these conditions as the foundation for IMF support in restructuring countries' arrears, Geithner said, would improve the system and better prepare the IMF to contribute to the favorable resolution of future crises that involve restructurings.

**Financing instruments**

Finally, Geithner suggested some changes that would make the IMF's financing instruments more effective in dealing with the challenges inherent in an increasingly integrated global economy. The reforms of the 1990s (including the increase in the financial size of the IMF, new facilities, and greater flexibility in the phasing of resources) were important, he said, as have been more recent IMF reforms designed to prevent the institution from making large-scale disbursements available without assurances that they would contribute to the resolution of a crisis.

Geithner proposed building on this recent progress by adding elements of a credible insurance mechanism to the IMF's facilities. What would be needed?

**Recent publications**

**IMF Working Papers (\$15.00)**

- 04/84: "Does Financial Globalization Induce Better Macroeconomic Policies?" Irina Tytell, Shang-Jin Wei
- 04/85: "Interest Rate Defenses of Currency Pegs," Juan Sole
- 04/86: "Japan's Distressed Debt Market," Kazunari Ohashi and Manmohan Singh
- 04/87: "Revisions Policy for Official Statistics: A Matter of Governance," Carol S. Carson, Sarmad Khawaja, and Thomas K. Morrison
- 04/88: "Productivity Shocks, Learning, and Open Economy Dynamics," Roland E. Daumont
- 04/89: "Does Regulatory Governance Matter for Financial System Stability? An Empirical Analysis," Udaibir S. Das; Marc G. Quintyn, and Kina Chenard
- 04/90: "Forecasting Thailand's Core Inflation," Tao Sun
- 04/91: "Capital Income Taxation and Economic Growth in Open Economies," Geremia Palomba
- 04/92: "A Cointegration Model for Search Equilibrium Wage Formation," Lourens Broersma, Frank A.G. den Butter, and Udo Kock

- 04/93: "Debt Accumulation in the CIS-7 Countries: Bad Luck, Bad Policies, or Bad Advice," Thomas F. Helbling, Ashoka Mody, and Ratna Sahay

**IMF Country Reports (\$15.00)**  
(Country name represents an Article IV consultation)

- 04/92: British Virgin Islands—Overseas Territory of the United Kingdom: Assessment of the Supervision and Regulation of the Financial Sector, Volume I—Review of Financial Sector Regulation and Supervision
- 04/93: British Virgin Islands—Overseas Territory of the United Kingdom: Assessment of the Supervision and Regulation of the Financial Sector, Volume II—Detailed Assessment of Observance of Standards and Codes
- 04/94: Norway
- 04/95: Burkina Faso: First Review Under the Three-Year Arrangement Under the PRGF, and Request for Waiver of Performance Criterion
- 04/96: India: Report on Observance of Standards and Codes—Data Module

First, before receiving IMF resources, a country's policy framework should be strong enough to restore confidence. Second, to help catalyze other resources, the IMF must calibrate the scale of the resources it provides to the country's need. Third, the IMF must build in the flexibility to structure programs appropriate to a country's circumstances and policy efforts. (For example, the IMF should be able to front-load financial packages when that would be warranted.) Fourth, the IMF should be prepared to support countries in pursuing reasonable restructuring proposals when circumstances warrant. And, fifth, the IMF should take steps to avoid either the reality or the perception that it can be induced to accept weak programs to allow a country to refinance its exposure.

These are modest proposals, Geithner said, and would not fundamentally alter the balance established by the IMF's Articles of Agreement between the rights and the obligations of its member countries. These changes would, however, help the IMF deal with future financial pressure in emerging market countries. "And, given the scale of the economic costs imposed by recent crises, that is an important goal."

### View from the private sector

Speaking from the perspective of a large international banking concern, William Rhodes noted the IMF's evolution over the past 60 years and exhorted it to keep two things constant: its support of meaningful reforms that meet the organization's high standards and its role as a catalyst for private sector finance,

which ensures that countries have access to the resources they need to grow. Experience has proved, he said, that the right mix of policy and official financing can restore investor confidence and catalyze private finance even in the most severe crises.

What should the IMF keep in mind as it looks to the future? Rhodes outlined five points that he would like to see the IMF take into account as it positions itself to uphold its key role as guardian of the international monetary system:

- Focus more on crisis prevention, including taking steps to strengthen Article IV consultations.
- Increase transparency. The IMF has made great progress but can do more.
- Work more closely with the private sector to have an informed market perspective. Rhodes pointed to the Capital Markets Consultative Group as a step in the right direction, adding that this initiative should be continued and even strengthened.
- Enhance credibility, which requires that the IMF carefully balance its roles of creditor and arbiter.
- Uphold its stated principles on a consistent basis. ■

Elisa Diehl  
IMF External Relations Department

For more information on the Bretton Woods Committee event on June 10—which also honored Paul Volcker, former U.S. Federal Reserve Board Chair, with its first Global Leadership Award—see [www.brettonwoods.org](http://www.brettonwoods.org).

04/97: Democratic Republic of the Congo: Third Review Under the Three-Year Arrangement Under the PRGF and Request for Waiver of Performance Criteria

04/98: Ukraine: Report on the Observance of Standards and Codes—Fiscal Transparency Module

04/99: Guinea

04/100: Guinea: Statistical Appendix

04/101: Belize: Selected Issues and Statistical Appendix

04/102: Belize

04/103: Singapore: Selected Issues

04/104: Singapore: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes

04/105: Singapore

04/106: Philippines: Report on the Observance of Standards and Codes—Banking Supervision

04/107: Democratic Republic of São Tomé and Príncipe: Statistical Appendix

04/108: Democratic Republic of São Tomé and Príncipe

04/109: Peru: Report on the Observance of Standards and Codes—Fiscal Transparency Module

04/110: Islamic State of Afghanistan: Staff-Monitored Program

04/111: Chad

04/112: Israel: Report on Observance of Standards and Codes—Fiscal Transparency Module

04/113: Romania: Ex Post Assessment of Longer-Term Program Engagement

Publications are available from IMF Publication Services, Box X2003, IMF, Washington, DC 20431 U.S.A.  
Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: [publications@imf.org](mailto:publications@imf.org).

For information on the IMF on the Internet—including the full texts of the English edition of the *IMF Survey*, the *IMF Survey's* annual *Supplement on the IMF, Finance & Development*, an updated *IMF Publications Catalog*, and daily SDR exchange rates of 45 currencies—please visit the IMF's website ([www.imf.org](http://www.imf.org)). The full texts of all Working Papers and Policy Discussion Papers are also available on the IMF's website.



The Bank of Spain in Madrid served as the conference venue.

### Bank of Spain–IMF conference

## Preparing the IMF for new challenges ahead

Even if a country is not itself at risk, it may be contributing to global imbalances and placing the rest of the world at risk.

—Rodrigo de Rato

IMF Managing Director Rodrigo de Rato said in a June 14 speech in Madrid that the IMF should look for new ways to encourage countries to heed its advice and that there is substantial room for improving the IMF’s surveillance of member countries’ economies. “In the area of surveillance, success cannot rely on early warning alone, it must also prompt early action,” he said at an event organized by Spain’s central bank and the IMF to mark the 60th anniversary of the Bretton Woods institutions.

IMF surveillance consists of confidential policy advice, coupled with peer pressure from other countries. “But peer pressure can also mean peer protection,” de Rato said. In a world increasingly defined by

financial globalization, it is no longer enough simply to focus on individual countries and their exposure to crisis. “Even if a country is not itself at risk, it may be contributing to global imbalances and placing the rest of the world at risk.” In this respect, he called on the United States to reduce its deficit and on Japan and Europe to promote economic growth by reforming their economies.

### Large loans may still be necessary

De Rato also responded to those who have criticized large loans to emerging market countries such as Korea, Brazil, and Turkey. “Some large IMF-supported programs raise concerns because they appear to suggest that a country’s geopolitical importance or other factors play a role in IMF loan decisions,” he said. But while such loans draw a lot of attention, “the IMF has also given major support to countries whose situation does not pose systemic risks or which may not rank high on the geopolitical agenda of our largest shareholders.”

The IMF’s lending decisions must reflect the principle of uniformity of treatment. And since no country is exactly like another, the IMF has developed financial arrangements that meet different needs. In most cases, the normal access limits that apply to IMF loans are sufficient, but in some rare cases, “exceptionally large access to IMF resources can be necessary to guard against risks to the global financial system,” de Rato said.

Large loans are made necessary by financial globalization, a process that should mostly be welcomed because it provides opportunities for private capital to finance investment in countries that can use the money

### Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
June 14	1.83	1.83	2.82
June 21	1.84	1.84	2.83

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members’ remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF’s financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website ([www.imf.org/cgi-shl/bur.pl?2004](http://www.imf.org/cgi-shl/bur.pl?2004)).

General information on IMF finances, including rates, may be accessed at [www.imf.org/external/fin.htm](http://www.imf.org/external/fin.htm).

Data: IMF Finance Department

productively. But according to de Rato, promised gains from financial globalization have yet to be fully realized. In fact, in many emerging market countries, capital flows have themselves been a source of volatility. This has created a new breed of shocks that are much harder to manage than the current account imbalances the IMF has traditionally dealt with.

Korea is one example of a country that required a substantial loan from the IMF to help it restore financial stability. The IMF's \$21 billion loan package to Korea in December 1997 was a very large loan by any standards, but it paid off: the country experienced strong economic growth by 1999 and even managed to repay the IMF ahead of schedule.

But while exceptional situations may require exceptional steps, "we also clearly need an IMF that can say 'no' selectively, perhaps more assertively, and, above all, more predictably," de Rato said. If countries knew that the IMF might decline to lend in some circumstances, they might adopt better policies in the first place. "To do this, we may have to think of ways of linking access to IMF resources more explicitly to a country's policy efforts before the crisis," de Rato said.

### Coordination is key

The IMF should also review its work in low-income countries. De Rato hoped that an upcoming report

by the IMF's Independent Evaluation Office on the Poverty Reduction and Growth Facility (the IMF's primary facility for lending to poor countries) and on Poverty Reduction Strategy Papers (which all poor countries receiving assistance from the IMF are required to submit) would help shed light on how the IMF can become more effective in its dealings with low-income countries.

The IMF should ensure better coordination with other international institutions such as the World Bank, various United Nations agencies, regional development banks, and the World Trade Organization, de Rato also said. This particular challenge is present in all the IMF's work, "but is especially important for our work in low-income countries, where we are only one partner among many in helping them achieve their longer-run development goals." ■

IMF Managing Director Rodrigo de Rato's speech, "The IMF at 60—Evolving Challenges, Evolving Role," was delivered on June 14 at a conference entitled "Dollars, Debts, and Deficits—60 Years After Bretton Woods," organized jointly by the Bank of Spain and the IMF. The full text of the speech is available on the IMF's website ([www.imf.org](http://www.imf.org)).

### De Rato congratulates Ahluwalia on new post

On June 21, IMF Managing Director Rodrigo de Rato congratulated Montek Singh Ahluwalia, the first director of the IMF's Independent Evaluation Office (IEO), on Ahluwalia's appointment as Deputy Chair of India's Planning Commission (a cabinet-level position). Ahluwalia, an Indian national with extensive experience in Indian government, had headed the IEO from July 2001. The office was created to conduct independent analyses of IMF policies and activities and, in so doing, strengthen the institution's learning process.

In setting out the IEO's first work program, Ahluwalia undertook extensive consultations, inside and outside the organization, which led to the selection of three initial topics for the IEO's review: fiscal adjustment in IMF-supported programs; the role of the IMF in three capital account crises (Indonesia, Korea, and Brazil); and the prolonged use of IMF resources. These studies, which were presented to the IMF's Executive Board in 2002-03, were subsequently released to the public and have contributed to a number of changes in IMF policies and procedures.

Under Ahluwalia's guidance, the IEO embarked on a second set of studies. Reports on these reviews are expected to be brought to the Executive Board this year. Topics include

a review of the IMF's Poverty Reduction and Growth Facility (the IMF's chief vehicle for providing concessional financing to low-income countries) and the joint IMF-World Bank Poverty Reduction Strategy Papers (which encourage country design and ownership of reforms and set a road map for development); the role of the IMF in Argentina from 1991 through 2002; and the IMF's technical assistance program.

In congratulating him, IMF Managing Director Rodrigo de Rato noted that Ahluwalia had served with distinction as the IEO's first director and that the IMF has benefited greatly from the IEO's well-researched and insightful reports on the organization's programs and policies. De Rato added that Ahluwalia's distinguished career in public service has been dedicated to the pursuit of sound economic policies. "As India continues on its path of economic reforms," he said, "it comes as no surprise to me that the authorities have once again turned to Mr. Ahluwalia for his services. He is dedicated and committed and will be missed at the IMF and the IEO."



## Are IMF-prescribed fiscal targets too tight?

One aspect of IMF operations that has traditionally drawn a great deal of attention is its fiscal policy advice to member countries. Is it, as some critics argue, too stringent, too inflexible? At a June 8 IMF Book Forum, Marcelo Selowsky (Assistant Director of the IMF's Independent Evaluation Office (IEO)), Allan Meltzer (Carnegie-Mellon University and American Enterprise Institute), and Nancy Birdsall (Center for Global Development) debated these questions.



Selowsky: "The IMF is not forceful enough in encouraging the authorities to collect from well-known taxpayers in arrears, particularly if they are powerful."

Does the IMF use a "cookie cutter" approach when it dispenses fiscal policy advice? Critics often characterize the IMF's fiscal policy advice as "one size fits all" and argue that its steady prescription of fiscal austerity curtails economic growth and social expenditures, and harms the poor in particular. Others suggest that its focus on reducing fiscal deficits introduces inefficiencies and inequalities and may not help countries achieve durable structural changes.

### Unwarranted criticism?

But how valid are these criticisms? A September 2003 report, *Fiscal Adjustment in IMF-Supported Programs*, by the IEO provides some answers. Selowsky, lead author of the report, explained that the IEO study found much more variation in the pattern of fiscal adjustment across programs than is generally assumed. Contrary to the general perception that IMF-supported programs invariably enforce austerity, for example, the study identified many instances in which fiscal deficits were actually projected to widen and expenditures to increase as a percentage of GDP. It also found no generalized evidence (other than in capital account crises) of a slowdown in growth during program years compared with precrises averages.

In certain areas, however, Selowsky noted a possible bias in program design. "We found that the IMF is extremely optimistic in projecting the recovery of private demand and growth, particularly when the country is going through a very rough period," he said. This optimism can lead to an understatement of the need for a more countercyclical fiscal stance and to a fiscal stance that is too tight. As private demand recovers less than projected, the end result may be a shortfall in total aggregate demand. Obviously, the fiscal stance should not depend solely on countercyclical considerations when the level of debt

is already too high, Selowsky explained. The problem is that all these considerations behind the fiscal stance are not well explained in program documents. There is no clear rationale for the magnitude and pace of the envisaged fiscal adjustment. In Selowsky's view, programs rely too much on value-added taxes and not enough on efforts to reduce evasion of customs, income, and corporate taxes. "The IMF is not forceful enough in encouraging the authorities to collect from well-known taxpayers in arrears, particularly if they are powerful."

Looking at the impact of fiscal adjustment on social sector expenditures—which are critical for the welfare of the poor—the study concluded that, on the whole, social spending was not lower than it would have been in the absence of an IMF program. In-depth country studies show, however, that even when aggregate social expenditures are maintained, those most relevant to the poor may be crowded out by, for example, government salaries.

The IEO report makes specific recommendations in these areas. Surveillance should set a clear roadmap of structural fiscal reforms and unbundle constraints to action. Surveillance and programs should mutually reinforce each other over time, with subsequent programs picking up reforms that require more time so as to ensure cumulative progress. Regarding social issues, the report urges the IMF to play a major role in encouraging countries to prepare programs and systems to protect the most vulnerable segments of society in case of budgetary retrenchments. Such measures cannot be put together at the last minute in the midst of a crisis. Governments should take the lead, which would also strengthen their program ownership, Selowsky said.

### Importance of politics

Both Meltzer and Birdsall praised the IEO's study as technically sound. It is, Meltzer observed, "comprehensive, careful, and balanced in its judgment." Birdsall applauded it for "responding to long-standing, sometimes misguided, exaggerated criticism of the way the IMF deals with fiscal reform issues." At the same time, however, she said "the report is willfully naive about the difficult politics of distribution and welfare, particularly in developing countries" where institutions are weak, checks and balances are missing, and sound economic institutions are not yet well developed.

What the IEO report does tell us, Meltzer pointed out, is that many countries miss their planned fiscal,



Meltzer: External developments clearly play a role, but political support represents the critical difference in whether reform targets are met.



economic growth, and structural reform targets. Why? Although external developments clearly play a role, he observed, political support represents the critical difference in whether these targets are achieved, adding that the report offers some explanation along these lines. It tells us, he said, that “insufficient progress in structural reform in the fiscal area is an important factor behind shortfalls in fiscal adjustment” and that “revenue from shortfalls seems to be associated with weak implementation.”

### Boosting program success

What changes are needed to make more programs succeed? In the report, the IMF’s Executive Directors point to the need for strong country ownership of the fiscal reform agenda and implementation process. Meltzer found this suggestion appropriate and desirable but added that “to be more successful in reforming fiscal and other policies in client countries, the IMF must reform itself.” The principal change must be “a shift away from current command-and-control procedures tied to dollops of money conditioned on the promise to make reforms.”

In Meltzer’s view, the IMF’s Executive Board lacks “curiosity about why programs do not succeed.” If Executive Directors were serious about wanting programs to succeed, he said, they would “shift to an incentive system where [IMF] payments are made for performance, not promises.” It is instructive, he noted, that Turkey took implementation far more seriously when it had the incentive of joining the European Union, and “India got its incentive from comparing the Hindu rate of growth to China’s vastly more successful program. Reforms that were previously politically impossible became distinctly possible.”

Taking his argument a step further, Meltzer asked why development occurs in some countries but not others. The answer is that institutions matter—a view that the current literature supports. Unless countries adopt supporting institutions, sustained development does not occur. Crisis resolution and crisis avoidance also depend on institutional reforms that require local leadership, sustained commitment, and the ability to maintain and support reform during the often costly adjustment period. The IMF, Meltzer said, “cannot bring a country to do what the citizens or their representatives do not want to do.” Birdsall agreed but added that if a country does not respond to incentives, “we can’t just throw up our hands” and walk away.

### Redefining the social contract

The IEO report expresses concern about countries’ ability to maintain social safety nets during periods of adjustment and distress but says little about the effect

of shifting the burden of adjustment up the income ladder, Meltzer said, adding that welfare decisions of this kind should be made locally, not in Washington. What incentive would the IMF have for reforming itself? It would be a way of telling its many vociferous critics, he observed, that the IMF provides incentives for reform and adjustment, and leaves these welfare and distributional decisions to the countries.

The report suggests that “the IMF could invite the authorities regularly during Article IV consultations to indicate which critical social programs and social services they would like to see protected in the event of adverse shocks.” The idea is basically for the country to take ownership and to work out the design and budgetary aspects of social programs with agencies that have expertise in this area, such as the World Bank and the World Health Organization, noted Selowsky.

Birdsall supported this recommendation, saying that inviting authorities to suggest which programs they would want to see protected is consistent with the IMF’s long-standing role in encouraging sound, medium-term fiscal programming, including fiscal restraint today to allow for countercyclical spending tomorrow. In her view, the IMF would, in implementing this recommendation, not only help countries protect fiscal adjustment from untoward political pressures but also rescue itself from the widespread perception—which is hampering its effectiveness—that its “mindless and callous support of fiscal discipline pushes spending reductions onto the poor.”

In the 21st century, Birdsall concluded, the IMF should be called upon to send the message more effectively that social policy involves more than increased spending on education and health care. The foundation of a good social contract in an open economy, she said, has to be fiscal discipline that will encourage lower interest rates, create jobs, minimize debt buildup, and allow for countercyclical spending to protect the poor. This will create the kind of political space on both the expenditure and tax fronts “that will ensure, in the long run, that the IMF is playing its worthy role in reducing poverty and inequality in the world.” ■

Christine Ebrahim-zadeh  
IMF External Relations Department

The full IEO report, *Fiscal Adjustment in IMF-Supported Programs*, is available at <http://www.imf.org/External/NP/ieo/2003/fis/pdf/main.pdf>. See also *IMF Survey*, September 8, 2003, page 262, for a discussion with Marcelo Selowsky about the study’s findings and recommendations.



Birdsall: The foundation of a good social contract has to be fiscal discipline that will encourage lower interest rates, create jobs, minimize debt buildup, and allow for countercyclical spending to protect the poor.

**Stand-By, EFF, and PRGF arrangements as of May 31**

<b>Member</b>	<b>Date of arrangement</b>	<b>Expiration date</b>	<b>Amount approved</b>	<b>Undrawn balance</b>
(million SDRs)				
<b>Stand-By</b>				
Argentina	September 20, 2003	September 19, 2006	8,981.00	4,810.00
Bolivia	April 2, 2003	June 15, 2004	85.75	21.43
Brazil	September 6, 2002	March 31, 2005	27,375.12	10,175.48
Colombia	January 15, 2003	January 14, 2005	1,548.00	1,548.00
Dominican Republic	August 29, 2003	August 28, 2005	437.80	306.46
Gabon	May 28, 2004	June 30, 2005	69.44	69.44
Jordan	July 3, 2002	July 2, 2004	85.28	74.62
Macedonia FYR	April 30, 2003	June 15, 2004	20.00	8.00
Paraguay	December 15, 2003	March 31, 2005	50.00	50.00
Turkey	February 4, 2002	February 3, 2005	12,821.20	1,360.80
Ukraine	March 29, 2004	March 28, 2005	411.60	411.60
Uruguay	April 1, 2002	March 31, 2005	2,128.30	559.20
<b>Total</b>			<b>54,013.49</b>	<b>19,395.03</b>
<b>EFF</b>				
Serbia and Montenegro	May 14, 2002	May 13, 2005	650.00	350.00
Sri Lanka	April 18, 2003	April 17, 2006	144.40	123.73
<b>Total</b>			<b>794.40</b>	<b>473.73</b>
<b>PRGF</b>				
Albania	June 21, 2002	June 20, 2005	28.00	12.00
Armenia	May 23, 2001	December 31, 2004	69.00	9.00
Azerbaijan	July 6, 2001	March 31, 2005	80.45	38.61
Bangladesh	June 20, 2003	June 19, 2006	347.00	248.00
Burkina Faso	June 11, 2003	June 10, 2006	24.08	17.20
Burundi	January 23, 2004	January 22, 2007	69.30	42.90
Cameroon	December 21, 2000	December 20, 2004	111.42	31.83
Cape Verde	April 10, 2002	April 9, 2005	8.64	3.72
Congo, Democratic Republic of	June 12, 2002	June 11, 2005	580.00	79.93
Côte d'Ivoire	March 29, 2002	March 28, 2005	292.68	234.14
Dominica	December 29, 2003	December 28, 2006	7.69	5.02
Ethiopia	March 22, 2001	July 31, 2004	100.28	10.43
Gambia, The	July 18, 2002	July 17, 2005	20.22	17.33
Ghana	May 9, 2003	May 8, 2006	184.50	131.80
Guyana	September 20, 2002	March 19, 2006	54.55	43.03
Honduras	February 27, 2004	February 26, 2007	71.20	61.03
Kenya	November 21, 2003	November 20, 2006	175.00	150.00
Kyrgyz Republic	December 6, 2001	December 5, 2004	73.40	19.12
Lao People's Democratic Republic	April 25, 2001	April 24, 2005	31.70	13.58
Lesotho	March 9, 2001	June 30, 2004	24.50	3.50
Madagascar	March 1, 2001	March 1, 2005	91.65	22.70
Malawi	December 21, 2000	December 20, 2004	45.11	32.23
Mauritania	July 18, 2003	July 17, 2006	6.44	5.52
Mongolia	September 28, 2001	July 31, 2005	28.49	16.28
Nepal	November 19, 2003	November 18, 2006	49.91	42.78
Nicaragua	December 13, 2002	December 12, 2005	97.50	55.71
Niger	December 22, 2000	June 30, 2004	59.20	8.44
Pakistan	December 6, 2001	December 5, 2004	1,033.70	344.56
Rwanda	August 12, 2002	August 11, 2005	4.00	2.86
Senegal	April 28, 2003	April 27, 2006	24.27	17.33
Sierra Leone	September 26, 2001	March 25, 2005	130.84	28.00
Sri Lanka	April 18, 2003	April 17, 2006	269.00	230.61
Tajikistan	December 11, 2002	December 10, 2005	65.00	39.20
Tanzania	August 16, 2003	August 15, 2006	19.60	14.00
Uganda	September 13, 2002	September 12, 2005	13.50	8.00
<b>Total</b>			<b>4,291.82</b>	<b>2,040.39</b>

Members drawing on the IMF "purchase" other members' currencies, or SDRs, with an equivalent amount of their own currency.

EFF = Extended Fund Facility.  
 PRGF = Poverty Reduction and Growth Facility.  
 Figures may not add to totals owing to rounding.  
 Data: IMF Finance Department

Available on the web ([www.imf.org](http://www.imf.org))

### Press Releases

- 04/105: IMF Executive Board Reviews Djibouti's Poverty Reduction Strategy, June 4
- 04/106: Statement by IMF Staff Mission to Malawi, June 4
- 04/107: IMF Approves \$144 Million PRGF Arrangement for Georgia, June 4
- 04/108: IMF Statement on the Conclusion of 2004 Article IV Consultation Discussions with Jamaica, June 4
- 04/109: IMF Completes Third Review and Approves \$147 Million Under Extended Arrangement with Serbia and Montenegro, June 7
- 04/110: IMF Managing Director Rato Names Jorge Márquez-Ruarte as Human Resources Director, June 7
- 04/111: The Democratic Republic of Congo Formally Begins Participation in the IMF's General Data Dissemination System, June 9
- 04/112: IMF Approves 26-Month \$422.8 Million Stand-By Arrangement for Peru, June 9
- 04/113: IMF Completes Third Review of Bolivia's Stand-By Arrangement, Approves \$16 Million Disbursement and Extension of Arrangement, June 10
- 04/114: IMF Completes Second and Third Reviews Under Rwanda's PRGF Arrangement, Approves \$1.68 Million Disbursement, and Grants Additional Interim Assistance of \$6.6 Million Under the Enhanced HIPC Initiative, June 10
- 04/115: IMF Deputy Managing Director Takatoshi Kato's Statement at a Seminar in Trinidad and Tobago, June 14
- 04/116: IMF Managing Director Rodrigo de Rato to Visit Japan, China, Singapore, and Vietnam, June 15
- 04/117: IMF Approves \$320.41 Million PRGF Arrangement for Zambia, June 16
- 04/118: IMF Executive Board Completes Seventh Review of Brazil's Stand-By Arrangement, June 18
- 04/119: Statement by IMF Managing Director on the Appointment of Montek Singh Ahluwalia, June 21 (see page 187)
- 04/120: IMF Approves in Principle \$16.6 Million PRGF Arrangement for Mozambique, June 21
- 04/121: IMF Managing Director Rodrigo de Rato's Statement at the Conclusion of His Visit to Japan, June 22 (see page 181)
- 04/122: IMF Staff Statement on the Discussions of the Eighth Review Under Turkey's Stand-By Arrangement, June 22
- 04/123: Statement by IMF 2004 Article IV Consultation Mission to the Islamic Republic of Iran, June 23
- 04/124: IMF Executive Board Completes Eighth Review Under Pakistan's PRGF-Supported Program and Approves Disbursement Amounting to \$253 Million, June 23
- 04/125: IMF Approves \$13.7 Million PRGF Arrangement for Mali, June 23
- 04/126: IMF Managing Director Rodrigo de Rato's Statement at the Conclusion of His Visit to the People's Republic of China, June 24 (see page 181)

### Public Information Notices

- 04/63: IMF Executive Board Approves the FY 2005 Administrative and Capital Budgets, June 16
- 04/64: IMF Concludes 2004 Article IV Consultation with Switzerland, June 18
- 04/65: IMF Concludes 2004 Article IV Consultation with Bulgaria, June 18

### Speeches

- "Economic Growth in a Shrinking World: The IMF and Globalization," Anne Krueger, IMF Acting Managing Director, Pacific Council on International Policy, San Diego, June 2
- "Opportunities for Emerging and Developing Countries in International Standard Setting: An IMF Perspective," Agustín Carstens, IMF Deputy Managing Director, Fourth Annual IMF–World Bank–Federal Reserve Seminar—"Basel II: The International Banking System at the Crossroads," Washington, D.C., June 2
- "Promoting International Financial Stability: The IMF at 60," Anne O. Krueger, IMF Acting Managing Director, UCSD Economic Roundtable, San Diego, June 3
- "Letting the Future In: India's Continuing Reform Agenda," Anne O. Krueger, IMF Acting Managing Director, Stanford India Conference, June 4
- "Anti-Money Laundering and Combating the Financing of Terrorism: The Challenges Ahead," Agustín Carstens, IMF Deputy Managing Director, IMF Seminar on Current Developments in Monetary and Financial Law, Washington, D.C., June 4
- Opening Remarks by Takatoshi Kato, IMF Deputy Managing Director, Seminar on Developmental Challenges Facing the Caribbean, Port of Spain, Trinidad, June 11
- "The Caribbean Economies: Adjusting to the Global Economy," Anoop Singh, Director, IMF Western Hemisphere Department, Seminar on Developmental Challenges Facing the Caribbean, Port of Spain, Trinidad, June 11
- "The Role of the IMF in the Caribbean," José Fajgenbaum, Deputy Director, IMF Western Hemisphere Department, Seminar on Developmental Challenges Facing the Caribbean, Port of Spain, Trinidad, June 12
- "The IMF at 60—Evolving Challenges, Evolving Role," Rodrigo de Rato y Figaredo, IMF Managing Director, Bank of Spain and IMF Conference on Dollars, Debts and Deficits—60 Years After Bretton Woods, Madrid, June 14

### Transcripts

- Press Briefings by Thomas C. Dawson, Director, IMF External Relations Department, May 13, May 27
- "Standards and Codes: Can They Prevent Financial Crises?" IMF Book Forum, May 27
- Press Briefings by Rodrigo de Rato, IMF Managing Director, June 9, June 22

PRGF=Poverty Reduction and Growth Facility

June 28, 2004

191

## Gulf states tackle labor market strains

**O**ver the past few decades, governments of the member countries of the Cooperation Council for the Arab States of the Gulf (GCC) have acted as employers of first and last resort. Nationals who sought jobs found them in the public sector, while foreign workers filled shortages in the private, non-oil sector. More recently, however, the number of young nationals entering the workforce has increasingly outstripped the economies' capacity to generate new jobs—a situation compounded by structural problems in the labor market. In a new IMF Working Paper, Ugo Fasano of the IMF's Middle East and Central Asia Department and Rishi Goyal of the IMF's Western Hemisphere Department examine how GCC governments can meet this challenge. Christine Ebrahim-zadeh of the IMF Survey spoke with them.

**IMF SURVEY:** How would you characterize the GCC's labor markets at present?

**FASANO:** Although labor market statistics are scant in GCC countries, there are signs that unemployment

pressures among nationals have started to emerge, particularly among first-time job seekers. Search periods after graduation, for instance, have become longer. However, the extent of those pressures differs across the countries. Bahrain, Oman, and Saudi Arabia, which already have relatively high percentages of nationals in their respective workforces, face more pressing challenges than do Kuwait, Qatar, or the United Arab Emirates. In addition, structural problems in the labor markets, such as mismatches in the skills supplied by national workers and those demanded by the private sector, are hindering adjustment.

**IMF SURVEY:** What is driving the emerging strains in GCC labor markets?

**GOYAL:** Three main developments. First, an increasing number of young nationals are entering the labor force as a result of high fertility rates in recent decades. It is estimated that the local labor force has been growing, on average, by more than 4 percent a year for the past several years in most GCC countries. With a substantial fraction of the population under the age of 14 in all GCC countries and an increasing number of women entering the labor market, high labor force growth rates are expected to continue over the medium term.

Second, the governments' role as employers of first and last resort for their nationals has almost reached its

limits. In most of the countries, the wage bill now exceeds 10 percent of GDP and cannot keep rising without jeopardizing priority spending in areas such as education and health care—areas that need to increase, given the demographic changes taking place—and without further weakening budgets' capacity to withstand oil price shocks. Governments have also started to narrow their demand for nationals to professionals who are specialized in these priority areas.

Third, growth of the non-oil sector has not accelerated in line with the rapid growth in the local labor force. In addition, most new jobs are becoming available in sectors such as trade, construction, manufacturing, and domestic services, which require relatively low skills and offer relatively low wages and have little appeal for local workers. Meanwhile, the private sector has continued to have access to an elastic supply of expatriate workers at internationally competitive wages.

**IMF SURVEY:** You also mentioned that structural weaknesses have exacerbated the problems.

**FASANO:** The segmentation of the labor market—in terms of wages, skills, and sectors of employment—will not make adjustment easy. Underlying this segmentation has been the implicit guarantee of employment for nationals in the government sector and the relatively more flexible hiring and firing practices that apply to expatriate workers. Nationals prefer to work in the government sector because of its relatively high wages, social allowances, retirement benefits, job security, and shorter working hours. This implicit guarantee for nationals has meant that the lowest acceptable wage for new entrants into the local labor force is high.

In addition, as I mentioned earlier, the skills national workers have do not match the skills demanded by the private sector. The anticipation of guaranteed public sector employment offers nationals little incentive to acquire the skills and training that the private sector values. And this is so even though education is essentially free. It is also surprising that enrollment in colleges and universities has remained low compared with countries with similar levels of per capita income—although enrollment has risen over time.

**IMF SURVEY:** What have governments in the region done thus far to address this problem?

**GOYAL:** Today, the percentage of GCC nationals working for the public sector ranges from a low of 35 per-



Fasano: "The anticipation of guaranteed public sector employment offers nationals little incentive to acquire the skills and training that the private sector values."

cent in Bahrain to over 90 percent in the United Arab Emirates. Bahrain began to diversify its economy earlier than other GCC countries and now has a much larger number of nationals working in the private sector. Endowed with smaller oil reserves, the Bahraini economy is the most diversified in the GCC area, with the non-oil sector accounting for over 80 percent of real GDP and a financial sector that is the single most important activity in the country.

Elsewhere in the GCC, the focus has shifted during the past decade to increasing job opportunities for nationals in the private sector. To this end, the authorities have relied on a combination of mandatory and administrative measures, complemented more recently by market-based strategies. Mandatory measures have included quantitative targets or quotas on the proportion of nationals employed by private companies in specific professions or sectors. Administrative measures have increased the relative cost of hiring expatriates through regulation of the supply of work permits for foreigners or fees and taxes on employers who hire foreign workers. The authorities have also provided incentives to private employers to hire nationals by rewarding tenders that meet quota requirements.

These mandatory and administrative measures have become part of a broader effort to expand the skills of national workers by improving training and education in line with private sector requirements. The authorities are intensifying efforts to eliminate the gap between the output of the local educational systems and the requirements of the market, and are encouraging self-employment opportunities by supporting the development of small enterprises through financing and training.

**IMF SURVEY: How successful have their efforts been? What lessons have been learned?**

**GOYAL:** The results have been mixed, with the sources of employment generation and its beneficiaries differing across the countries. During the second half of the 1990s, the private sector created the majority of jobs in Bahrain, Oman, and the United Arab Emirates. In contrast, the public sector accounted for more than three-fourths of employment creation in Kuwait and about one-half in Saudi Arabia. During the same period, nationals were the main beneficiaries of job creation in Bahrain, Oman, and Saudi Arabia, while expatriate workers reaped a large proportion of the new jobs created in Kuwait and the United Arab Emirates.

The absorption of national workers by the private sector therefore remains a challenge. Mandatory quantitative measures are difficult to enforce in practice, particularly at the firm level. Besides, as most new

job opportunities require relatively low levels of education and pay relatively low wages, nationals appear unwilling to accept these positions, and, as a result, the private sector has continued to offer most of these jobs to foreign workers.

Quotas should be applied with flexibility and pragmatism, taking into account labor market conditions and regularly assessing the impact of quotas on long-term job creation. Closing the labor market to expatriate workers will in itself not diminish unemployment pressures in GCC countries. Education and training systems are insufficiently compatible with local labor market requirements, and this has hindered the replacement of expatriates in skilled positions. In addition, wage expectations of the new entrants remain high and rigid, reflecting, in part, continued expectations of public sector employment. There is preliminary evidence, however, that nationals may have started to accept lower entry salaries in the past few years.

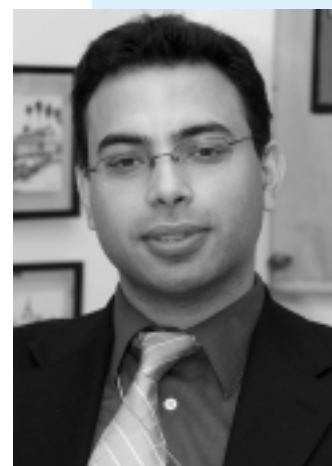
**IMF SURVEY: What more can these countries do to mount an effective labor market strategy?**

**FASANO:** An effective labor market strategy should focus on promoting a vibrant non-oil economy, strengthening investment in human capital, and adopting labor market institutional reforms. Robust non-oil economic growth is not expected to be sufficient to create new jobs for nationals in the period ahead, as the authorities in the region have recognized. Thus, efforts are particularly needed to further integrate the labor markets by addressing the causes behind their segmentation.

An important component of such efforts is to narrow the wage differential, including benefits, between the public and the private sectors, by making, for instance, social benefits available to all working nationals irrespective of sector of employment and by announcing and enforcing strict limits on public sector employment.

The GCC countries will also need to strengthen educational and vocational training to encourage skill acquisition by nationals and eliminate, over time, the mismatch between skills supplied by national workers and those demanded by the private sector. Reforming school curricula, encouraging firms to establish internships, and awarding targeted training vouchers could help prospective national workers build their skills and expertise.

Finally, the authorities should rely mainly on price- and market-based interventions—rather than quantitative ones—to encourage the substitution of national for expatriate workers. The imposition of targets or



Goyal: “Education and training systems are insufficiently compatible with local labor market requirements, and this has hindered the replacement of expatriates in skilled positions.”

quotas may produce short-term positive results, but this practice has, at best, ambiguous effects on long-term employment generation for nationals and could hinder productivity growth and competitiveness.

Simulations that we conducted show that such a strategy could help alleviate unemployment pressures while striking a balance between maintaining a liberal foreign labor policy and a reasonable level of competitiveness of the non-oil sector. It is encouraging that

the labor market strategy across GCC countries presents elements of this overall strategy. ■

Copies of IMF Working Paper No. 04/71, "Emerging Strains in GCC Labor Markets," by Ugo Fasano and Rishi Goyal, are available for \$15.00 each. Please see page 184 for ordering details. The full text is also available on the IMF's website ([www.imf.org](http://www.imf.org)).

*Central Bank of Trinidad and Tobago–IMF seminar*

**The Caribbean faces up to globalization**



IMF Deputy Managing Director Takatoshi Kato (left) greets Trinidad and Tobago Prime Minister Patrick Manning.

**T**he economic performance of the Caribbean region has weakened in recent years, amid a series of natural disasters and an increasingly competitive global economic environment. What can be done to spur higher growth was the topic of "Developmental Challenges Facing the Caribbean"—a

seminar held in Trinidad on June 11–12. The event, part of celebrations marking the 40th anniversary of the Central Bank of Trinidad and Tobago, underscored the urgency of encouraging more flexible labor markets and lowering debt ratios as these economies seek to become more adaptive to the demands of a fast-changing global economy.

Since 1980, average per capita income in the Caribbean region has grown by only about 1½ percent a year—roughly 1 percentage point below the average for other developing countries. In recent years growth has slowed in several countries, notably those in the Eastern Caribbean Currency Union. At the same time, fiscal balances have deteriorated markedly, and public debt in 15 countries of the Caribbean now averages more than 90 percent of GDP. The region has also

suffered disproportionately from natural disasters, with several islands repeatedly devastated by hurricanes. Most recently, severe floods devastated parts of the Dominican Republic and Haiti, particularly affecting the poor. In addition, two important elements in the region's economy—tourism and offshore banking—were dealt a blow following the events of September 11.

The region is a diverse one—populations range from 8½ million in the Dominican Republic to less than 50,000 in St. Kitts and Nevis, and GDP per capita varies from over \$16,000 in The Bahamas to only about \$500 in Haiti. But there are a remarkable number of shared features, too. The region features, for example, a widespread commitment to democratic political systems, a relatively high level of educational attainment, and natural beauty that makes it one of the world's top tourist destinations. But, as one presenter put it, the economic performance can best be described as middling. There is scope for improvement, as "the Caribbean economies seem not to be performing at their full potential," said Takatoshi Kato (IMF Deputy Managing Director).

What is holding the region back? The main theme of the two-day seminar, which was jointly organized by the Central Bank of Trinidad and Tobago and the IMF, is the difficulty Caribbean economies have had in adjusting to the forces of globalization. As Ewart S. Williams (Governor, Central Bank of Trinidad and Tobago) noted, globalization has expanded growth opportunities, but it has also created challenges for most developing countries "and certainly for those in the Caribbean region." One example of this has been the profound change associated with the dismantling of trade barriers worldwide. This has eroded the preferential access that exporters traditionally have had to European markets. Sugar and bananas—once mainstays of many Caribbean economies—are no longer competitive.



Singh: "Fiscal adjustment and structural reform can initiate a virtuous circle toward debt sustainability and growth."

**Photo credits:** Issei Kato for Reuters, page 181; Bretton Woods Committee, pages 181 and 183–84; Eugene Salazar and Michael Spilotro for the IMF, pages 183–85, 187–89, and 192–93; Bank of Spain, page 186; Central Bank of Trinidad and Tobago, pages 194–96.

### Benefiting from globalization

Despite difficulties, the region has, in many ways, been at the forefront of the globalization process and has, as Anoop Singh (Director, IMF's Western Hemisphere Department) explained, seen progress on numerous fronts. Technological advances in transportation have allowed tourism to flourish and enabled countries to diversify their economies beyond dependence on single commodities. In recent years, Caribbean countries with relatively cheap labor costs have also been able to benefit from outsourcing.

Increased regional cooperation was widely perceived as having great potential benefits. Given the small size of many of the region's island economies, freeing up the movement of labor would allow for better use of skills and provide greater scope to exploit economies of scale. Nevertheless, the movement toward establishing the Caribbean Single Market Economy initiative has been slow. In the absence of a powerful supranational authority and an intraregional transfer mechanism, such as in the European Union, it has been difficult to implement the necessary steps, even though the long-term benefits are universally recognized.

### Why has growth lagged?

According to Keith Nurse (Senior Lecturer, University of the West Indies), one of the main impediments to growth has been the region's slow response to changes in the competitive environment. Kato concurred, underscoring the need for increased flexibility given the changes associated with the globalization process and the region's susceptibility to shocks. In the view of many participants, removing labor market rigidities held the key to reducing high unemployment rates, enabling workers to move from declining to emerging sectors, and facilitating adjustment to shocks—something that is particularly important for the countries (like most of those in the region) that have fixed exchange rate regimes. It will also be critical, as local academics stressed, that the educational system become more responsive to the changing needs of the workplace and the increasing role of knowledge in jobs.

Greater entrepreneurship and a more risk-taking business environment can play an important stimulative role, as Sanjay Kathuria (Lead Economist, World Bank) emphasized. But this will require greater competitive pressure and a more supportive investment climate. Also crucial, he added, is the effective delivery of public services, which will, in turn, require more efficiency in collecting and spending tax revenue, and a larger role for the

private sector in the delivery of services. Kathuria cited India as a telling example of how these forces had combined to transform a number of sleepy old firms selling outdated products into highly competitive, world-class companies.

### Macroeconomic environment

The single most important factor underlying the sharp accumulation of debt has been a rapid increase in government expenditures—current and capital—rather than a stagnation of revenues. Over the past five years, as Ratna Sahay (Assistant Director, IMF's Western Hemisphere Department) explained, the fiscal positions have deteriorated in each of the 15 countries in the region. While negative external shocks played a part, policy slippages also occurred. The positive association between increased public investment and economic growth observed in many countries in the past has also broken down in recent years. Faced with high public debt, low growth, and reduced availability of external grants, the room to pursue countercyclical policies is increasingly limited.

Several commentators underscored the urgency of addressing the region's macroeconomic imbalances. Nouriel Roubini (Professor, New York University) discussed the causality between a buildup of debt and a deceleration of growth, noting that very high debt levels in some countries in the region were likely crowding out private investment and depressing growth. In his view, a rapid improvement in fiscal balances was essential.

Sir Dwight Venner (Governor, Eastern Caribbean Currency Board) agreed that the focus needed to be on fiscal adjustment. But he also cautioned that development needs should not be forgotten and pointed out that further development of the nascent government securities market would impose market discipline by rewarding responsible governments and penalizing the laggards.

Many saw scope to tighten tax loopholes and redirect spending. In his remarks to the gathering, Singh noted that "While the region's tax effort is generally relatively high in proportion to GDP, there is still much room to reduce tax concessions and exemp-



Williams: Globalization has expanded growth opportunities, but it has also created challenges.



Sahay: Fiscal positions have deteriorated in each of the region's 15 countries.



Sir Dwight Venner (left), Governor of the Eastern Caribbean Currency Board, confers with IMF Executive Director Ian Bennett.



**Laura Wallace**  
Editor-in-Chief  
**Sheila Meehan**  
Managing Editor

**Christine Ebrahim-zadeh**  
Production Manager

**Camilla Andersen**  
**Elisa Diehl**  
**Jacqueline Irving**  
Assistant Editors

**Niccole Braynen-Kimani**  
**Maureen Burke**  
Editorial Assistants

**Julio Prego**  
Graphic Artist

**Graham Hacche**  
Senior Advisor  
**Prakash Loungani**  
Associate Editor

The *IMF Survey* (ISSN 0047-083X) is published in English, French, and Spanish by the IMF 22 times a year, plus an annual *Supplement on the IMF* and an annual index. Opinions and materials in the *IMF Survey* do not necessarily reflect official views of the IMF. Any maps used are for the convenience of readers, based on National Geographic's *Atlas of the World*, Sixth Edition; the denominations used and the boundaries shown do not imply any judgment by the IMF on the legal status of any territory or any endorsement or acceptance of such boundaries. Text from the *IMF Survey* may be reprinted, with due credit given, but photographs and illustrations cannot be reproduced in any form. Address editorial correspondence to Current Publications Division, Room IS7-1100, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-8585; or e-mail any comments to [imfsurvey@imf.org](mailto:imfsurvey@imf.org). The *IMF Survey* is mailed first class in Canada, Mexico, and the United States, and by airspeed elsewhere. Private firms and individuals are charged \$79.00 annually. Apply for subscriptions to Publication Services, Box X2004, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-7430; fax: (202) 623-7201; e-mail: [publications@imf.org](mailto:publications@imf.org).

tions, and reorient spending away from subsidies and wages and toward greater infrastructure support." Singh also cited widespread support for strengthening financial supervision. "We have learned from other countries how financial sector weaknesses and public debt vulnerabilities can interact to the detriment of macroeconomic stability and growth," he said. Encouraging the regional policymakers, he noted that "fiscal adjustment and structural reform can initiate a virtuous circle toward debt sustainability and growth."

### Choosing between continuity and change

"Our economic aspirations are not so different from our political and social objectives," said Patrick Manning (Prime Minister, Trinidad and Tobago), arguing that sustained economic growth would reduce poverty and bring benefits in many other areas. While not as prevalent as in many other parts of the world, poverty is a major concern in the Caribbean. Many participants argued for improving safety nets and opportunities for training, especially in the context of enhancing flexibility and the need to provide opportunities for displaced workers.

"The challenge is how best to choose between continuity and change," Manning said. The consensus of the participants was that there had been too much continuity and too little change. But while



The seminar on the challenges facing the Caribbean drew participants from government, academia, international organizations, local businesses, trade unions, and the press.

there was agreement on objectives, participants stopped short of converging on the process forward.

A final panel discussion focused on the role of international financial institutions in the Caribbean. José Fajgenbaum (Deputy Director, IMF's Western Hemisphere Department) stated that the IMF intends to remain actively engaged in the region by providing quality policy advice, supporting institution building through the Caribbean Regional Technical Assistance Center (CARTAC), and extending financial assistance in countries with IMF-supported programs. He also underscored that Caribbean countries would need to take more proactive control of their own policy agendas. ■

Tobias Rasmussen  
IMF Western Hemisphere Department

### G8 agree to continue providing debt relief under HIPC Initiative

The Group of Eight (G8) leaders agreed at their economic summit meeting held on Sea Island, Georgia, United States, on June 10 to continue providing debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative. The leaders also directed their finance ministers to work with donors, the World Bank, the IMF, and other international financial institutions to provide "topping up" financing to the HIPC Initiative, where necessary.

The HIPC Initiative, established in 1996, included a "sunset clause" to avoid the adverse incentives of a permanent facility, minimize moral hazard, and encourage early adoption of reform programs. The initiative is currently set to expire on December 31, 2004. G8 leaders recog-

nized, however, that the year-end expiry of the sunset clause—which has already been extended three times—would leave several countries with debts in excess of the thresholds set by the initiative.

The Executive Boards of the World Bank and the IMF will meet in July to discuss alternative ways of extending HIPC debt relief. These options are intended to give heavily indebted poor countries more time to put in place the reform programs needed to establish their eligibility for HIPC debt relief. A decision will be made by the World Bank and IMF Boards in September in the context of a review of the most recent progress report on the HIPC Initiative.