

IMF Is Helping Countries Respond to Food Price Crisis

The IMF is helping low-income countries hit by high food prices take appropriate policy action while providing financial assistance to some of the worst-affected nations, Managing Director Dominique Strauss-Kahn said.

In remarks prepared for a June 3–5 United Nations conference in Rome on world food security, Strauss-Kahn said that high food prices were stoking worldwide inflation and undercutting the economies of low-income countries, particularly in Africa.

The IMF has doubled financial assistance to four low-income countries affected by food and fuel price hikes and is discussing additional support with another 11 countries, Strauss-Kahn told delegates. He said that Burkina Faso, the Kyrgyz Republic, Mali, and Niger received the extra aid.

The IMF said on May 29 it was giving an extra \$21 million to the landlocked West African nation of Mali to help with the crisis and boosting assistance to the Kyrgyz Republic, a mountainous Central Asian country, by \$14.4 million.

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Maya Victon/AFP

Rice harvest in Doro, Indonesia: the IMF says the food price crisis can be managed and that action is a “moral and economic imperative.”

Inflation Risks Have Reemerged

IMF First Deputy Managing Director John Lipsky has called for a strong policy response by governments around the world to address commodity supply bottlenecks and longer-term supply issues while tackling inflationary risks.

Lipsky warned in a May 8 speech at the Council on Foreign Relations in New York

that the recent pickup in inflation around the world in part reflected the impact of higher energy and commodity prices. “This inflation speed-up must be taken seriously, as it creates potentially significant challenges to economic stability that could undermine prospects for restoring the combination of solid growth and low inflation that prevailed earlier in this decade,” he said.

Demand for commodities has remained robust because of strong growth in emerging and developing economies, led by China and India, whose growth is more energy- and commodity-intensive than that of more developed economies.

As spare capacity and inventories have dwindled, the oil market has become highly sensitive to news of supply disruptions and geopolitical events. This has pushed oil prices

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Turkey's Challenge

Turkey's economy has performed well since the 2001 crisis, but is now facing less favorable external conditions.

Global developments are creating headwinds for growth, inflation, and external financing. The current environment poses a policy challenge for Turkey, as it does for many emerging markets.

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Khaled Desouki/AFP

Filling up a car in Cairo, Egypt: world oil markets are expected to remain under pressure.



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Inflation risks

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to all-time highs in real terms, surpassing their 1979 peak by some 16 percent.

The IMF also forecasts that food prices will remain high.

Policy responses

Lipsky said that, in the IMF's view, policies must adjust both to the reality of permanent relative price shifts and, in some cases, to a broader resurgence in inflation.

Advanced, emerging, and developing economies alike have a role to play in ensuring that policies do not hinder the restoration of demand-supply balances in commodities markets. He identified a number of appropriate structural policy responses:

- **Promoting a demand response while cushioning vulnerable groups.** Given that some portion of the latest increases in oil prices appears to be durable, allowing a demand response to the reality of higher oil prices will be crucial. Indeed, the pass-through of changes in international oil prices to domestic prices would help promote an inevitable demand response to changing market conditions and encourage conservation. At the same time, well-targeted policy supports should be put in place to protect the most vulnerable groups.
- **Encouraging investment in the oil sector.** Policies are needed to foster greater investment in oil. These include efforts by oil producers—particularly those in emerging and developing countries—to ensure that investment regimes are stable and predictable; encourage greater cooperation and synergies between national and international oil companies through well-designed partnerships; and facilitate the establishment of an orderly, predictable, and transparent market through improved data dissemination on demand and supply conditions.

- **Reducing biofuel subsidies.** Efforts to reduce the level of protectionism and subsidies aimed at stimulating biofuels production would remove distortions and allow for greater overall efficiency.

- **Improving agricultural policies.** Without sufficient infrastructure to increase cultivation, boost productivity, and bring

agricultural products to the market, the supply response in many emerging and developing countries may remain elusive. Thus, policies should aim to upgrade infrastructure, distribution, and storage systems; expand irrigation systems; and redirect subsidies toward high-yield products and key agricultural inputs, such as fertilizer. At the same time, subsidized production in advanced countries should be phased out.

Macroeconomic policies also critical

- In the **United States**, policy interest rates have been lowered significantly as the growth outlook has deteriorated. As U.S. growth recovers, developments in inflation and inflationary expectations will assume greater importance for policymakers. The 2008 fiscal stimulus should help provide some cushion for demand. However, new fiscal measures could focus on stabilizing key sectors that are vital to limiting downside risks to growth, such as the housing sector and the financial system.

- In the **euro area**, the sharp rise in inflation and concerns about potential deterioration in inflationary expectations are dampening consumer confidence and spending. The inflation outlook appropriately is central to the policy considerations of the European Central Bank. Policy prospects could shift, however, if inflationary expectations remain well anchored and slowing growth reduces inflationary pressures. For Japan, core inflation remains very low at 0.1 percent and, given the uncertainty concerning growth prospects, Bank of Japan policy is not expected to change soon.

- In **emerging economies** whose currencies are closely linked to the dollar and that are facing overheating concerns, macroeconomic policies need to be tightened. In China, movement toward a more flexible exchange rate regime could provide greater scope for effective and stabilizing monetary policy action. Among Middle Eastern commodity exporters, fiscal spending should aim to alleviate supply bottlenecks—particularly in infrastructure—that have contributed to inflation pressures. ■

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UN food security conference

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Crisis can be managed

Strauss-Kahn, a former French finance minister, said in remarks read into the record that the crisis could be managed if the world took appropriate action to

- address immediate needs of the worst-affected regions and feed the hungry
- help countries direct support to people who need it most, while avoiding actions that make things worse, such as export bans and price controls; and
- help countries contain the macroeconomic costs and stop the crisis from turning into a general inflation or balance of payments problem.

Balance of payments effects can also be large. IMF projections show that in about one-half of African countries the increase in the cost of food imports could exceed 1 percent of GDP this year. Increases are greatest in some of the poorest countries, such as the Democratic Republic of the Congo (almost 2 percent) and Mauritania (3 percent). In other countries, higher fuel prices are also having an important negative impact.

The Rome meeting, chaired by United Nations Secretary-General Ban Ki-moon, brought together the heads of key UN agencies, as well as the IMF and the World Bank, along with many heads of state and government. Ban called on world leaders gathered at the summit to take “bold and urgent” steps to tackle the global food crisis, including boosting food production and revitalizing agriculture to ensure long-term food security.

Addressing the high-level conference, Ban said that more than 850 million people around the globe were short of food before the current crisis began. That number could rise by a further 100 million, and the poorest of the poor will be the hardest hit.

Not a global food shortage

Strauss-Kahn said it was important to know there was not a global food shortage. “In fact, there is enough food to feed

the world,” he stated. “Rather, the problem is that prices have risen and many people cannot afford food. So we need to get food—or the money to buy food—to those most in need.” He welcomed the appeal of the World Food Program for \$755 million to deal with the surge in food costs.

Emergency measures should be cost effective and well targeted and not undermine the long-term objectives of increasing food production. Strauss-Kahn said that scaling up targeted social safety net measures, such as the food-for-work program and conditional cash transfers to the poorest, can be very effective, as shown in Brazil and Mexico.

Other effective short-term measures are reducing or eliminating tariffs on key food items (which more than 40 countries have done), temporary subsidies on the one or two products most vital for the poor, and expanding the school feeding programs that exist in many countries (for example, Kenya and South Africa).

Some responses, however, should be avoided, such as export restrictions, which export hunger from one country to another; subsidies that do not target the poor; or direct price controls, which discourage production.

“Already we are hearing that farmers in developing countries are abandoning rice production, as domestic prices do not cover input costs,” Strauss-Kahn said.

Food prices to remain high

A report issued May 29 by the United Nations Food and Agriculture Organization (FAO) and the Organization for Economic Cooperation and Development (OECD) predicts that food prices in the next 10 years will remain well above the levels of the past decade.

The report says that current high prices will hit the poor and hungry the hardest and calls for the urgent mobilization of humanitarian aid as well as a greater focus on boosting agricultural production in the longer term.

“Coherent action is urgently needed by the international community to deal with the impact of higher prices on the hungry and poor,” Jacques Diouf, Director-General of the FAO, said at a press conference in Paris.

“Today some 862 million people are suffering from hunger and malnourishment—this highlights the need to reinvest in agriculture. It should be clear now that agriculture needs to be put back onto the development agenda.”

Using prices corrected for inflation, the report says that, over the next decade, rice and sugar prices will increase by less than 10 percent; wheat by less than 20 percent; butter, coarse grains, and oilseeds will rise by 30 percent; and vegetable oils by more than 50 percent. High oil prices, changing diets, urbanization, economic growth, and expanding populations are underlying factors behind the rise in food prices, according to the report.

The FAO and OECD also cite growing demand for biofuel as another factor forcing up prices, saying that world ethanol production has tripled between 2000 and 2007 and is expected to double again in the next decade. Climate change, low stock levels, and speculation could also add to price volatility.

World Bank commitment

The World Bank Group announced on May 29 that it would support global efforts to overcome the global food crisis with a new \$1.2 billion rapid financing facility to address immediate needs, including \$200 million in grants targeted to the vulnerable in the world’s poorest countries.

Announcing several measures to address immediate to longer-term food challenges, the World Bank Group said it would boost its overall support for global agriculture and food to \$6 billion next year up from \$4 billion, and would launch risk management tools and crop insurance to protect poor countries and smallholders. ■

IMF Closely Involved in Drive to Relieve Global Food Crisis

The IMF is preparing a study about the impact of high food and fuel prices.

In the following interview, Mark Plant, Deputy Director of the IMF's Policy Development and Review Department, explains the status of the various strands of work taking place within the IMF on food and fuel prices.

IMF Survey: It seems as though this crisis crept up on the world. Were the warning signs ignored?

Plant: Signs of a possible food problem have been visible for a while. The world has been consuming more food than it has been producing for a few years, prices have been creeping up, and inventories are at historic lows. And we should not forget that this time around, the food price cycle is positively correlated with the one for oil. Fertilizer and transportation costs are affected by the oil price. And the oil price rose dramatically in a very short period of time.

Also, global food markets—that is, food export markets—are often thin, especially the one for rice. In the current environment of uncertainty, financial turmoil, and the search for safe havens such as commodities, this can lead to very volatile prices, perhaps with some overshooting.

Nobody could have foreseen that the financial crisis, some flight into commodities, and an oil price hike would all happen at a time when food stocks happen to be low.

IMF Survey: How quickly will the IMF revamp its lending instruments to be able to help out more quickly in this crisis?

Plant: Very quickly. The IMF is preparing a review of the Exogenous Shocks Facility (ESF) for Board consideration in June. The modified facility will provide more rapid and effective shocks financing and be a streamlined version of the structure of financing instruments for low-income countries. But I would underscore that the ESF is available now, if any country needs immediate help.



Buying produce in a supermarket in Beijing, China: food prices are on the rise around the world.

SNImaging

IMF Survey: Is the PRGF [Poverty Reduction and Growth Facility] a suitable instrument for assisting crisis-hit countries?

Plant: Yes. Countries with PRGF-supported programs can request augmentations of their arrangements if they are confronting balance of payments problems. The IMF's area departments are in active discussion with 10–15 low-income countries on possible Fund financial assistance to help address the balance of payments impact of rising food and fuel prices.

IMF Survey: How much does the IMF expect to lend to countries affected by the food price hikes? What will it do to ensure that the money goes to worst-affected people?

Plant: The IMF will consider all requests for financial assistance and decisions will be made based on country-specific needs. Augmentations in the past have been in the range of 15–20 percent of quota. On your second question, the IMF provides balance of payments assistance. In other words, the Fund can help fund import costs. At the same time, teams will very carefully assess the emergency measures put in place in their countries to make sure that they adequately target the most vulnerable.

IMF Survey: Many civil society organizations blame the present situation on the Fund's

past advice to low-income countries, such as recommending cuts in food and fuel subsidies or not allowing enough fiscal space for increases in these subsidies. What's your response?

Plant: The IMF is well aware that food security is one of the key objectives of any government. IMF-recommended policies are intended to support this objective.

As we all know, the key element in any government's decision making is how to allocate scarce resources. In low-income countries in particular, the overall rate of taxation is often limited and the tax base is very small. Until the recent run-up, food prices have been at historic lows for many years. Financial support for health or education systems and for infrastructure were higher on the policy priority list of most low-income country governments. These priorities may now have changed—but government resources are just as scarce.

So there will be a tendency to look to subsidies. But our advice has focused on eliminating generalized subsidies in favor of targeted transfers that benefit the poor. Most countries have immense social and economic needs and resources are scarce; it would be inappropriate to use them for supporting consumption of the rich. At the same time, the policymakers have to ensure that subsidy policies do not destroy longer-term incentives to produce. This is not an easy thing to get right and it requires a lot of expertise—not just macroeconomics. And we rely on other institutions, such as the World Bank, to advise on these issues.

IMF-supported programs are designed to provide fiscal space to meet government priority spending, while not jeopardizing long-term macroeconomic stability. With the food crisis upon us, we can help the authorities respond flexibly to spend on programs critical to keep people well-nourished. ■

Middle East, Central Asia Outlook Remains Bright

Despite slowing world growth, the outlook for the Middle East and Central Asia remains favorable in 2008, with commodity prices, including oil, expected to remain high, says the IMF's latest forecast.

The surge in investment and strong productivity gains from broad-based structural reforms are expected to sustain growth above the 6 percent level (see table). However, against the background of persistently high fuel and food prices, strong domestic demand, and supply bottlenecks, inflationary pressures are unlikely to abate. Inflation is forecast to climb to 10.7 percent in 2008, up from 9.2 percent last year.

The IMF's *Regional Economic Outlook for the Middle East and Central Asia* said that with high oil prices boosting oil revenues, fiscal and current account surpluses in oil-producing countries are projected to remain large despite stronger imports and further fiscal expansion.

In most non-oil-producing countries, the policy stance will likely aim to rein in fiscal and external deficits, thereby reducing further vulnerabilities.

Risks to the outlook are broadly neutral, with some upside risks from domestic demand likely to be balanced by downside risks from the external sector. High oil prices and further cuts in U.S. interest rates could lead to a stronger-than-expected increase in domestic demand in the Gulf Cooperation Council (GCC) countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates).

Furthermore, the growing surplus in oil producers, combined with concerns about asset quality in advanced economies, may well lead to increased inflows to the other countries in the region, fueling stronger credit and domestic demand.

However, a protracted slowdown in advanced economies would hurt growth in most countries, depressing exports and commodity prices. Tighter credit in advanced economies and lower risk appetite, as evi-

Strong performance

GDP growth is expected to remain strong throughout most of the region.

(annual change; percent)

	2006	Est. 2007	Proj. 2008
Middle East and Central Asia	6.6	6.4	6.3
Oil exporters	6.4	6.3	6.2
Low-income countries	8.1	8.7	7.1
Emerging markets	6.6	6.0	6.3
Caucasus and Central Asia	13.1	11.9	8.8
Middle East and North Africa	5.8	5.7	6.0
Gulf Cooperation Council	6.0	5.6	6.1
Maghreb	4.6	4.6	6.0

Sources: Data provided by country authorities; and IMF staff estimates and projections.

denced by widening sovereign spreads, could also curtail the capital inflows that have supported growth in many countries.

"All countries in the region have been largely unscathed by the recent financial turmoil in developed countries, except Kazakhstan, where the banking sector relied heavily on foreign borrowing," said Mohsin Khan, Director of the IMF's Middle East and Central Asia Department.

Despite continued strength in import growth (20 percent in U.S. dollar terms), high oil prices will keep the region's current account surplus above 18 percent of GDP in 2008, leading to a further accumulation of international reserves, now close to the \$1 trillion mark, the report said.

The key challenge in the short run for most countries is to contain rising inflationary pressures, and for countries with large external debts and current account deficits to protect their external stability in the context of high oil prices and slowing world growth.

The appropriate policy mix will depend on each country's circumstances but would most likely call for fiscal and monetary tightening, and greater exchange rate flexibility when feasible. In oil-exporting countries with currencies pegged to the U.S. dollar, demand management policies will face challenges in controlling inflation, given the continuing

bias toward monetary easing in the United States. The burden of the adjustment may well have to fall on fiscal policy, particularly in the GCC countries, where a change in the exchange rate regime would be disruptive in the runup to the planned monetary union.

The report said that policymakers need to remain focused on strengthening policy frameworks, promoting sound financial deepening, and supporting the growth potential of the private sector.

In particular, countries need to continue strengthening their fiscal policy frameworks tailored to address specific issues in their fiscal outlook, notably the efficient and sustainable use of oil revenues in oil-exporting countries and high public debt in some low-income and emerging market economies. Phasing out fuel and food subsidies while establishing a more targeted safety net would help some countries preserve long-term fiscal sustainability, enhance efficiency of spending, and improve equity.

For countries where greater exchange rate flexibility is desirable over the medium term, it is important to continue to lay the foundation of an independent monetary policy. Despite the challenges ahead, GCC countries are encouraged to keep the agenda of the proposed monetary union on track, including reaching consensus on the appropriate exchange rate regime.

Continued development of banking systems will be critical for achieving high growth and for successful integration into the world economy. Dealing with the large stock of nonperforming loans and restructuring state banks in some countries will be crucial for enhancing the banking sector's efficiency and lowering the cost of borrowing. Strong supervisory vigilance is also important.

The report noted that the private sector is essential for the expansion and diversification of the production and export base of the region's economies, and for the creation of jobs for the rapidly growing labor force—a pressing problem for many countries. ■

Emerging Markets Weather Fallout from Financial Crisis

Despite the severe fallout from the subprime meltdown that is dampening world growth and depressing financial markets, emerging market countries are weathering the financial crisis relatively well, according to participants at the 10th annual Global Bond Market Forum.

“Emerging market economies so far have proven to be broadly resilient,” IMF First Deputy Managing Director John Lipsky told the April 29–30 forum, jointly hosted by the Organization for Economic Cooperation and Development (OECD), the World Bank, and the IMF. It was held this year in Washington, D.C.

But Lipsky added that heightened risk aversion and liquidity retrenchment from the ongoing turbulence in global capital markets has affected financial markets in emerging economies through higher volatility, increased risk reflected in higher yields, and sharply lower bond issuance—although conditions varied widely across countries.

“These developments clearly demonstrate the interdependence of both risks and their transmission in an increasingly integrated global financial market,” Lipsky said.

Jaime Caruana, Director of the IMF’s Monetary and Capital Markets Department, said emerging markets had done well

despite the dislocation in credit and funding markets, particularly in the United States, because of their improved economic and fiscal policies, high external liquidity positions, robust current account surpluses, and strong growth.

Emerging market governments and many companies have used the favorable market and external conditions of the past five years to improve their capacity to weather a drought of external capital. Central bank reserves have grown and corporate cash levels remain high.

But Caruana told the conference that emerging market countries are vulnerable to the market turmoil through three main financial channels:

- The general repricing of credit risks has increased the cost of external financing and reduced the availability of funding.
- Because of pressure on parent banks in mature markets, funding of subsidiaries in emerging markets could recede, although this so far has not been the case.
- If growth slows in emerging markets, investment flows could retrench, prompting a sharp correction in equity valuations and increased potential for currency volatility.

The importance of a more complex distribution of liquidity across the

financial landscape was underscored by Hans Blommestein, the Head of Debt Management and Bond Markets Program at the OECD.

With investors—including hedge funds—seeking to reduce risk and deleverage, capital markets in emerging economies have already seen a significant drop in the issuance of below-investment-grade credits.

Delegates to the conference noted that global default risks could force up premiums in emerging markets and thus pose the greatest threat to affordable borrowing in these countries.

Going forward, banking sector balance sheet pressures in the United States and the European Union may crimp the ability of emerging corporate borrowers to access funds, meaning that the rollover risk for emerging market syndicated loan amortizations will likely increase. Even if credit quality remains intact, arbitrage factors may raise the cost of borrowing in external markets.

Delegates noted that the first real test of the attractiveness of local market investment in emerging markets will be if the U.S. dollar or global commodity price cycles turn. The main questions for investors continue to be how deep the credit market contraction will be and how long the reduced access to funds will last.

Top 10 markets dominate

The local institutional investor base in emerging markets is growing rapidly. But trading is concentrated in the top 10 markets, which account for 80 percent of total volumes and 84 percent of domestic volumes.

The top 10 emerging economy debt markets are: Mexico, Brazil, South Africa, Turkey, Argentina, Poland, Korea, India, Hungary, and Russia.

Overall liquidity trends in emerging domestic debt markets are improving. There has been a discernible move by foreign investors (including hedge funds) into these local markets, with secondary market liquidity shifting from external debt to local market debt.

Whereas larger trades are still taking place on over-the-counter markets, a shift is under way toward electronic trading platforms, especially for the most liquid assets.

Michael Klein, World Bank Vice President and Chief Economist, noted the capital markets advisory work of the World Bank Group in more than 30 countries and the recently launched Global Emerging Markets Local Currency Bond Program (GEMLOC), which combines the World Bank’s comparative advantage and the private sector to help develop local currency bond markets.

Role of the IMF

During the conference, the IMF highlighted its work in helping foster the deepening of local bond markets in emerging economies. Countries with well-functioning and liquid local bond markets are likely to better cope with shocks and the risks stemming from a protracted global credit crisis.

The IMF is working with member countries to help strengthen regulatory and supervisory frameworks, including in derivatives, repo, and securitization markets. It is also helping improve public debt management and debt market develop-



Heightened risk aversion in global capital markets has affected financial markets in emerging economies.

ment, while encouraging a broadening and diversification of the local investor base.

The IMF is gleaning important lessons from the current crisis to enrich its policy advice to its member countries. Notably, with the rapid growth of local bond markets in emerging economies, market participants need to have the appropriate incentives to monitor and manage the risks underlying new instruments, while making sure that credit discipline is not weakened.

At the same time, regulatory frameworks need to be reevaluated, taking on board lessons learned from the current difficulties in advanced markets. Inadequate transparency and disclosure by financial institutions

can also erode investor confidence and may cause institutions to become far more cautious about counterparty exposures.

Many emerging market countries—such as Brazil, Mexico, Poland, South Africa, Thailand, and Turkey—have made marked progress in implementing reforms to foster the development of local bond markets. Secondary market liquidity has improved in countries that have provided an enabling environment for local bond market development.

The development of repo and derivatives markets has been an important step in countries such as Mexico, Brazil, and Korea. Electronic trading platforms in some of these countries have helped in price guidance.

Private sector perspective

Lipsky briefed the conference on the findings of an IMF working group that was set up to examine private sector perspectives on major impediments to capital market development in emerging economies. The group was established under the auspices of the Fund's Capital Markets Consultative Group, which liaises with the private sector. The working group's report is to be finalized by June 2008.

The working group highlights that the high costs of access to some of these markets are symptomatic of the diversity of tax treatments, investment restrictions such as capital controls, and inefficiencies in market infrastructure. It also stresses the importance of easing access to local markets, lowering transaction costs, and broadening the local institutional investor base.

According to the working group, as emerging economies continue to pursue policies to broaden and deepen local capital markets and enhance financial regulations to keep pace with financial innovation, a number of issues will need to be addressed. They include

- increasing ease of access to local markets and lowering transaction costs;
- further enhancing liquidity in local government bond markets;
- enhancing availability of domestic financing;
- broadening and deepening the local institutional investor base; and
- harnessing corporate finance (especially corporate bond markets) to meet investor demand. ■

Mangal Goswami and Ceyla Pazarbasioglu
IMF Monetary and Capital Markets Department

Greater Access to Data Promotes Market Efficiency

Prompted by the view that the severity of the emerging market crises of the 1990s was partially attributable to a lack of timely statistics, the international community asked the IMF to develop voluntary standards for the dissemination of economic and financial statistics.

The IMF established the Special Data Dissemination Standard (SDDS) in 1996 to guide IMF members that have, or that might seek, access to international capital markets in the dissemination of economic and financial data. It also prescribes that countries provide descriptions of required variables (metadata), along with preannounced time schedules for data releases.

The initiative's other tier—the General Data Dissemination System (GDDS)—was established in 1997 to guide countries in developing sound statistical systems.

Ten years later, 153 of the IMF's 185 member countries participate in the Data Dissemination Initiative. The initiative is now an integral part of the international financial architecture.

The IMF's *Data Dissemination Initiative After 10 Years*, edited by William E. Alexander, John Cady, and Jesus Gonzalez-Garcia, describes the experience with the SDDS and the GDDS. The book details how the SDDS was enhanced in 1999 with the introduction of the reserves template as an additional required element, followed later by the addition of requirements related to external debt and the international investment position.

The volume also includes empirical papers on the market efficiency effects of the initiative and provides evidence that participation, in particular for SDDS subscribers, helps reduce both sovereign borrowing costs and



The 100-meter-tall Bayterek Tower in Astana, Kazakhstan: the country successfully progressed from GDDS to SDDS status in 2003.

exchange rate volatility. The book concludes with a discussion of future challenges and possible enhancements to the initiative. ■

For more information, see www.imf.org/external/pubs/cat/longres.cfm?sk=20313.0.

Côte d'Ivoire Poised for Comeback

Côte d'Ivoire is set for a comeback. GDP growth should double to 3 percent in 2008 and return to a 5–6 percent path in a few years. Private sector confidence is returning as the country emerges from years of political instability that culminated in civil war in late 2002.

International support—including from the IMF—has been key to the nascent recovery, but many challenges remain. The seeds of the conflict were planted during two decades of flawed economic management, immigration and struggles over land, and a difficult transition to democracy. If Côte d'Ivoire succeeds in overcoming the conflict's damage, it could become once again a driving force of the region.

A star that lost its shine

For 20 years after independence in 1960, Côte d'Ivoire was an economic miracle. With growth rates of 7 percent a year and a dominant position as a cocoa, coffee, and cotton producer, it was widely expected to be the

first sub-Saharan African country to emerge as developed. Sudden losses in terms of trade combined with overly ambitious public investment and external borrowing abruptly collapsed this dream in the mid-1980s.

Efforts to put the economy back on its feet were considered too little, too late, until the CFA franc devaluation in January 1994. By then, just after the death of President Houphouët-Boigny, the country was struggling with the transition from autocracy to democracy, one element of which was that one-quarter of the population was of recent immigrant origin. Tensions over land ownership were exacerbated by high unemployment and gave rise to the concept of *Ivoirité*—a set of beliefs about who is a true Ivoirien and who is not. Its exploitation for political aims made ethnicity a new factor in Ivoirien politics.

The civil war broke out in September 2002 and, after a few months of fighting, the country split into two: the north was held by the rebel *Forces Nouvelles* and the south by the government headed by President Gbagbo. Despite intermediation by the international community, the next four years saw little progress toward reunification. A turning point came in March 2007 with the Ouagadougou Accord, which established a transition government and set a road map for disarmament, redeployment of public administration in the north, identification of the population, and elections in 2008.

The years of conflict and instability exacted a high toll: almost a million persons were displaced, several millions were pushed into poverty, and social indicators plunged. Infrastructure, once well above regional standards, declined, especially in the north.

Between 2000 and 2007, per capita GDP fell sharply, although the economy showed some resilience, thanks to favorable cocoa and other commodity prices and a sharp increase in oil production from 2004. Membership in the West African Economic and Monetary Union kept inflation low. However, Côte



Issouf Sanogo/AFP/Getty images

Dock workers load cocoa beans in the port of San Pédro in Côte d'Ivoire.

d'Ivoire was no longer the locomotive of the region, as trade and remittances were disrupted and investor confidence suffered. The port of Abidjan lost its preeminence as a regional hub.

With government revenue falling, donor funds drying up, and scarce fiscal resources being directed to the military, government investment and social spending fell, and domestic and external arrears mounted. Capital fled the country and private investment dropped.

Governance deteriorated and corruption flourished, as individuals took advantage of lawlessness and a dysfunctional judiciary. Military roadblocks and racketeering extorted payments from the population.

Reversing the downward spiral

The transition government that took office in April 2007 set out to restart the engine of growth and reverse the downward spiral of conflict and poverty. Among its first actions was to reengage with the international financial institutions and obtain assistance for its crisis-exit strategy. Because the dialogue with the IMF had continued throughout the crisis (see box, next page), an economic program was quickly agreed on. It focused on four priorities:

- restoring the role of the budget at the center of economic policies;
- substantially raising pro-poor and other crisis-exit spending;

Key Political Developments, 1999–2008

December 1999 Coup d'état by General Gueï ousts President Bédié, elected in 1995

October 2000 Amid political instability and violence, Gbagbo elected president

September 2002 Coup attempt, civil war, *Forces Nouvelles* hold north, 4,000 French troops deployed

January 2003 Linas-Marcoussis Peace Accord, government of national reconciliation

February 2004 UN sends 7,000 peacekeeping forces (UNOCI)

Late 2005 UN Security Council endorses postponement of presidential elections to October 2006

March 2007 Ouagadougou Accord signed between Gbagbo and Soro. New transition government, Soro prime minister. Presidential elections planned for February 2008

March 2008 Presidential elections announced for November 2008

- relaunching the pre-conflict reforms, with initial focus on transparency in public resource management; and
- rebuilding the business environment.

In support of this program, the IMF provided \$128.4 million in Emergency Post-Conflict Assistance (EPCA) in two equal disbursements in August 2007 and April 2008.

Since the program's May 2007 launch, implementation has been generally on track. A modest primary basic surplus (defined as revenue minus total expenditure, excluding interest and foreign-financed investment) of ½ percent of GDP was achieved in 2007, and the 2008 budget aims for the same objective. However, the share of pro-poor and crisis-exit spending has remained below target, largely because of high sovereignty spending (by the presidency and the prime minister's office) and difficulties in reaching a consensus on reducing the military wage bill.

The authorities resumed debt service payments to the African Development Bank (AfDB) and the World Bank in mid-2007 and cleared, with the help of a World Bank grant, all arrears to the latter. They expect to clear AfDB arrears in July. Donors have pledged substantial assistance for crisis-exit programs, but disbursements have so far lagged.

Structural reforms have also progressed. The government adopted the 2008 budget on time and started publishing detailed budget execution statements. Electricity tariffs, unchanged since 2001, were raised and audits of the extractive, refining, and electricity sectors were launched. Preparation of a Poverty

A Concerted International Effort

1994, 1998, 2002 IMF approves successive three-year PRGF arrangements

September 2002 Disruption of PRGF as civil war starts

May 2005–May 2007 Discussions with IMF and World Bank on reengagement; agreed economic program for 2006 did not materialize

April–August 2007 Agreement with World Bank and AfDB on arrears clearance plan (April), pledges of donor support for crisis-exit programs, World Bank approves pre-arrears clearance post-conflict grant (July)

August 2007 IMF approves first EPCA—disbursement of SDR 40.65 million

April 1, 2008 Following partial arrears clearance by authorities, World Bank approves arrears clearance and budget support grants

April 4, 2008 IMF approves second EPCA—disbursement of SDR 40.65 million

Reduction Strategy Paper resumed, for completion by September 2008. Repayment of domestic arrears, equivalent to 1½ percent of GDP in 2007, helped boost private sector confidence, as did progress in unifying the country, reopening trade routes, and redeploying public administration.

With progress on a broad policy front, the economy grew by 1½ percent in 2007; with domestic and foreign investment picking up, growth should double in 2008.

Restoring Côte d'Ivoire's luster

Unlike many other post-conflict countries, Côte d'Ivoire did not suffer wholesale destruction of its capital stock or its policy and administrative capacity. In addition, reconstruction is taking place in a favorable environment of high energy and commodity prices. These factors raise hopes that speedy progress can be made toward erasing the damage of the crisis years and achieving a peace dividend.

But key to attaining that goal will be free and fair elections, full reunification, and the strengthening of state institutions. The authorities must also step up efforts to mobilize resources—notably to strengthen and unify tax administration and collect adequate revenue from the petroleum and cocoa sectors, particularly in the former rebel zone. They

should also direct a greater share of spending toward basic social needs and infrastructure rehabilitation, as well as fight corruption and improve the judicial system. Finally, deeper structural reforms are imperative to ensure more efficient public resource management.

If the EPCA is successful, it could become a bridge towards a three-year program under the Poverty Reduction and Growth Facility (PRGF). Such a program would also pave the way for Côte d'Ivoire's renewed participation in the Heavily Indebted Poor Countries (HIPC) Initiative and help restore its role as the economic motor of the region.

Lessons learned

What lessons can be drawn from Côte d'Ivoire's efforts to emerge from conflict?

- **Early and continuous dialogue among the authorities and stakeholders, including the IMF, is critical.** Such a dialogue helps foster a consensus on sound economic policies and build relations with donors while the peace process is still evolving. This dialogue must include political parties and civil society.

- **Good governance practices should be given high priority.** To ensure the effective use of public resources for reconstruction and to regain donor and private sector confidence, an early emphasis on reinstating these practices is essential. Publication of relevant information, such as budgets and their outcomes, is key for restoring transparency and accountability.

- **Capacity building should be resumed as early as possible.** Even though technical capacity remained intact during the crisis, Côte d'Ivoire had not kept abreast of evolving best practices. Resuming technical assistance has thus been important to start returning to international standards and addressing corruption in public sector activities.

- **Early, sustained, and concerted international support is key.** EPCA aims to provide financial assistance to a post-conflict country—even before full political stability has been restored, as long as a transition government has sufficient legitimacy. Early IMF engagement can play a catalytic role by assuring donors that policy planning and implementation and public financial management are improving. ■

Holger Fabig, IMF African Department, and

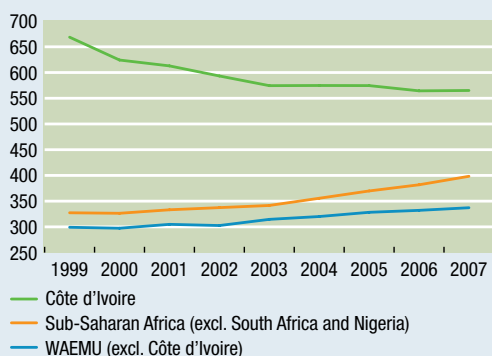
Bruno de Schatzen

IMF Policy Development and Review Department

Decline in GDP

Per capita GDP fell sharply in Côte d'Ivoire between 1999 and 2007; the country was no longer the locomotive of the region.

(U.S. dollars, at 2000 prices and exchange rates)



Source: IMF, *African Regional Economic Outlook*.

Ghana's Reforms Transform Its Financial Sector

Ghana's macroeconomic stabilization has allowed it to achieve remarkable success in developing its financial sector.

The development has been driven by well-sequenced financial sector liberalization policies, enhanced competition (including from abroad), and gradual capital account liberalization. The success of Ghana's reforms can be attributed largely to solid "buy-in" from key stakeholders—especially the private sector—and coordinated donor assistance.

But Ghana still has much to do. It needs to deepen its secondary capital markets; reform small and medium-sized enterprise finance, microfinance, and rural banking; and increase the private sector role in the pension and insurance systems. It must also expand its equity market and ensure careful supervision of the rapidly evolving financial system.

The Ghanaian financial system has been profoundly transformed since the IMF–World Bank Financial Sector Assessment Program (FSAP) assessments in 2000 and 2003:

- Financial sector development has had a notable impact on growth, which rose to 6.3 percent in 2007 from 4.5 percent in 2002.
- The ratio of money (M2) to GDP, the traditional measure of financial deepening, doubled after 2004, reaching 43 percent of GDP by the end of 2007. Much of the increase was funded by an increase in demand and savings deposits.
- The banking system has grown, fueled by credit expansion. Banks now account for about 70 percent of the financial sector.
- Financial sector vulnerabilities have been reduced. Improved banking supervision now gives priority to capital adequacy, bank risk management, and more on-site supervision.
- The government has passed most of the bills recommended by the 2003 FSAP to improve prudential supervision and financial intermediation.

Ghana's financial sector development has been guided by the government's Financial Sector Strategic Plan. The plan spells out

policy and legislative reforms to deepen the financial sector and build capital markets while keeping the economy stable. It also aims to increase outreach and access to financial services.

The reforms have benefited from ownership by government and key stakeholders. Coordinated donor assistance has been vital to the institutional development and training programs that are key to Ghana's strategy.

Reduced direct involvement of the state has unleashed the dynamism of the financial sector. The government expects to complete selling its shares in private financial institutions by the end of 2008. In the pension area, Ghana's facilitation of private schemes is vital to building its domestic capital market. The state's role is thus shifting toward oversight to ensure the integrity of the financial system.

Financial stability, soundness

Although the Ghanaian financial system incorporates a range of institutions, the banking system dominates. In 2007, the ratio of total banking system assets to GDP was 72.4 percent. But the system is concentrated, with the three largest banks accounting for 41 percent of banking sector assets.

Despite the banking system's rapid growth, the system is becoming increasingly sound, thanks to determined regulation, significant technological advances in the sector, and more forceful risk management by banks.

At the same time, more aggressive lending has not impaired the capital adequacy of the banking system. In fact, the capital adequacy ratio reached 14.8 percent in 2007 from 9.5 percent in 2003.

The quality of financial assets has also improved, with the share of nonperforming loans in the aggregate bank credit portfolio falling to 5.4 percent in 2007 from 14.7 percent in 2003. This was attributable to better loan recovery and rapid credit growth; to date, most of the new loans are performing.

Ghana's financial reforms have increased the banking system's resilience to potential

financial shocks. Moreover, the central bank is carefully monitoring the system's financial stability; it publishes a periodic financial stability report that is discussed by the central bank's monetary policy committee.

Ghana's introduction of a partial capital account liberalization in 2006 was a watershed development. It opened up the longer end of the market to nonresident investors and has helped accelerate development of Ghana's domestic capital markets.

But the secondary government bond market remains illiquid because most such bonds that are not held by the central bank are bought by banks. One priority is to broaden the local private investor base beyond the Social Security and National Insurance Trust and the State Insurance Corporation.

Although the Ghana Stock Exchange (GSE) has been a source of financing for corporations, it remains small and illiquid. Trading is discontinuous, the total value traded is less than 1 percent of GDP, and turnover is below 4 percent. Now that regulatory reform of the GSE has been completed, the government's priority is to expand the investor base through public education and fiscal incentives for pension funds.

Next steps

Despite its achievements, the reform agenda remains incomplete. The government must deepen secondary capital markets and reform small and medium-sized enterprise finance, microfinance, rural banking, and pension and insurance systems. It must address cost inefficiencies, which keep interest rate spreads too high, and continuously adapt supervision to keep the financial sector stable. The central bank is also introducing a National Payments System to ensure the delivery of financial services to all segments of the population. ■

*Mahamadu Bawumia and Theresa Owusu-Danso
Bank of Ghana
and Arnold McIntyre
IMF African Department*

Turkey—Navigating Through Choppier Waters

Turkey's economy has performed well since the 2001 crisis, but is now facing less favorable external conditions. Thanks to good policies and a benign external environment, Turkey has experienced six years of strong and stable economic performance, including in comparison to its emerging market peers.

More recently, however, the global environment has turned decidedly less favorable. The financial crisis that originated in the U.S. mortgage market has caused a broader tightening of credit conditions and dimmed prospects for world growth, while record-high commodity prices are fueling global inflationary pressures. These trends have also started affecting the Turkish economy.

Clouds on horizon

High global prices for energy and food, combined with the effects of a domestic drought, have recently pushed up Turkish consumer price inflation to 9¾ percent. The risk is that these shocks might cause broader-based price pressures, significantly delaying convergence to the official 4 percent inflation target.

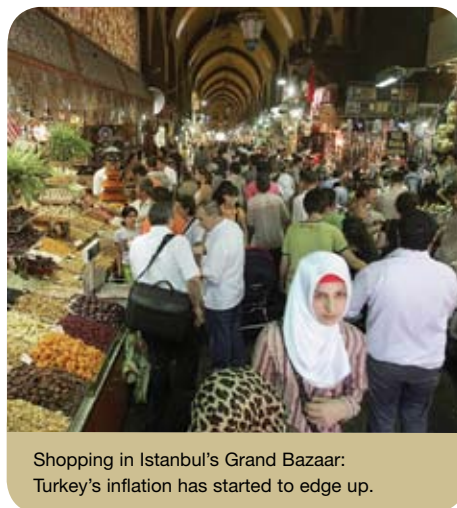
The same adverse supply shocks have also slowed Turkey's economic growth in recent months. Growth is projected to slip to 4.0 percent in 2008 from 4.5 percent last year and 6.9 percent in 2006.

Near-term prospects are further clouded by the expected slowdown in global economic activity: IMF staff research suggests that a 1 percentage point reduction in industrial-country growth tends to reduce Turkey's growth by a cumulative 0.8 percentage points over two years. Under current conditions, however, this impact should be mitigated somewhat by the continued dynamism of other emerging markets, whose share in Turkey's total exports has risen from 20 percent to 26 percent over the past three years alone.

According to the IMF research, only about half of the total spillover from industrial-country growth comes via the trade channel. This points to an important role for financial

transmission channels. Indeed, Turkish asset prices have tended to respond more strongly to global market fluctuations than any other large emerging market.

In this context, the ongoing tightening of global credit conditions poses a particular challenge given Turkey's large external financing requirement—about 17½ percent of GDP in 2008. Judging from historical



Shopping in Istanbul's Grand Bazaar: Turkey's inflation has started to edge up.

Louisa Goullamaki/AFP

trends, tighter global liquidity would normally entail reduced capital inflows for Turkey, although data for the past two years point to some decoupling.

On the positive side, the composition of Turkey's external financing has clearly improved in recent years, with foreign direct investment inflows surging to unprecedented levels and covering half of the current account deficit in 2007. Moreover, Turkey's stock of gross external debt (34 percent of GDP) is actually lower than in many other emerging markets.

This reflects a sharp strengthening of public sector balance sheets, which has been partly offset by an increase in private sector external debt, due to extensive corporate borrowing.

Weatherproofing the economy

In many ways, Turkey today is in a much stronger position to cope with external headwinds than throughout its entire pre-2001 history. Under the auspices of two consecutive

Stand-By Arrangements with the IMF—the latest one expires on May 10—the authorities achieved an impressive fiscal consolidation, built up large foreign exchange reserves, granted independence to the central bank and introduced inflation targeting, advanced privatization, and undertook important reforms, notably in social security, tax administration, and the banking sector.

Nonetheless, the current difficult environment poses a challenge for short-term *macroeconomic policies* in Turkey as in many other emerging markets. The Turkish authorities are trying to balance growth concerns with the need to ensure disinflation and external adjustment. The chosen policy mix leaves little margin for error. In particular, following last year's fiscal slippages, it will be critical to stick closely to this year's fiscal target (a primary surplus of at least 3.5 percent of GDP) and engineer a gradual tightening of monetary policy over the coming months.

The medium-term journey

Looking beyond the current cycle, Turkey's medium-term challenge is to combine continued *macroeconomic policy* discipline (close adherence to the announced medium-term fiscal path and convergence to the 4 percent inflation target) with the right set of *microeconomic reforms* to increase the economy's resilience to shocks while boosting potential growth. As detailed in an earlier *IMF Survey* article, the IMF has recommended action in four main areas:

- enhancing the institutional framework for fiscal policy by adopting a fiscal rule;
 - making labor markets more flexible;
 - addressing bottlenecks in electricity supply;
- and
- deepening financial intermediation.

Together, these reform steps would help generate fiscal space to lower high marginal tax rates, create jobs, reduce informality, and raise productivity, thus affording higher living standards on a sustained basis. ■

Prakash Kanman and André Meier
IMF European Department

Study Shows Larger Islamic Banks Need Prudential Eye

Institutions offering Islamic financial services constitute a significant and growing share of the financial system in several countries.

Since the inception of Islamic banking about three decades ago, the number and reach of Islamic financial institutions worldwide has risen from one institution in one country in 1975 to more than 300 institutions operating in more than 75 countries.

The entire banking systems of Sudan and Iran are based on Islamic finance principles. Although Islamic banks are concentrated in the Middle East and Southeast Asia, they are also niche players in Europe and the United States. According to McKinsey & Co., Islamic banking assets and assets under management reached \$750 billion in 2006, and the Islamic finance sector is expected to reach \$1 trillion by 2010.

Islamic or Shariah-compliant banking provides and uses financial services and products that conform to Islamic religious practices and laws, which, in particular, prohibit the payment and receipt of interest at a fixed or predetermined rate. In practice, this means that instead of loans, Islamic banks use profit-and-loss sharing arrangements (PLS), purchase and resale of goods and services, and the provision of services for fees for the basis of contracts.

Benchmark rate

In PLS modes, the rate of return on financial assets is not known or fixed prior to undertaking the transaction. In purchase-resale transactions, a markup is determined based on a benchmark rate of return, typically a return determined in international markets, such as the London interbank offered rate (LIBOR).

Islamic banks also determine return on deposits differently. In a commercial bank, the rate of return is set contractually (fixed in advance or tied to a reference rate) and does not depend on the bank's lending performance. In an Islamic bank, the rate of return on a deposit is directly dependent on the quality of the bank's investment decisions.

If the bank records losses as a result of bad investments, depositors may lose some (or all) of their deposits. The contractual agreement between depositors and the Islamic banks does not predetermine any rates of return, it only sets the ratio according to which profits and losses are distributed between the parties to the deposit contract.

There is a large body of descriptive literature about Islamic finance, but there has been relatively little empirical work on Islamic banking and financial stability, an area of increasing interest as Islamic banking grows. In a new IMF working paper we attempt to fill this gap in the literature, using data on 18 banking systems with a substantial presence of Islamic banks to provide



Islamic banks are concentrated in the Middle East and Southeast Asia and are niche players in Europe and the United States.

Karim Sahib/AFP/Getty

a cross-country empirical analysis of the role of Islamic banks in financial stability.

A prudential perspective

Are Islamic banks more or less stable than traditional banks? A majority of the relevant literature suggests that the risks posed by Islamic banks to the financial system differ in many ways from those posed by conventional banks. Risks unique to Islamic banks arise from the specific features of Islamic contracts, and the overall legal, governance, and liquidity infrastructure of Islamic finance.

For example, PLS financing shifts the direct credit risk from banks to their investment depositors. But it also increases the overall degree of risk of the asset side of banks' balance sheets, because it makes Islamic banks vulnerable to risks normally borne by equity investors rather than holders of debt. Also, because of their compliance with Islamic law, Islamic banks can use fewer risk-hedging techniques and instruments (such as derivatives and swaps) than conventional banks do.

Moreover, most Islamic banks have operated in environments with less developed or nonexistent interbank and money markets and government securities, and with limited availability of (and access to) lender-of-last-resort facilities operated by central banks. These differences have been reduced somewhat because of recent developments in Islamic money market instruments and Islamic lender-of-last-resort modes, and the implicit commitment to provide liquidity support to all banks during exceptional circumstances in most countries.

Less risky

In some ways, Islamic banks could be less risky than conventional banks. For example, Islamic banks are able to pass through a negative shock from the asset side (such as a worsened economic situation that causes lower cash flow from PLS transactions) to the investment depositors.

The risk-sharing arrangements on the deposit side thus arguably provide another layer of protection to the bank, in addition to its book capital. Also, it could be argued that the need to provide a stable and competitive return to investors, the shareholders' responsibility for negligence or misconduct (operational risk), and the more difficult access to liquidity put pressures on Islamic banks to be more conservative.

Furthermore, because investors (depositors) share in the risks (and typically do not have deposit insurance), they have more incentive to exercise tight oversight over bank management. Finally, Islamic banks have traditionally held a larger proportion of their assets than commercial banks in reserve accounts with central banks or in correspondent accounts with other banks. So, even if Islamic investments are more risky than conventional investments, from a financial stability perspective the question is whether or not these higher risks are offset by bigger buffers.

Whether Islamic banks are more or less stable than conventional banks depends on the relative sizes of the effects discussed above, and it may in principle differ from country to country and even from bank to bank.

Islamic banks and financial stability

An increasingly popular way of assessing banks' soundness is to analyze their so-called z-scores. The z-score combines a bank's capitalization, profitability, and a measure of risk faced by the bank into a single index. The interpretation of the z-score is

straightforward: the lower the score, the more likely it is that a bank will run out of capital.

Defining large banks as those with total assets of more than \$1 billion and small banks as all others, the paper finds that

- small Islamic banks tend to be financially stronger (that is, have higher z-scores) than small and large commercial banks,
- large commercial banks tend to be financially stronger than large Islamic banks, and
- small Islamic banks tend to be financially stronger than large Islamic banks (see chart).

A plausible explanation for the contrast between the high stability in small Islamic banks and the relatively lower stability in larger entities is that it is significantly more complex for Islamic banks to adjust their credit risk monitoring system as they become bigger. For example, the PLS modes used by Islamic banks are more diverse and more difficult to standardize than loans used by commercial banks.

As a result, as the scale of the banking operation grows, monitoring of credit risk becomes rapidly much more complex. That results in a greater prominence of problems relating to adverse selection and moral hazard. Another explanation is that small banks concentrate on low-risk investments and fee income, whereas large banks do more PLS business.

We also found that as the presence of Islamic banks grows in a country's financial system, there is no significant impact on the soundness of other banks. This suggests that Islamic and commercial banks can coexist in the same system without substantial "crowding out" effects through competition and deteriorating soundness.

Sensitivity tests

These findings are subject to several caveats relating to the cross-country data. Databases often are incomplete in coverage of Islamic and commercial banks. Moreover, we focused on only fully fledged Islamic banks and did not cover Islamic branches operated by some commercial banks.

Data limitations also prevented the study from fully taking into account all aspects of Islamic financial contracts—for example, by distinguishing between PLS and other investments. Nonetheless, the main results are encouragingly robust with respect to a range of sensitivity tests, such as using different measures of financial soundness and different estimation methods.

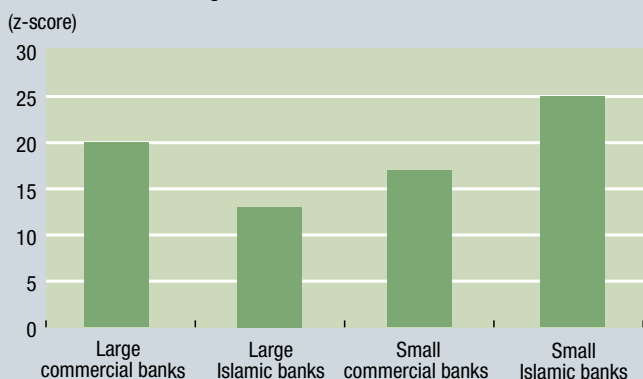
Our findings underscore the importance for regulators of paying attention to the prudential risks of Islamic banks, in particular those that are large. In addition, with the continuing above-average growth rates of Islamic finance, Islamic banks should invest into their credit risk management capabilities, because they are entering into more complex and larger projects. ■

Martin Cihák and Heiko Hesse
IMF European Department

This article is based on IMF Working Paper No. 08/16, "Islamic Banks and Financial Stability: An Empirical Analysis," by Martin Cihák and Heiko Hesse.

Gauging bank soundness

Small Islamic banks were sounder than big and small commercial banks, while large Islamic banks were the least sound.



Source: Authors' calculations, BankScope.

Note: A z-score is used as a measure of bank soundness. It combines equity, return on assets and a risk measure called return volatility to gauge how likely it is that a bank will become insolvent—that is, run out of capital. The higher the z-score, the less likely it is that a bank will become insolvent. The study covered 18 banking systems with substantial Islamic bank presence during the period 1993–2004.

Watchdog Releases Report on IMF Corporate Governance

The IMF's Independent Evaluation Office (IEO) released on May 28 a report assessing the governance of the institution.

The report calls for changes in the IMF's governance, including clarifying the respective roles of various bodies within the institution and reorienting the job of the Executive Board. In the following interview, IEO Director Tom Bernes elaborates on the report's findings.

IMF Survey: This IEO report was an unusual topic for an evaluation. Most IEO assessments have been on Fund policies and their implementation. This is the first time that the IEO has assessed the Executive Board. What challenges did this bring out?

Bernes: As you suggest, this evaluation differs from our earlier ones, which often start with a Board policy decision and go on to evaluate how it has been implemented and whether it's been effective or not.

In this case, we looked at the entire governance structure of the Fund, focusing on the three most important elements—the IMFC [the International Monetary and Financial Committee], the Executive Board, and Management. We started with the formal structure of the IMF, which is set out in the Articles of Agreement, but then we also had to understand how that operated in real life because in any organization you have both the formal set of rules and the informal ways of working. To provide benchmarks and comparisons, we looked at other multilateral institutions, as well as relevant best practice in the public and private sectors.

IMF Survey: What were the main findings?

Bernes: The study found that some of the structures and practices that had served the Fund well had become obsolete in our view, both because the Fund had changed and because of changes in the environment in which it operates.

Over 60 years, a lot has changed. Still, the

Key Points

The evaluation focuses on three major elements of the IMF's governance structure—the International Monetary and Financial Committee (IMFC), the Executive Board, and the Fund's Management. It finds that effectiveness has been the strongest aspect of Fund governance, whereas accountability and voice have been the weakest. If left unaddressed, these weaknesses would likely undermine effectiveness over time.

The evaluation suggests a number of ways to address the main areas in need of reform, including clarifying the respective roles of the various governance bodies within the Fund and reorienting the Executive Board's activities away from day-to-day operational activities toward a supervisory role—thereby enabling it to play a more effective role in formulating strategy, monitoring policy implementation to ensure timely corrective action, and exercising effective oversight of Management. Significant ministerial-level involvement from member countries will be needed to implement these reforms, as well as in the future governance of the Fund, perhaps through the activation of a Council of Ministers.

Fund remains relatively effective, especially compared with other international organizations with almost universal membership. However, we did find a lack of clarity on the respective roles of the IMFC, the Board, and Management.

The IMFC often operates as the main channel for ministers to provide guidance, even though formally it is only an advisory group. We believe that a more active and transparent role for ministers is needed to strengthen both accountability and legitimacy.

Executive Board practices have evolved over time gradually, particularly from the time when it started, when there were 12 directors representing 44 countries. We

now have 24 Executive Directors with staffs and we have 185 member countries. Many of these practices need to be reformed so as to be better aligned with the current situation and with best practice on good governance.

The Board still discusses and approves most operational issues. This doesn't leave the Board sufficient time to focus on strategic issues and to develop a broader perspective because it is so intimately involved with virtually every action the Fund formally takes.

The last finding is on an accountability framework for the Board and the Managing Director. Although such a framework has been formally established, it has not yet been operationalized so as to monitor performance, provide feedback, and ensure corrective actions.

IMF Survey: What were your key recommendations, based on these findings?

Bernes: The four main ones were to clarify roles of the various bodies, to activate the Council of Ministers, to shift the focus of Board activity toward a more supervisory role with a greater focus on oversight and strategy design, and to establish and operationalize an accountability framework for Management.

We have a number of other specific recommendations, which include creating a Board Audit committee; clarifying and strengthening the ethics and conflict of interest framework for Board and Management; establishing whistle-blower mechanisms (an area where some activity seems to be under way); improving the summing-up process for Board meetings so as to provide greater clarity both internally and in terms of communicating to the outside world; and making more active use of committees by the Board to streamline their work processes.

IMF Survey: You recommended that the Board become more strategic and less involved in day-to-day operations. How would it work with a Council?

Bernes: The division of labor between the Council and the Board would flow directly from their respective composition as well as from the fact that the Council would likely meet only a few hours probably twice a year—not too different from the IMFC today. The Council would focus on setting the overarching goals of the organization, taking decisions that require discussion and endorsement at the highest political level, and overseeing the Board. The Board itself would develop strategies for Council approval and track implementation of these strategies and policies. It would also have oversight of Management for day-to-day operations.

We believe that the activation of a Council would formalize these roles, and by clarifying who does what, it may reduce the overlap with the Board. At a minimum, it would also enhance transparency and put accountability for important decisions more clearly where they belong.

Indeed, one of the things that we heard in our interviews with ministers, both current and previous members of the IMFC, was a feeling of disengagement, only endorsing items that had been worked through. So the message came through to us that, in fact, if there were key issues where ministers were making the decisions, then there would be greater engagement and sense of ownership.

IMF Survey: The IEO conducted a number of surveys for this report. What did they reveal?

Bernes: We surveyed current and past Board members, senior officials in capitals (both from finance ministries and central banks),



IMF Photo

Tom Bernes, Director of the IMF's Independent Evaluation Office, proposes creating a Council of Ministers to set overarching goals for the Fund.

and senior IMF staff. We also sought views from civil society.

It's reassuring that the differences in responses between the groups were largely of degree rather than of sharply contrasting views. But there were some messages that did come through clearly to us. One was a widely shared view that accountability mechanisms for the Board and for Management are inadequate or insufficiently used.

A second shared view was that a majority of member country authorities consider Board financial oversight inadequate, or they simply were unaware of the framework, which given that Governors have to sign off on the financial statements at the Annual Meetings, clearly indicates an area that needs to be addressed.

IMF Survey: Are you satisfied with the outcome of the Board discussion?

Bernes: We were very pleased with the outcome, and certainly one left the discussion with the sense that the report was taken seri-

ously. Of course, the proof of the pudding is in the eating. The fact that some action is already occurring is a positive indication.

These are not easy issues. What we try to do in the report is provide a platform for discussion because there is no single corporate structure that one can just apply wholesale.

As we indicate, there are a number of dimensions that any structure would have to satisfy in terms of effectiveness and efficiency of the organization, in terms of accountability, and in terms of providing voice for all the various stakeholders. And there are trade-offs in those dimensions.

Let me give you one example. Research and experience indicates that once you've moved beyond a Board of 8 to 12 members, the efficiency of that process starts to break down, which impedes their ability to be effective in strategy design.

On the other hand, you have to ensure voice and legitimacy. That's very hard to do for a 185-member organization with only 8 to 10 Executive Directors. The objective is to find the balance that will largely satisfy the membership.

IMF Survey: What are the next steps?

Bernes: Executive Directors have decided to launch a process to identify those actions that could be implemented in the near future to improve their processes. They also believe that consultation with other stakeholders is needed. We will contribute to that process by disseminating our report to authorities in capitals, to think tanks, and to civil society. ■

Gita Bhatt

IMF External Relations Department

Statement by the IMF Managing Director on the IEO Report

I very much welcome the IEO report entitled, "Report by the Independent Evaluation Office on the Evaluation of Aspects of IMF Corporate Governance—Including the Role of the Executive Board."

In recent months, significant progress has been made in the reform of the Fund's governance framework. In particular, the Fund's Board of Governors has initiated a process that I am confident will realign members' voting power within the Fund in a manner that enhances the Fund's effectiveness and legitimacy.

The IEO report includes analysis and recommendations covering a wide range of issues beyond quota and voice reform that involve the fundamental institutional framework of the Fund. The staff has circulated comments on selected aspects of the IEO report.

The Board discussion of the IEO report should be seen as the beginning of a process of considering governance reforms going beyond the areas covered so far. It provides an excellent opportunity to hear the views of Executive Directors on various aspects of IMF governance. As I have indicated in my informal conversations with Executive Directors, as Managing Director I will aim to learn from the IEO's report and from the Board's discussion of its recommendations.

On the basis of the discussions on governance being opened by the IEO report, I hope we can develop broadly shared ideas among the membership at large that will enable us to advance further in building a stronger, more modern, and more effective Fund. I plan to announce some initiatives to take the governance reform forward in the coming weeks.

Governors Approve Broader IMF Investment Authority

The IMF's Board of Governors approved on May 5 a broadening of the Fund's investment authority, a key element of the proposed new IMF income model that will allow the institution to generate revenue from a variety of sources.

So far, the IMF has largely been dependent on income earned from lending to finance its operations. But the IMF's lending has fallen in recent years, reducing income earned.

The IMF's broader investment mandate will enable the institution to increase the average expected return and adapt its investment strategy over time. The investment policies will reflect the public nature of the funds to be invested and include safeguards to ensure that IMF investments do not lead to actual or perceived conflicts of interest.

The new income model also foresees the creation of an endowment funded by limited gold sales. Once established, the endowment with profits from the gold sales will be invested.



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Mali Gets \$21 Million

The IMF Executive Board approved in late May a disbursement of \$21.2 million to help Mali finance costs arising from higher food and oil import prices.

The disbursement is the first installment of Mali's three-year, \$46 million arrangement under the Poverty Reduction and Growth Facility. In approving the loan, the IMF Executive Board supported a front-loaded disbursement schedule for the country, whose economy has doubled in size since the early 1990s but remains vulnerable to shocks.

IMF Announces Director Appointments

IMF Managing Director Dominique Strauss-Kahn announced that he will appoint four new IMF department directors: Olivier Blanchard, Research; Antoinette Sayeh, African; Andrew Tweedie, Finance; and Reza Moghadam, Policy Development and Review.

Blanchard, who takes up his post on September 1, is a Professor of Economics at the Massachusetts Institute of Technology. Sayeh, who is expected to assume her post on July 7, is Liberia's Finance Minister. The other appointees are currently on the IMF staff.

Zambia to Receive \$79 Million

The IMF Executive Board approved a three-year, \$79 million Poverty Reduction and Growth Facility arrangement for Zambia in support of the country's policies to alleviate poverty and sustain growth. The June 4 decision enables Zambia to request an initial disbursement of \$11 million.

IMF Deputy Managing Director Takatoshi Kato commended the Zambian authorities for their "prudent macroeconomic policies, which, in the context of high copper prices and debt relief, contributed to robust economic growth."



Vyacheslav Oseledko/AFP Photo

Kyrgyz Access Doubles

The IMF's Executive Board has approved a doubling in the Kyrgyz Republic's access under the Poverty Reduction and Growth Facility (PRGF) to \$28.8 million from \$14.4 million to help the country address the impact of high food and fuel prices. The decision followed the Board's final review of the country's three-year PRGF arrangement, triggering a disbursement of \$16.5 million.

"The Kyrgyz Republic's near-term outlook has become more uncertain, with inflation rising and growth expected to slow," IMF Deputy Managing Director Murilo Portugal noted. He attributed the country's challenges to rising food and energy prices and spillover effects from the slowdown in neighboring Kazakhstan.

IMF Survey

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