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Interview with Montek Singh Ahluwalia

Independent Evaluation Office establishes credibility

After serving for three years as the first director of the IMF's Independent Evaluation Office (IEO), Montek Singh Ahluwalia, an Indian national, left the IEO to take up a cabinet-level position as Deputy Chair of India's Planning Commission, which is chaired by the Prime Minister. Christine Ebrahim-zadeh of the IMF Survey spoke with him about his experience at the IEO.

IMF SURVEY: You told us in a January 2002 interview that the IEO could enhance the IMF's credibility only if it first established its own credibility. Has the IEO accomplished this?

AHLUWALIA: Ideally this should be answered by others, but yes, I feel we have established our credibility. I have been very pleased by the reaction to our reports from the Executive Board, management, staff, and external observers.

IMF SURVEY: How does the IEO maintain its "credibility balance," given that the outside world tends to be

skeptical about the office's independence and those within the IMF tend to be skeptical about whether the office really knows what it is like to negotiate with member country authorities?

AHLUWALIA: This is indeed a challenge. An evaluation office that is completely unconnected to the IMF would appear to be more independent but would face serious limitations. For one, it would not have access to inside documentation, which would greatly limit its usefulness. Also, it is useful to have some IMF staff members with intimate knowledge of how IMF negotiations work when making recommendations that can help promote learning.

The terms of reference of the IEO contain many features that help achieve credibility. First, the majority of our staff have to come from outside the IMF, ensuring a high degree of objectivity and critical input. Second, the fact that the IMF Executive Board—not management—chooses the director of the IEO boosts credibility. *(Please turn to the following page)*

Ahluwalia leaves a "much stronger" IMF

The IMF's Executive Board paid tribute to Montek Singh Ahluwalia, the departing head of the Independent Evaluation Office (IEO), on June 24, emphasizing how exceptionally fortunate the IMF was to have had the benefit of Ahluwalia's skills, experience, leadership, and sensitivity in establishing the new office's reputation. "There is no doubt in my mind," said Deputy Managing Director Takatoshi Kato, who chaired the session, "that the IMF is a much stronger institution than it was before the IEO was created, better able to listen and learn, and more accountable for its actions."

The process of creating the IEO had been long and arduous, and the office's success, as Michael Callaghan, chair of the Board's Committee on Evaluation, acknowledged, crucially depended "on the capability of the director and the quality of the initial evaluations." Abbas Mirakhor, dean of the Board, remarked that Ahluwalia's unique combination of experience in the trenches of policymaking, superb communication and listening skills, and "unbounded intellectual curiosity and distinguished academic credentials" fit the bill.

The efforts of Ahluwalia and the IEO in "seeking out, listening, and consulting with all who expressed interest in the IMF's work and the work of the IEO," Mirakhor added, "produced masterfully balanced, insightful evaluations and recommendations." The quality of its efforts did not go unnoticed, with the IEO's work held up as "state of the art" in the field.

There was wide praise, too, for Ahluwalia's warmth, charm, patience, diplomatic skill, and "eternal good spirit." He would be, as IMF First Deputy Managing Director Anne Krueger said, "a hard act to follow." Mirakhor summed up the Board's appreciation and best wishes, telling Ahluwalia that "we are grateful for your contributions, blessed by having you among us, and hopeful in looking forward to your further contributions to the development and growth of one of our most important member countries, India."



Abbas Mirakhor (left) and Montek Singh Ahluwalia.

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(Continued from front page) Third, once the director's term is up, he or she cannot take a job with the IMF, eliminating incentives to be "nice to management." Fourth, we do not "negotiate" our reports with IMF management. The text is not changed after it is sent to management for comments, but these comments are sent to the Board along with any IEO reactions. Finally, the work program is not subject to approval by the Board but is determined by the director on the basis of consultation with many stakeholders.

IMF SURVEY: Does the IEO really have the freedom to criticize the Executive Board and the Group of Seven countries—given that it is dependent on Board approval of its budget?

AHLUWALIA: Yes, I believe we have such freedom, and the Board has encouraged us in this. In the course of discussion of our possible work program, some Board members explicitly asked the IEO to evaluate the functioning of the Board and its role in decision making. We have not yet taken this up as a separate subject of evaluation, but we have touched on this in individual studies, especially those on recent capital account crises. Concern is often expressed that the G-7 exercise disproportionate influence. Since they also command a large voting share, this is not surprising, but sometimes concern arises because it is felt that the influence is not exerted transparently through the exercise of voting power but by influencing the management outside the Board.

Sovereign governments, which are shareholders of the IMF, have the right to convey their concerns and policy preferences to IMF management directly, and management will obviously listen particularly closely to shareholders that have a large weight in voting or that can command a majority of the votes. It may be that the voting shares need to be reweighted to increase the share of borrowing countries, but that is a separate issue. The important issue for the efficient functioning of the IMF is to ensure that shareholder influence does not lead to decisions that bypass the Board. Good governance requires that decisions on all critical issues should be taken by the Board, with full information, so that the issues can be effectively discussed with all Board members having a chance to express their views. Our evaluations reveal some shortcomings in this area. There is a tendency to give the Board less information than they should have on the risks of programs. This needs to be corrected.

IMF SURVEY: The IEO has released reports on fiscal adjustment in IMF programs, capital account crises, and prolonged use of IMF resources. Have you been satisfied with the responses and follow-through?

AHLUWALIA: I have been very pleased with the attention paid to our recommendations. The broad thrust of our recommendations on all these reports has not only been accepted, but welcomed. The follow-through issue is more complex. We can only assess the quality of follow-through after a year or two of experience. I think the IEO should assess the quality of follow-up action to inform the Board on this important aspect, and the IEO plans to submit later this year proposals for discussion with the Board on possible ways to do this.

IMF SURVEY: How do you respond to the criticism that IEO studies are too broad to elicit firm responses from the Board?

AHLUWALIA: Our first two or three studies did cover broad issues. Since we were new, it was logical to take up issues that had been of concern for some time and to define them fairly broadly. However, many of our recommendations were quite specific, and the Board has given firm directions on these. In the case of prolonged use of IMF resources, for example, we found that although the Board has on several occasions in the past pronounced on ways to minimize prolonged use, there was no accepted definition of prolonged use, so it was never clear in which cases the Board pronouncements were to apply. The IEO recommended a definition of prolonged use, a version of which was accepted. Staff now have clear guidance on which countries fall into that category, for which extra due diligence has been prescribed. This includes taking a step back in such cases and examining what has and has not worked in previous programs before proposing yet another program. The first outcomes of such an exercise went to the Board recently.

IMF SURVEY: What has most surprised you about the IMF and its operations? And do you see the IMF staying ahead of the curve in terms of the kinds of changes that globalization is bringing about?

AHLUWALIA: Let me give two examples—one positive and one negative. On the positive side, I was pleasantly surprised by the extent of internal debate that takes place. The image of the IMF—that everyone operates with the same mechanical, "cookie cutter" approach—does not reflect reality. There is much more internal debate than people think, though the reports to the Board often do not reflect this, which is also understandable. For example, as the IEO report on the Indonesian crisis points out, there was a great deal of debate within the IMF about the appropriate monetary policy stance the government should adopt.

On the negative side, I was surprised that many IMF program documents typically did not spell out the

The image of the IMF—that everyone operates with the same mechanical, "cookie cutter" approach—does not reflect reality.

—Montek Singh Ahluwalia

rationale of program design, including the size of fiscal correction required. Greater transparency in this area is desirable, and the Board has agreed.

Whether the IMF can stay ahead of the curve is a question that time will answer. The IMF has changed enormously over the past two or three years. However, to stay ahead of the curve in a world that is rapidly transforming itself is not easy. It will require leadership on the part of management as well as a shared vision of the role of the institution on the part of shareholders.

IMF SURVEY: The IMF's Board, management, and staff often see themselves as bearing the brunt of unfair and ill-informed criticisms. What can the IMF do to engage its critics?

AHLUWALIA: The best way to respond to critics is by increasing transparency, subjecting yourself to independent evaluation, and using that evaluation to decide how to do things better. The creation of the IEO helps in this process. Incidentally, the procedures followed by the IEO are designed to enable outside critics to have their say. For example, in the process of evaluating the Poverty Reduction and Growth Facility and Poverty Reduction Strategy Papers, which deal with issues that civil society is very concerned with, we received a 40-page document from OXFAM that details its view of what is wrong. When our report is published, it will enable OXFAM to decide whether we have addressed its concerns.

IMF SURVEY: You are about to view the IMF again from a shareholder's perspective. What would you urge the IMF to do to improve the value of its surveillance?

AHLUWALIA: Candid surveillance can provide a useful input for the authorities. The IMF is in a unique position to compare what is happening in a country with what other countries are doing, and this is of special value. India is gradually transforming itself by opening up its economy and reforming the financial sector and is now classified as an emerging market economy. It is very useful to know what the other 10 or 20 countries that fall roughly into this category are doing.

IMF SURVEY: Had you stayed on at the IEO, what topics would you have liked to see the office take up next?

AHLUWALIA: In addition to this year's work program, which includes evaluation of the financial sector assessment program, the IMF's approach to capital account liberalization, and multilateral surveillance, we already have identified one topic that will be picked up next year—structural conditionality in the IMF.

There are two other subjects that would be interesting. One is a review of IMF operations in Turkey.

Turkey is a large borrower that has had a series of IMF-supported programs since 1999; we could learn a great deal from such episodes of exceptional access to IMF resources. The other topic I would have liked to do is a review of Article IV bilateral surveillance. The U.K. Chair and the U.K. Chancellor of the Exchequer have been raising the issue of needing a “fresh pair of eyes” for surveillance, particularly for program countries. I think this is an extremely important issue. In our evaluation of the prolonged use of IMF resources, we already made some recommendations to strengthen surveillance in program countries. But there is a broader question whether the new demands of surveillance require different organizational structures.

IMF SURVEY: Any words of advice for your successor?

AHLUWALIA: He or she will benefit from a superb team in place. My only advice would be to ensure that enough early attention is paid to recruitment to ensure that the mix of high-quality insiders and outsiders is preserved.

IMF SURVEY: Finally, you are jumping back into the fray in India. What does the country need to do to create that much sought-after “take off”? And how do you balance the search for that kind of economic dynamism with the urgent needs of the poor?

AHLUWALIA: India has accelerated to a higher growth bar—the average growth rate in the past five years is a little under 6 percent, which is pretty good compared to other countries. However, it is not good enough compared to our own targets, and it is not good enough if we want to achieve our poverty reduction and employment targets. The new government has announced a Common Minimum Program with a target growth rate of between 7 and 8 percent, combined with economic reforms that have a “human face.” In practice, this means that we have to address very large deficiencies in the social sectors, particularly in health and education.

Liberalization in industry is generally seen to have had good effects and will continue. However, a massive improvement in physical infrastructure is needed to achieve rapid industrial growth. Agricultural growth in India needs to increase from about 2.7 percent to approximately 4 percent. This has to happen through diversification into noncereal and noncrop agriculture, and a lot of this has to take place in the non-irrigated or rain-fed areas. We need to spell out an agenda of agricultural reforms to achieve these objectives. These are areas where I hope the Planning Commission can identify and push new initiatives that will help move India forward. ■

I was surprised that many IMF program documents typically did not spell out the rationale of program design, including the size of fiscal correction required.

—Montek Singh Ahluwalia



Getting statistical revisions right

In the world of statistics, “revision” is not a pleasant word. Revisions usually mean more work, angry phone calls, and e-mails from frustrated users. Sometimes, you even have to admit a mistake. According to Carol Carson, head of the IMF’s Statistics Department, statisticians often think of their careers in terms of how many major revisions they survived. Which may explain why only a handful of countries have a revisions policy today, despite revisions being a key to good governance in statistics. To help countries overcome the stigma attached to revising their data, Carson and her colleagues Sarmad Khawara and Thomas Morrison recently mapped out a set of good practices. Camilla Andersen spoke to Carson about these recommendations and what led to them.

Revisions have the potential to make or break the reputation of a statistical office. If they are not explained properly, confusion, even distrust, may result. “Revisions can be particularly sensitive if statistical agencies handle them in an unprofessional manner,” Carson observes. For this reason alone, revisions matter—a lot. But data revisions have also come to the fore for three other reasons:

Why revisions happen

There are three main reasons why, in the lifetime of a set of data, revisions may be needed.

- **New source data.** Preliminary estimates may be put together on the basis of a sample rather than a full count, or they may be based on unaudited data. When the full or audited data become available, the estimates are revised. Or, in some other way, the source data that are being used become more complete or better.
- **Routine recalculations.** Seasonal adjustments are carried out in many time series to uncover trends. Modern seasonal adjustment techniques take average experience, for instance over five years. With a move forward in time, one year drops off and a new year of experience is brought in. The best example is the consumer price index, which many countries say they do not revise. What they really mean is that they are revising not because they have collected new information on prices but because they are bringing in new seasonal adjustments.
- **Methodological improvements.** The past 10 years have seen the preparation of many new manuals, including the IMF’s manuals on monetary and financial statistics and government finance statistics, and the multiagency manual on external debt. As countries adopt new methodologies, they change some of their definitions and concepts, and must revise accordingly.

New work on methodology has prompted revisions in many countries. As countries adopt new international standards, major revisions often follow (see box below).

The lack of international guidelines on revisions policy is complicating the work of regional organizations. According to Carson, “there is a need, for policy purposes, for data that cover the whole region,” but regional statistical offices are finding it difficult to compile such data because each country has its own approach to revisions. As a result, regional data often do not match countries’ own data, raising questions about credibility. Constantly revising the regional data is not an option either. If regional aggregates are revised every time a country revises, “it is changed so often that it’s hard to know what the numbers mean.”

Organizations such as the IMF need to distinguish between bona fide data revisions and suspect ones. If a country has a loan with the IMF and knowingly submits false data, it becomes an instance of “misreporting.” This can lead to various sanctions against the country, including having to repay the loan early, and, in serious cases, being banned from further lending. Revisions can sometimes be taken as a clue to suspect data.

Wait for perfect data?

Of course, different users have different needs, and most statistical organizations recognize this. “One of the jobs of the statistical agency is making the trade-offs that keep everyone optimally happy,” Carson says. Policymakers, investors, international organizations, and the media strongly emphasize timeliness. Politicians tend to tell statisticians to “put together the numbers, tell us what their strengths and weaknesses are, so that we can be aware, but go ahead and give them to us—don’t wait for complete source data to make them perfect.” In contrast, academics typically say, “We want to do research on the definitive numbers, and we will cheerfully wait until all the source data have come in.” Financial analysts in the private sector probably have needs much like those of policymakers.

Getting revisions right

So what should countries do to get revisions right? Carson and her colleagues identified eight “best practices” that should form the backbone of any country’s revisions policy. Most countries follow some of these practices, but very few follow them all. “A country can take the list, carry out a self-assessment, and ask itself: ‘How can we improve our practices?’” Carson says. These best practices encourage statistical agencies to

- *Consult with users.* Communicate with those who will be affected by your revisions. Keep communication open and include the media to help users understand the “why” of revisions.

- *Manage expectations.* Include a short statement in press releases and other means of communication that explains when to expect revisions.

- *Maintain a predictable revisions cycle.* If you are working with a series that has several revisions, try to maintain a steady cycle. For example, the U.S. GDP is revised three times a quarter. Users are well aware of the cycle and use the statistics accordingly.

- *Limit major revisions.* Major methodological revisions that involve a definition or concept are particularly troublesome to users. Typically, these revisions mean revising back in time, and this may entail rewriting history. Carson and her colleagues recommend saving such revisions and doing them every four to six years to avoid constant revisions.

- *Carry revisions back several years.* IMF mission chiefs and other analysts who do projections and economic analyses need long time series. Carry revisions back to give them history with which to work.

- *Document revisions carefully.* When a press release is issued with revised numbers, identify clearly which ones are revised and which ones are not. When you are planning major methodological revisions, give users advance notice so they can understand the changes. If you are changing a table format, give them the format in advance so they can reprogram their own format. When the revisions actually come out, explain the source of the revisions. If you have breaks in a series, label them clearly and include explanatory notes.

- *Educate users about the likely size of revisions.* Remind users of the likely size of revisions based on past history. For instance, when you publish preliminary estimates, tell users within what range it is likely to be revised.

- *Admit mistakes.* If you make a mistake—and mistakes happen even in the best agency—make the revision in a transparent and timely way. Just say, in essence, we made a mistake, and here is the right number. When an agency announces a revision in this way, it is accepted as a revision and nothing more sinister.

How to avoid adverse publicity

The main reason statisticians are wary of revisions is their tendency to generate bad publicity. Carson highlighted three instances that could have gone badly wrong, but in the end went well.

“As we were working on this paper, we were watching a revision in the United Kingdom that had the potential to be quite tricky. This was in their time series on imports, which was affected—apparently it

is widespread in Europe—by fraud in the way the value-added tax (VAT) was used. As a result of doing work to identify what was missing from their imports—because of this VAT fraud—they did a major upward revision in their imports, changing their current account balance, which is a very sensitive number. They did it following all the good practices, and it was very successful,” Carson says.

A second example involved China, which last November decided to change its practices for revising those all-important GDP data—a brave undertaking, given the attention of world media to China and its spectacular growth rates. Traditionally, China’s first estimate for its annual GDP had come out before the year ended, sometime in December. “But once it was published, even though more complete source data became available, they did not revise the percentage growth rate. They revised the level—the number of yuan—but the percentage change was never revised. That made them fair game to critics of Chinese statistics and the media,” says Carson.

Last November, however, China put in place a new policy on revisions. “Now they do not make an estimate before the close of the year, and they have established at what points during the year they make the estimates. After the first estimate, they acknowledge that it is a revision, and they change the level estimate and the growth rate.”

“Another example we were pleased to follow involved a transition country that had upward revisions in external debt as it began to follow the methodology of the new manual on external debt,” Carson says. “This was particularly interesting in a transition country, because in many of the countries of the former Soviet Union, ‘revision’ was interchangeable with ‘mistake’—and people who made mistakes did not have bright statistical futures. They were very nervous and at one stage wrote to us saying, ‘we have done our work on external debt with the new methodology and we are finding that our external debt looks larger—help us!’ We wrote back, abstracting the good practices from this paper and saying that if they followed these guidelines, they would come through with flying colors. They did—by bringing in people from outside, including the press, and explaining the revisions. We talked to them at the IMF–World Bank annual meetings last year, and they were just beaming! That made us feel good.” ■

Copies of IMF Working Paper No. 04/87, “Revisions Policy for Official Statistics: A Matter of Governance,” by Carol S. Carson, Sarmad Khawaja, and Thomas K. Morrison, are available for \$15.00 each. See page 211 for ordering information. The full text is also available on the IMF’s website (www.imf.org).

Statisticians often think of their careers in terms of how many major revisions they survived.

—Carol Carson

IMF workshop

Sizable boost in HIV/AIDS assistance will challenge low-income countries

There is a consensus in the international community that more resources are needed to help low-income countries battle HIV/AIDS. The IMF has welcomed this emerging commitment by donors and is working with recipient countries to make the best possible use of the new resources.

Over the next several years, funding for HIV/AIDS prevention and treatment is expected to rise dramatically—from \$5 billion in 2003 to \$8 billion in 2004 and \$20 billion by 2008. This increase represents an enormous opportunity to intensify the fight against HIV/AIDS and to strengthen health systems in general. But such rapid increases in external funding can pose

serious challenges for countries seeking to absorb the added resources effectively. If these challenges are not confronted, they could not only compromise the expected benefits but also endanger longer-term political support.

The IMF's Fiscal Affairs Department

sponsored a half-day workshop on June 28 to listen to the concerns of agencies directly involved in this effort, to clarify the IMF's role, and to explore areas for greater cooperation and coordination. The workshop drew participants from UNAIDS; the UN Millennium Project; the World Trade Organization; the World Bank; the European Commission; the U.K. Department for International Development; the President's Emergency Program for AIDS Relief at the U.S. Department of State; the Center for Global Development; the Global Equity Center; Harvard University; Friends of the Global Fight Against AIDS, Tuberculosis, and Malaria; the Clinton Foundation; Physicians for Human Rights; ActionAID USA; and Debt AIDS Trade Africa (DATA).

Identifying the challenges

Workshop participants voiced concerns about the IMF's role in countries expected to receive increased aid. Would IMF conditionality—in the form of ceilings

on budget deficits, on government employment and overall wages and salaries, or on debt—prevent health ministries from making use of the increased aid? There was some understanding of the concern that a large boost in financing for the Millennium Development Goals might create macroeconomic pressures that would be difficult to manage, but some fear that an IMF that is focused on short-term macroeconomic stability might put at risk programs designed to save lives and produce substantial long-term benefits. Thus a number argued for the need to balance concerns about short-term macroeconomic stability with the desire to expand beneficial policy programs.

IMF staff identified several concerns associated with the use of grants. The unpredictability of such flows, sometimes caused by donors' conditionality, can make budgeting difficult. Also, particularly relevant in the light of the surge in funding related to HIV/AIDS, anomalies arise when resources are provided only for some elements of a program (e.g., drugs) but not other critical inputs (e.g., staff training). Further, there are macroeconomic risks associated with large grant flows—including high inflation, which retards growth and acts like a tax especially on the poor; real appreciation of the currency, which can hinder the rural poor from exporting commodities vital to their livelihood; and rising domestic interest rates, which can squeeze social spending by raising public debt service payments.

What are the implications for public expenditure management if new funds flow off-budget? Much of the increased resources for HIV/AIDS are expected to flow directly to nongovernmental organizations. But, in parallel, increased demands may be made on public health programs—demands that will be difficult to meet if the governments themselves do not receive new funding.

Delivering programs to save lives requires more than new financing and good macroeconomic management. International agencies other than the IMF have lead roles in helping countries overcome other formidable challenges. Participants pointed to the inadequate numbers of medical and paramedical personnel in many AIDS-afflicted countries and the limited capacity for training. Increased funding for HIV/AIDS prevention and treatment, they feared, could draw resources away from, and therefore erode, other critical programs in the health sector. Weak implementation and constrained managerial capacity in developing country health systems were also a cause for concern.



An orphan receives treatment at an AIDS clinic in Battambang, Cambodia.

Looking forward

What should the IMF be doing to help the effort against HIV/AIDS in poor countries? In the view of many participants, the organization—given its unique role in discussions with country authorities on macroeconomic policies—needs to ensure that in each country the budget has sufficient room for HIV/AIDS prevention and treatment.

There was wide agreement that there was no room for a “one size fits all” approach. Countries differ in the severity of their HIV/AIDS epidemics, the capacity to absorb additional resources quickly, the stability of the macroeconomic policy environment, and the range of challenges faced in raising growth, reducing poverty, and meeting the other Millennium Development Goals.

Participants pressed the IMF for a clear statement of its position on increased fiscal deficits and wage bills, if financed by external grants, and the level of inflation the IMF was prepared to accept as a by-product of fighting HIV/AIDS. The IMF staff said that, given the need for pragmatism and within recognized bounds of macroeconomic policy objectives, there was scope for some flexibility with regard to the potential short and long-term macroeconomic policy trade-offs that countries face.

As a number of speakers noted, the IMF has become more flexible—for example, focusing less on policies to reduce current account deficits if an adequate and sustainable flow of aid is available. One of the IMF’s key roles, its staff said, is to advise countries on the possible macroeconomic consequences of alternative scenarios and the likely trade-offs that need to be considered. The IMF can also provide advice on ways in which additional resources can be provided to minimize adverse macroeconomic effects.

Weighing short and long-term goals

Most participants agreed that “Dutch disease” effects (inflation, real exchange rate appreciation) associated with massive aid inflows should be of concern to the IMF. There was debate, however, on just how large these effects are likely to be and whether they justify constraining aid flows that could save lives. Participants asked the IMF to quantify Dutch disease effects and make trade-offs explicit. They also saw the task of weighing conflicting short and long-term goals as a political question that should be resolved within the framework of a country’s Poverty Reduction Strategy Paper.

A recurrent topic in the workshop was how to integrate large aid inflows into recipient countries’ budget processes. Most participants considered this critical to ensure country ownership; find the right

balance between AIDS-related outlays and other spending, including efforts to reach the Millennium Development Goals; guarantee complementary domestic spending; and avoid duplication. One speaker suggested heavier reliance on NGOs in aid disbursements, given their shorter processing time. The IMF was viewed as the principal outside player in influencing budget decisions. And while the need for country ownership over budget decisions was recognized, there was also a call for greater transparency so that the criteria used in making decisions would be clear to sectoral ministries, donors, UN agencies, and civil society.

Translating aid into progress

How can countries ensure that an unprecedented level of assistance is translated into favorable outcomes? Participants agreed that a dramatic change was needed in the capacity to deliver public services, and there were a number of suggestions on how to coordinate capacity-building efforts. Some emphasized the need for a medium-term perspective, so that programs for accelerating the training of medical and paramedical manpower and community health workers can be put in place to facilitate the absorption of the increasing financial resources.

Clearly, better communication and coordination will be needed between IMF staff, donors, and other agencies concerned to facilitate and manage the effective absorption and utilization of additional HIV/AIDS resources. There would be considerable value, too, in greater coordination in the field to anticipate likely problems in implementation. The IMF’s resident representatives, in particular, were asked to play a more active role. And IMF staff should coordinate more effectively with donors to get a clearer picture of the likely timing and magnitude of resource flows.

As many participants saw it, the IMF should also have a greater role in facilitating a more informed dialogue between ministries so that the issues associated with budgetary decisions can be clarified and Dutch disease effects can be quantified. Some suggested that the IMF undertake in-depth country studies to determine how countries integrate large flows into their budget process, deal with volatility in resource flows, and cope with pressures on public sector wage rates in selected sectors. Finally, there was support for a follow-up meeting in 2005 to share views on the successes and failures experienced in specific countries where there has been a scaling-up of efforts to treat and prevent HIV/AIDS. ■

Peter Heller and Erik Lueth, IMF Fiscal Affairs Department
Michael Bell and Jennifer Bisping, IMF External Relations
Department

IMF staff should coordinate more effectively with donors to get a clearer picture of the likely timing and magnitude of resource flows.

Krueger condemns protectionism

The struggle to convince the free trade skeptics

In May, IMF First Deputy Managing Director Anne Krueger spoke at the Graduate Institute of International Studies in Geneva, where she examined why opposition to trade liberalization remains so strong in some quarters and what policy options might win over the skeptics. Excerpts of her remarks follow; the full text is available on the IMF's website (www.imf.org).

The benefits of free trade

The benefits of free trade are clear. The latest U.S. *Economic Report of the President*, issued in Washington earlier this year, cites a study by Warczarg and Welch of 133 countries between 1950 and 1988. Countries that liberalized their trade regimes enjoyed annual growth rates about ½ of 1 percent higher after liberalization. And opening up to international trade has become increasingly important: removal of trade barriers during the 1990s raised growth rates by 2½ percent a year.

For me, the single figure that brings home how much was achieved in that postwar era is the gap between life expectancy in rich countries and that in poor countries. In 1950, that gap was 30 years. It is around 10 years today—because life expectancy in most poor countries has risen even more than it has in rich countries.

A puzzle?

Why, given its proven track record, is trade liberalization something governments around the world seem so reluctant to embrace? And why are the opponents of free trade in society as a whole so much more vocal than its advocates? One explanation for government behavior is that many of them have been captured by special interest groups. Modern-day agricultural protection is a classic example, of course.

Agricultural protection in rich industrial countries is, simply, indefensible. Its sheer scale is shocking. The annual cost to consumers and taxpayers of 29 Organization for Economic Cooperation and Development (OECD) members' support for agriculture and horticulture is so large that it could pay for each of the 56 million cows in the OECD dairy herd to enjoy a first-class air ticket around the world. Each cow would also have \$1,450 spending money to finance stopovers in the United States, Europe, and Asia.

This is amusing, of course, but it is also alarming. And countless similar examples abound. It has been estimated, for example, that each one of the 2,300 jobs saved in the American sugar industry through barriers

to imports in the 1990s cost around \$800,000 a year. Such industrial-country protection imposes enormous costs on consumers and taxpayers in rich countries. And it deprives poor farmers in poor countries of access to open markets where they might have a comparative advantage.

But agricultural protection is hardly rare in developing countries either. I could cite plenty of examples of state protection for small groups of producers in developing countries that benefit no one but those producers. Such protection penalizes consumers—and penalizes poor consumers disproportionately because they spend more of their incomes on food.

Some explanations

Why are protectionists so successful? Almost all of the evidence suggests that protection does not achieve its aims. In the U.S. auto industry, for example, protection, mainly through the use of voluntary export restraints, simply postponed the restructuring of the industry. Only when the automakers were subject to tough competition were they forced to become more efficient and productive. This resulted in thousands of jobs lost—jobs the protection had been intended to save. And in the interim, protection delivered higher profits to the mainly Japanese car producers whose exports to the United States were limited under the voluntary export restraints. It's a similar story in the United Kingdom and elsewhere in Europe for cars, and for most industrial countries that over the years tried to protect a range of industries from foreign competition.

Protecting the output of an industry raises the price paid by the consumer—whether at the retail level or by other industries. Such costs are in almost all cases likely to be significantly higher than the putative benefits of protection. Protection also deprives consumers of variety. Protection for one industry, by raising the price of that industry's output, will raise the costs of producers that consume that good as part of their production process.

But protection imposes another set of costs on producers, specifically those geared to export production. By raising the cost of some (protected) intermediate products, it enables other countries to compete more effectively and so disadvantages exporters in the country providing protection for one or more of its import-competing industries. Pressure for protection is usually misguided, because it ignores the balance of costs and benefits involved. It also deprives citizens of the opportunity to make informed choices.



Krueger: "Pressure for protection is usually misguided, because it ignores the balance of costs and benefits involved."

Role of government

One of the most puzzling aspects of the debate on free trade is why trade is singled out as an agent of change that has to be fought against. Far more jobs are lost through technological change, for instance. Many of these job losses are hidden, in the sense that it is easier for an industrialist to argue that this or that factory has been closed, or its workforce reduced, because of the pressure of international trade—or “unfair foreign competition”—rather than acknowledge that the change was in response to technological advances, poor management, or other factors.

The difficulties that policymakers can face at the national level, because of the influence of special interest groups, serve to reinforce the case for multilateral trade liberalization: acting multilaterally makes the jobs of governments easier—in part because export-competing industries can form international alliances to lobby more effectively for trade liberalization. Multilateral action also brings higher returns at a lower cost than unilateral liberalization can.

It is clearly important that the Doha Round succeed; and it is important that the current momentum be maintained if a successful outcome is to remain within reach. The World Bank calculates that two-thirds of the benefits of a successful Doha Round would accrue to developing countries themselves. And most of that would come from lowering their trade barriers against each other.

Role of the IMF

Trade liberalization can be a critical factor in delivering the macroeconomic stability that the IMF seeks to help its members achieve. The benefits of unilateral liberalization overwhelmingly accrue to the country doing the liberalizing. Of course, as I have said, multi-

lateral liberalization is both easier for governments and brings even greater benefit; and the IMF has unequivocally and enthusiastically supported the Doha Round. We recognize that policymakers in some developing countries are fearful about the possible impact of further multilateral trade liberalization. We think that in the vast majority of cases, such fears are misguided.

But to assuage the fears of those who might be adversely affected in the short term, the IMF has launched a new initiative, the Trade Integration Mechanism, or TIM. Countries facing balance of payments difficulties as a result of multilateral trade liberalization will be able to seek assistance through the TIM, whether or not they are currently receiving financial assistance through an IMF-supported program.

Only a very small number of countries will ever find themselves needing the assistance that the TIM offers. But if its existence helps provide policymakers in those countries with the assurance they need, it should make it much easier for them to embrace the Doha Development Agenda, knowing that they will be able to exploit the opportunities that an agreement will provide, while worrying less about the potential downside risks, however small these might be.

Win-win outcome

Free trade is a win-win situation. Everybody can gain, and the gains are large enough to enable compensation to be provided to the losers. Compare that to protection, where the losses are significant and substantial—and the benefits are modest and often illusory or short term. I've set out some of the factors that I believe have enabled the opponents of free trade to win the argument far more often than is justified by the evidence. More empirical research on the effects of protection can help. So, too, can institutional change that strengthens the inputs of consumers and industrial users of goods for which protection is sought.

Those of us who believe that free trade is in the interest of all people—rich and poor—and all countries—developed and developing—therefore face an enormous challenge. We must seek to persuade the skeptics of the benefits of free trade.

A successful Doha Round outcome would, in my view, be the best possible means of achieving these objectives. It would reduce the risk of a slide back to the beggar-my-neighbor protectionism of the 1930s. It will make possible a new era of rapid economic growth, rising living standards, and falling poverty. And it would offer the best possible chance of turning the Millennium Development Goals into achievements rather than targets. ■

It is clearly important that the Doha Round succeed; and it is important that the current momentum be maintained if a successful outcome is to remain within reach.

—Anne Krueger

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
June 28	1.82	1.82	2.80
July 5	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).

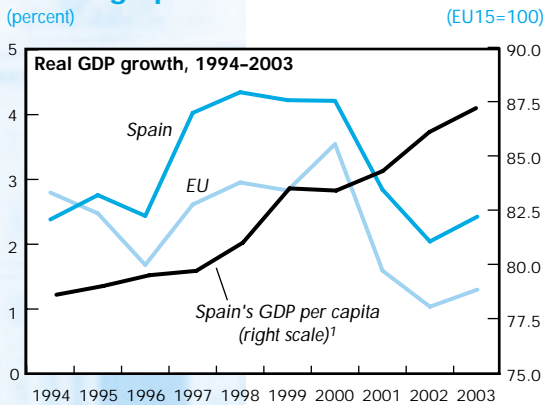
General information on IMF finances, including rates, may be accessed at www.imf.org/external/fin.htm.

Data: IMF Finance Department

How will Spain fare in a European Union of 25 member states?

Since joining the European Union (EU) in 1986, Spain has experienced a dramatic improvement in living standards. Growth has been spurred by a combination of prudent macroeconomic policies, structural reforms, and investment in infrastructure financed to a large extent by transfers from the EU. But Spain must now compete with 10 new member states—mainly from Central and Eastern Europe—for market share, foreign direct investment, and EU structural funds. Alexander Hoffmaister from the IMF's European Department outlines the challenges facing Spain in the new Europe.

Catching up fast (percent)



Data: Eurostat; and IMF staff estimates
¹In purchasing power parity.

Spain has been growing faster than the rest of the EU since the mid-1990s (see chart). As a result, there has been a significant catching-up in living standards. Spain's per capita income exceeded 85 percent of the EU average in 2002—an increase of roughly 10 percentage points compared to a decade ago—and increased further in 2003. Robust

growth has been spurred by prudent macroeconomic policies, with large fiscal deficits in the early 1990s giving way to balanced budgets. And as a founding member of the EU's Economic and Monetary Union, Spain enjoyed a decline in real interest rates, which facilitated private investment. Expenditure control allowed the government to reduce taxes, and reforms in the labor and product markets led to more jobs. Domestic demand was also buoyed by investment in public infrastructure and booming construction. In short, Spain has thrived since joining the EU. But will it continue to do so in the enlarged EU?

EU enlargement will certainly test Spain's ability to preserve the gains of the past two decades. Not only are wages sharply lower in the new member states (EU-10), but workers there are also highly skilled. This has helped the EU-10 capture growing market share in the old member states (EU-15). The EU-10 have also become magnets for foreign direct investment (FDI) from the EU-15: flows have almost doubled in the past five years and have, on average, exceeded

investment in Spain by significant margins. Moreover, Spain's real effective exchange rate has appreciated steadily over the past years—in part reflecting the strengthening of the euro against the dollar. Some of the appreciation could be the natural by-product of strong growth, but weak productivity growth suggests otherwise. Also, export profit margins have come under pressure following strong increases in unit labor costs. The economy's ability to cope with a global environment that promises intensified competition will depend on arresting these trends.

The opportunities and challenges Spain faces in the new EU are influenced by fundamental factors that underlie the patterns of trade and investment flows, including geography (physical distance to markets, access to seaports, and a common border) and cultural ties. Accounting for these factors is essential when trying to examine the economic impact of enlargement.

More trade, but not in all products

Judging by the experience of previous enlargements, the inclusion of new member states will most likely lead to new trade opportunities. The "gravity framework"—commonly used to study bilateral trade—suggests that there are substantial opportunities for increased trade with the EU-10. In contrast with previous enlargements, the current round will not involve a significant reduction in trade barriers, since most of these have already been removed. But the continued harmonization of legislation and regulations will likely lead to trade expansion—gravity model estimates point to substantial "under-trading" between the EU-15 and the EU-10.

But Spain's exports to the EU-14 (EU-15 minus Spain) could still be displaced by increased competition from the EU-10. Spain's primary trading partners are within the EU-14, with machinery and transport equipment (including automobiles) constituting more than half of Spain's exports. And even though trade between Spain and the EU-10 more than doubled over the past decade, total trade flows remain small. Spain is more than 1,000 kilometers farther away from the new

Photo credits: Eugene Salazar and Michael Spilotro for the IMF, pages 197–99, 201, 204, and 210; Thomas White for Reuters, page 202; Alberto Lowe for Reuters, page 205; Bank of Spain, pages 206–7; World Bank, pages 208–9; and Claro Cortes IV for Reuters, pages 211–12.

member states than the average EU country and does not share a border with any of them.

Against this background, Spain's exports to the EU-14 will probably face increasing competition, with shipments of machinery and equipment likely to decline over the medium term. However, evidence from empirical models designed to analyze export competition in the EU points to little, if any, change in the overall level of Spain's exports to the EU-14. This implies that the potential losses in machinery and equipment will be offset by other export products. In sum, enlargement will likely change the composition of Spain's exports, but within the context of unchanged total export flows.

Stiff competition for FDI

About two-thirds of FDI in Spain originates in the EU-15, with the service sector (real estate and business activities) attracting most of it. The bulk of FDI in the new member states also originates in the EU-15 and goes to the service (mainly banking and other financial services) and manufacturing sectors. The low-cost yet skilled labor forces of the EU-10 continue to make them attractive locations for FDI. Eastward relocation of production plants is therefore to be expected. In fact, this process had already begun before enlargement, affecting, most notably, automobile production plants.

The gravity framework also provides some insight regarding the impact of enlargement on FDI. Previous enlargements led to large increases in FDI (although initially perhaps with some overshooting). Increases are also likely to follow the most recent enlargement, and Spain will probably benefit. These projections, however, should be taken with a grain of salt because of problems associated with the reporting of bilateral FDI flows.

No more EU transfers beyond 2006

Spain has benefited greatly from investments in infrastructure made possible by assistance from European Structural Funds and the Cohesion Fund. But its eligibility for transfers once the current allocation expires is in question. Because the addition of the EU-10 has reduced the average per capita income of the EU by more than 10 percent, Spain's per capita income (as a percentage of the enlarged EU average) is now above the 90 percent threshold for the Cohesion Fund. Moreover, the new per capita average also means that most of Spain's regions—which in the past have been among the largest beneficiaries of money from the Structural Funds—are now above the 75 percent threshold for "Objective 1" funds (which are aimed at helping less developed regions

expand basic infrastructure and foster private investment) and will no longer qualify for these transfers once the current allocation expires in 2006.

Objective 1 funds account for the bulk of transfers from the European Structural Funds destined to Spain. And while Objective 1 regions have benefited from these inflows, economic growth in these regions has (with a few exceptions) lagged development in Spain as a whole. In part, this may reflect the inherent difficulties of diversifying production in specific regions given their geographical characteristics. But one should also keep in mind that it is not easy to assess the economic growth (or employment) that would have resulted in the absence of EU transfers.

What will the phasing out of structural transfers mean for Spain? Available estimates of the adverse effects vary, but with the future of the transfers currently under discussion, it is premature to assess the impact on the economy. Still, by boosting infrastructure, the beneficial effects are likely to outlive the expiration of transfers, and costs will be borne by specific regions in the medium and long run.

Little, if any, migration

Migration is also likely to be affected by EU enlargement. In principle, citizens of the new member states have the right to reside in any EU country. However, transitional arrangements allow EU-15 states to limit movement of workers from EU-10 countries for a period of up to seven years after enlargement. Even after the removal of such restrictions, however, it is unlikely that migratory flows will have a substantial impact on Spain's economy, given the distance and the lack of cultural ties, including the lack of an established beachhead of immigrants from Central and Eastern Europe.

Overall, EU enlargement presents Spain with more potential benefits than losses. Be it through increased trade or FDI, enlargement will offer new opportunities for business, particularly if Spain maintains the sound macroeconomic policies of the past decade. But Spain will need to be flexible to adjust to the changes in its economic and political environment, as the effects of enlargement are likely to be felt to different degrees in different sectors over time. Further reforms in labor and product markets will be especially important if Spain is to succeed in minimizing the cost of adjustment and continue flourishing in the EU. ■

Copies of IMF Country Report No. 04/90, *Spain: Selected Issues*, are available for \$15.00 each. See page 211 for ordering details. The full text is also available on the IMF's website (www.imf.org).

Annual Bank Conference on Development Economics

Globalization, trade linkages, and infrastructure policies draw scrutiny

Globalization, trade, and infrastructure policy-making were among the wide range of development-related topics discussed at the 16th Annual Bank Conference on Development Economics (ABCDE), held at the World Bank on May 3–4, 2004. This article highlights presentations delivered by Vernon Smith, 2002 Nobel Prize Laureate in economics and professor of economics and law at George Mason University; Riccardo Faini, professor of economics at the University of Rome and former IMF Executive Director for Italy; and Rémy Prud'homme, professor emeritus at the University of Paris.



Vernon Smith

Widely recognized as the “father of experimental economics,” Smith commented during a keynote address on the functions served by markets for commodities and services, which he described as the foundation of wealth creation, and on the worldwide extension of such markets—that is, globalization. Markets for capital, in contrast, are far more uncertain than markets for commodities and services, he explained, because a function of capital markets is to anticipate innovation—including the commodities and services of the future.

Globalization is not new, Smith emphasized. Rather, it is a modern word describing an ancient human process of migration and the search for betterment, and the worldwide expansion of resource specialization. At many times and places in its prehistory, exchange was extended to strangers through barter and ultimately the use of commodity markets (money). “Early humans set the stage for a vast expansion of wealth and well-being,” Smith noted, “whenever a tribe discovered that it was better to trade with neighboring tribes than to kill them.”

Crucial linkages

A more current look at three different facets of globalization—trade, foreign direct investment (FDI), and human migration—reveals that the complementarities among them have become increasingly pervasive, said Faini. This is both good and bad news for the global economy, however, in that the effects of a more liberal regime tend to be mutually reinforcing but backtracking in one area tends to have a negative effect on other areas.

Trade liberalization should not be examined in isolation from other aspects of globalization, Faini said. Crucial linkages between trade liberalization, on the

one hand, and FDI and human migration, on the other, have further knock-on effects on trade liberalization itself. For example, one of his main findings is that trade liberalization—aside from its standard, though somewhat controversial, effects on growth—can enhance a host country’s attractiveness for FDI, adding a channel through which a more liberal trade regime can favor growth. Moreover, Faini found evidence based on cross-country analyses that a skilled labor force is important in helping a country attract FDI and that liberal trade policies and the stock of FDI in a country are positively correlated with incentives in that country to acquire an education.

Other empirical research has shown that trade liberalization has actually been associated with diverse growth experiences, including some that have been negative, remarked Gerry Helleiner, professor emeritus at the University of Toronto, in his commentary on Faini’s findings. And trade liberalization will still reduce—rather than encourage—FDI that has as its main motive access to markets, argued Helleiner. At the same time, it is worth noting, he added, that multinational companies have always favored trade liberalization and, from their standpoint, trade and FDI have always been complementary. As for Faini’s finding that trade liberalization is positively related to the host country’s infrastructure and human capital, Helleiner pointed out that Anders Hoffmann and other economists have suggested that the obvious direct approach is to subsidize education rather than work indirectly to remove trade barriers.

Infrastructure ignored

It is probably no accident that the concept of infrastructure was practically ignored by development economists until 20 or so years ago, declared Prud'homme, because the concept is “not a very good one.” In infrastructure policymaking, “the devil is in the details,” he said, making it difficult, if not impossible, to design and recommend “infrastructure policies” generally. This is because infrastructure is so very heterogeneous, including in terms of type, context, financing methods, and pricing practices. “What is true for road construction might be wrong for power generation; what is true in 2000 might be wrong in 2010,” Prud'homme pointed out.

Noting that it is not possible to define an “optimal” level of infrastructure endowment and then determine the amount by which infrastructure investment



Riccardo Faini

should be increased or decreased, he stressed the importance of proceeding sector by sector, and even project by project, bringing to bear all the resources of public policy analysis.

Eduardo Engel, professor of economics at Yale University, praised Prud'homme's research on infrastructure and development as an important contribution, notably for its role in pointing out that the risks and uncertainties associated with infrastructure are large. He suggested nevertheless that Prud'homme's work would have been strengthened by more emphasis on policy lessons, particularly relating to developing countries.

For her part, Nemat Shafik, Vice President-Infrastructure for the World Bank, agreed with Prud'homme that much of infrastructure economics does not lend itself to making policy recommendations in the abstract. She added that good infrastruc-

ture economics is fundamentally empirical and, in many ways, antithetical to the deeply theoretical tendency of contemporary economics. Noting that infrastructural development is a core function for the World Bank, Shafik said that the Bank has a key role to play in working with governments to arrive at better risk allocations, which drive many of the observed efficiency gains. However, the fact that governments don't like to admit that they might break their promises in the future poses an obstacle from an operational perspective, she said. ■

Jacqueline Irving
IMF External Relations Department



Rémy Prud'homme

For more information on the ABCDE proceedings, see <http://econ.worldbank.org/abcde/index.php?confid=33788>.

Available on the web (www.imf.org)

Press Releases

- 04/127: IMF Managing Director Rodrigo de Rato's Statement at the Conclusion of a Visit to Singapore, June 25
- 04/128: IMF Executive Board Expresses Appreciation of Montek Ahluwalia's Distinguished Record of Service, June 25
- 04/129: First Deputy Managing Director Anne Krueger's Statement to the IMF Executive Board on Montek Ahluwalia, June 25
- 04/130: Statement on the Departure of the IMF Staff Mission to Argentina, June 25
- 04/131: IMF Managing Director Rodrigo de Rato's Statement at the Conclusion of His Visit to Hanoi, June 28
- 04/132: IMF Completes Sixth and Final Review Under Niger's PRGF Arrangement and Approves \$12.4 Million Disbursement, June 29
- 04/133: IMF Completes Fifth Review of the Kyrgyz Republic's Three-Year PRGF Arrangement and Approves \$14 Million Disbursement, June 30
- 04/134: IMF Executive Board Completes Third Review Under Stand-By Arrangement for Colombia and Approves \$284 Million Disbursement, June 30
- 04/135: Statement by the Managing Director on June 16, 2004, on the Work Program of the Executive Board, July 1
- 04/136: IMF Executive Board Completes Third and Final Review Under the Stand-By Arrangement with Jordan, July 6
- 04/137: IMF Approves \$367 Million Stand-By Arrangement with Romania, July 7
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- 04/139: IMF Considers the Complaint Regarding Zimbabwe's Compulsory Withdrawal from the IMF, July 8
- 04/140: Statement by IMF Staff Mission to Madagascar, July 8

Public Information Notices

- 04/66: IMF Concludes 2004 Article IV Consultation with the United Arab Emirates, June 29
- 04/67: IMF Concludes 2003 Article IV Consultation with South Africa, July 1
- 04/68: IMF Concludes 2004 Article IV Consultation with Lebanon, July 7

Speeches

- "Improving the Policy Response to Financial Crisis," Agustín Carstens, IMF Deputy Managing Director, Bank of Spain and IMF International Conference on Dollars, Debt, and Deficits—60 Years After Bretton Woods, Madrid, June 14
- "Trade, Jobs and Growth: Why You Can't Have One Without the Others," Anne O. Krueger, IMF First Deputy Managing Director, Reuters Trade, Globalization and Outsourcing Conference, New York, June 15
- "Crisis Resolution: What the Fund is Doing," Anne O. Krueger, IMF First Deputy Managing Director, Central Bank of Austria Conference, 60 Years of Bretton Woods—The Governance of the International Financial System—Looking Ahead, Vienna, June 22
- "The IMF at 60: Equipped for Today's Challenges?" Anne O. Krueger, IMF First Deputy Managing Director, American Academy, Berlin, June 23
- "The IMF at 60: What Role for the Future?" Anne O. Krueger, IMF First Deputy Managing Director, Central Bank of Iceland, Reykjavik, Iceland, June 24
- Remarks by Agustín Carstens, IMF Deputy Managing Director, High-Level Segment of ECOSOC, New York, June 28

Transcript

- Press Briefings by Thomas C. Dawson, Director, IMF External Relations Department, June 18, July 1

PRGF=Poverty Reduction and Growth Facility

July 12, 2004

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China's rising economic clout magnifies urgency of its reforms

China's extraordinary economic progress over the past two decades has made the country a major player in the world economy. But sustaining strong and balanced growth poses a number of difficult challenges for its policymakers. Eswar Prasad, editor of a new collection of IMF research on China, spoke with Sheila Meehan about the complexity and interconnectedness of pending reforms and the likelihood that a quickening pace of change in the Chinese and global economies may necessitate a departure from the country's incremental approach to reform.



Prasad: "China is now at a stage of its development where it is difficult to ignore the interconnectedness of reform requirements on various fronts."

IMF SURVEY: Not so long ago, there seemed to be widespread wariness about China's trade expansion and its growing economic clout in Asia. Those fears seem to have diminished considerably.

PRASAD: External trade has been a key part of China's remarkable success. It is clear, as our research by Thomas Rumbaugh and Nicolas Blancher indicates, that China has become a major processing hub for exports from the rest of Asia to the industrial world. This has enabled many efficiency gains within the region and allowed other Asian economies to pursue greater specialization based on their comparative advantage. Asia is also benefiting from China's voracious appetite for imports—both for processing for export and for domestic consumption.

Over the past few years, while global economic growth was relatively weak, China's dynamism helped sustain growth within the region. And on a global scale, China accounted for almost one quarter of world growth over the past two years measured in terms of purchasing power parity.

One of the key reasons we have pulled together our recent research into an Occasional Paper is the increasing regional and global interest in the Chinese growth experience and the challenges facing the country. The rising need to understand how its policies translate into macroeconomic outcomes and their potential international spillovers have really put China's policy challenges at center stage.

IMF SURVEY: Asia and the world may now view China's growth much more positively, but they are correspondingly much quicker to become alarmed by any prospect of this growth being derailed. Can China sustain its rapid growth, and is there a risk of overheating?

PRASAD: The fundamental strength of China's macroeconomy was evident last year when it shook

off the effects of the SARS epidemic and posted very strong growth. But maintaining stable and balanced growth does represent a very significant challenge for policymakers. Reforms of the banking and state enterprise sectors will have to be combined with measures to tackle high levels of unemployment and underemployment, poverty that remains widespread despite recent progress, and widening regional disparities in income. In addition, periods of rapid growth—such as the one China has recently been experiencing—inherently carry the risk of a buildup in imbalances.

There has lately been a great deal of concern expressed about the potential for overheating, and we share this concern. Tarhan Feyzioğlu's analysis in the chapter on price dynamics suggests that the true extent of this risk may, in fact, be temporarily masked by certain supply-side factors. The authorities have taken a number of measures to address potential overheating, but the effectiveness of these measures will need to be monitored carefully in the coming months. There may also be important negative effects from excess capacity resulting from overinvestment in some sectors. Overinvestment in projects that are not commercially viable has particularly serious implications for the banking sector, because much of the financing still comes from the banking sector and could lead to an accumulation of future nonperforming loans. Short-term risks could thus translate into medium-term structural problems.

IMF SURVEY: How critical is the role of the banking sector? And has there been progress on reforms in that sector?

PRASAD: Financial sector intermediation in China occurs mainly through the banking sector, and its effectiveness is absolutely crucial for the efficient performance of the economy. In our Occasional Paper, Steven Barnett examined developments in this sector and found significant progress in dealing with some banking sector problems—notably in terms of reducing the large stock of nonperforming loans. Recent recapitalizations of two of the large state-owned commercial banks, if combined with appropriate measures to improve their commercial orientation, should definitely help in advancing banking reforms.

Time is really of the essence, since China has committed itself to opening up its financial sector to foreign competition by the end of 2006. While the sheer

size of China's banking system may make it difficult to move forward very quickly, the more fundamental challenge is to change the structure of incentives, so that the state-owned banking system can make its loans on a commercial basis. The recent liberalization of domestic lending rates should help this process, as it allows banks to allocate credit based on risk considerations and price the loans accordingly.

There are also much broader ramifications of the banking reforms. With the banking system being largely state owned, there is a presumption that deposits are implicitly guaranteed by the state. It is particularly important that the banking reform succeed in avoiding a buildup of contingent fiscal liabilities.

IMF SURVEY: Isn't China's fiscal position quite sound?

PRASAD: As Annalisa Fedelino and Raju Jan Singh point out in our Occasional Paper, China's fiscal numbers look very good by international standards, especially relative to many other emerging market countries. China's fiscal deficit is currently only about 3 percent of GDP, and its ratio of public debt to GDP is about 26 percent. But the big concern is the buildup of contingent liabilities. These are associated not only with the banking system but also with the unfunded obligations of the pension system. Expenditure pressures are also likely to rise as social needs, including for education and health care, increase. Meeting these future pressures on the budget will require some belt-tightening now, in addition to reforms to limit the growth of contingent liabilities.

It will also be essential to reform the expenditure management system and improve tax administration

to get better control over fiscal outcomes. Fiscal relations between the central and local governments will have to be reconsidered, too. The fiscal federalist structure, which has already been significantly changed, may require some fine-tuning to ensure that the poorer provinces have adequate resources to meet basic social needs. This is particularly important given the large and rising income disparities across provinces.

IMF SURVEY: Don't some of these structural issues and regional disparities also have implications for China's labor market?

PRASAD: Many structural problems often do come home to roost in the labor market. Official figures suggest a relatively low unemployment rate in China, but the problem of nonemployment—working-age people who may not be looking for jobs, are not registered as unemployed, or may be surplus labor in rural areas—is very large. For instance, the authorities' own estimates suggest that there may be 150 million underemployed people in the rural sector. In our paper, Ray Brooks estimates that, with the inflow of new graduates and workers laid off as a result of the restructuring of state enterprises, the unemployment rate could in fact increase in the next two to three years—even if China continues to grow as fast as it is doing now.

This does not argue for stopping economic restructuring, but it does suggest a need to facilitate the reallocation of labor from the public sector to the private sector and from declining to dynamic industries, and to provide a better way for labor to move from areas of lower demand to areas where it can be

A fundamental challenge is to change the structure of incentives, so that the state-owned banking system can make its loans on a commercial basis.

—Eswar Prasad

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better utilized. This would require an efficient social safety net, including a well-designed unemployment insurance system. Better macroeconomic management tools will also be necessary to deal with any shocks that may hit the economy during this challenging period of transition.

IMF SURVEY: *There have been numerous calls for China to reconsider its exchange rate regime. How essential is this for the country's overall reform process?*

PRASAD: Much of the public debate on this issue has unfortunately been focused on trying to determine the "equilibrium," or appropriate level, of the exchange rate. This is a very difficult task, as our analysis by Tao Wang indicates. Existing techniques yield a wide range of estimates, each of them very imprecise. This is a fairly typical problem for a developing economy, especially one undergoing substantial structural change.

And, as our analysis shows, different types of shocks can affect the path of the exchange rate in different ways. So even if you could determine the right exchange rate today, it is not obvious how much and in what direction it would shift over the medium term as the economy undertakes reforms and deals with different shocks.

The IMF has for a long time taken a different tack, arguing that introducing more flexibility in the exchange rate should be the key priority. This would provide a better buffer against domestic and external shocks, as it would allow for a more independent monetary policy. The authorities agree with us that, over the longer term, they do need more exchange rate flexibility for better macroeconomic management.

The question is one of timing. We have noted that making the move when the economy is in a position of strength on both the external and domestic fronts might make the transition much easier. We have also made the point to the authorities that exchange rate flexibility should ideally precede capital account liberalization. Judging by historical experience, countries that first moved on exchange rate flexibility have had much better outcomes.

IMF SURVEY: *How would you suggest that China's policymakers prioritize this very complicated set of reforms?*

PRASAD: China has traditionally taken a gradualist and incremental approach to reforms and, given the size and complexity of its economy, this has worked well. But China is now at a stage of its development where it is difficult to ignore the interconnectedness of reform requirements on various fronts. For instance,



China's voracious appetite for imports, including consumer goods, has benefited the Asian region.

it is difficult to reform the banking sector unless it is accompanied by state enterprise reform. Furthermore, in an era when China is more integrated into the global economy, it is much harder to take very small steps because the pace of reform is going to be dictated by external as well as domestic requirements.

There are no easy answers to some of the difficult policy challenges, and the authorities know best what the constraints are in terms of where they can move and how. But history and international experiences do provide a rough guide to what works and what does not. And it is clear that delaying necessary reforms typically ends up forcing the hands of policymakers under far less favorable circumstances.

The authorities have signaled their determination to push through a concerted reform agenda, and we have been helping them design many of these reforms through our extensive technical assistance programs. Given its growing prominence in the world economy, it has become increasingly important for China to take timely and decisive policy actions. ■

Copies of IMF Occasional Paper No. 232, *China's Growth and Integration into the World Economy: Prospects and Challenges*, edited by Eswar Prasad, are available for \$25.00 (\$22.00 academic rate) for each from IMF Publication Services. See page 211 for ordering information.